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When Is It Worthwhile to Use Courts to Search for Exclusionary Conduct?

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WHEN IS IT WORTHWHILE TO USE COURTS TO SEARCH FOR EXCLUSIONARY CONDUCT?

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I want to talk today about the puzzle of exclusionary conduct. Aggressive, competitive conduct by any firm, even one with market power, is beneficial to consumers. Courts should prize and encourage it. Aggressive, exclusionary conduct is deleterious to consumers, and courts should condemn it. The big problem lies in this: competitive and exclusionary conduct look alike. The dominant firm is an aggressor and expands its market share at the expense of its smaller rival. The rival yelps and sues—or complains to the Antitrust Division and state attorney general and asks *them* to sue in its stead.

Can litigation separate exclusion from competition? What we would have to know is *future* market structure and performance. Will aggression today be followed by monopoly tomorrow (bad) or more aggression tomorrow (good)? Few litigants or judges are gifted with prevision, and the Federal Trade Commission recently brought an action against a group of supposed psychics who widely advertised on late night TV. If claims of ability to foresee the future are bunk when made on TV, are they better when made by plaintiffs, prosecutors, and judges?

Before tackling this question, it is appropriate to step back and ask what antitrust is for, because the question used to have an easy answer when Justice Peckham could write so easily about small dealers and worthy men,[1] as if we were out to protect the welfare of producers. Yet competition is a

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[1] *See* United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290, 323 (1897).

gale of creative destruction (this is Joseph Schumpeter's memorable phrase), and it is through the process of weeding out the weakest firms that the economy as a whole receives the greatest boost. Antitrust law and bankruptcy law go hand in hand.

The goal of antitrust, to be more precise, is preventing the allocative loss that comes about when firms raise price over long run marginal cost, and thus deprive consumers of goods for which they are willing to pay more than the cost of production.

This implies a program for antitrust: look for situations in which firms can increase their long run profits by reducing output.[2] Cartels are one and mergers ending in substantial market shares are another. Vertical restrictions do not fit this category. For a person who cares about consumers' welfare, there are only two difficult issues: joint ventures and exclusion. Joint ventures are hard because they can simultaneously improve efficiency and facilitate coordination by rivals. Performing rights societies such as the American Society of Composers, Authors and Publishers ("ASCAP") and research consortia are examples. But my interest today is exclusion, which comes in two flavors: predatory practices and raising rivals' costs. The idea of the former is that the dominant firm drives down price, prevents the rival from making a profit, and raises price when the rival has been ejected. The idea of the latter is that price rises immediately because elasticity of supply has been curtailed. In the short run predatory prices look like beneficial competition; raising rivals' costs has a different short run pattern, but it can be mistaken for any other element of doing business. General Motors does not sell engines to Ford, and this may raise

[2] *See generally* Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984); Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 263 (1981). These days the view that antitrust law should intervene only to prevent an actual or impending reduction in output is widely shared. *See* Herbert Hovenkamp, *The Rationalization of Antitrust*, 116 HARV. L. REV. 917, 927-38 (2003) (attempting to identify the few, and often subtle, remaining differences between the Chicago and Harvard approaches to antitrust).

Ford's costs; but the separation also is essential to rivalry, and an order compelling GM and Ford to cooperate would be poison for consumers.

A person concerned about consumers' welfare (a convenient shorthand for the allocative efficiency costs of monopoly) must be exceedingly suspicious of claims that new products or low prices injure consumers by excluding rivals. Lower prices and new products are always good in the short run; they are what we seek to *promote*. Claims that the long run will depart from the short run are easy to make but hard to prove. As Yogi Berra put it, "It is always hard to make predictions, especially about the future." Instead of making predictions that are impossible to test—and will injure consumers if wrong—wait to see what happens. If monopolistic prices happen later, prosecute then.

Consider for a moment the claim made by the Antitrust Division that Microsoft's provision of Internet Explorer at zero marginal price would drive other browsers out of the market. Judges cannot talk about pending cases, but this claim has dropped out of the litigation, so I think that it is permissible to offer a comment. I was hoping to be able to talk about the whole case today, but two states have appealed from the district judge's final decision, and Sun is prosecuting a separate suit based on Microsoft's antipathy to Java, so I must settle for a tidbit.

What happens in the browser wars is not interesting unless accompanied by a claim that after extinguishing its rivals Microsoft would raise price and decrease output. So what has happened? Certainly Internet Explorer's market share went up. Internet Explorer today enjoys the dominant position that once belonged to Netscape. But did Microsoft raise price and curtail output? Of this there is no evidence. Nor could it do so any time soon. There are at least five other distinctive browsers available—I have Mozilla (which also serves as the code base of Netscape and Camino), Opera, iCab, OmniWeb, and Safari installed on my computers. The last of these was released in January 2003, and development continues on others. OmniWeb and Safari may be the most interesting: they run only on Mac OS X, which holds a very small share of the operating system market. Yet a chance to compete for a share of this small segment has been enough to induce the development and distribution of two new browsers. This says all we need to know about the claim that, as soon as one browser gets the lion's share, competition will cease. In this market output continues to rise, and price stays low. Claims that prices will rise later cannot be refuted—the future lies ahead—but why should the future differ from the past? Anyway, a return very long delayed can never repay the gains foregone. This is why the Supreme Court held in *Matsushita*, the TV case, that a low-price-now strategy by Japanese producers could not be condemned as exclusionary.[3] From today's perspective the argument of the 1980s that Japan would use below cost sales to monopolize consumer electronics seems absurd. Prices of consumer electronic gizmos remain low and, just as economists said, any attempt by the Japanese producers to raise price works to the advantage of makers in Korea and China.[4]

So predictions about how dominant firms eliminate competition have not panned out in these markets. To evaluate whether exclusion may work better elsewhere, one must formulate and test hypotheses. The *Journal of Law & Economics* was created in large measure to test the predictions that antitrust enforcers and judges made in major antitrust prosecutions. A cascade of articles showed that they were unreliable whenever they got away from simple rules such as "don't form cartels" and "don't merge to

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

[4] Like other supposed "victims" of predatory or exclusionary conduct, they did not have any trouble raising capital. Money markets are large, competitive, and liquid; no more is required. No one supposes that capital markets are "perfect" in the sense that all profitable ventures are funded, and no others are. Life is full of chances, and errors can be caused by fraud, costly information, or the stochastic quality of competition. But these errors are not systematic: it is no more likely that a good project will fail to find suppliers of capital than that a bad project will do so. (In competition, if errors *were* biased, the lenders making such errors would go out of business).

monopoly"—and there was a high error rate even in the application of the simple rules. I think it likely that the future will be like the past: the ability of judges and other regulators to second-guess markets has not improved. Economic models may have improved, but it is real world performance that matters. If "choose better regulators" or "educate the judges" has not been a successful prescription for the last 112 years, it will not become a good prescription tomorrow. This is not a matter of "faith in markets" or some other quasi-religious creed but of evidence. We want to look for suits actually filed that nailed bad practices (successes) or banned good ones (false positives), plus suits not filed where it turned out that exclusion occurred (false negatives). Only if the gains from the successful suits exceed the losses from the false positives can we say that litigation about exclusionary practices has been a success. And aside from pointing to the AT&T divestiture in 1982—something that likely was inevitable because of technological change, independent of antitrust—few people are able to identify even one success in this line of work.

In other words, judges and enforcers must be wary of claims that take the form: "Here is a model in which bad results *can* happen; let's use the legal system to find out *whether* they happen." That approach assumes away the costs of false positives. Because these costs are high (that is what errors over the last century tell us), we should not seek to test theory in the halls of government, where mistakes may be inflicted on the populace. Test models the professional way, by gathering data, running regressions, and publishing in professional journals. Before predicting that the future will be unlike the past—that is, before predicting that judges and juries will acquire a comparative advantage at identifying practices that are bound to reduce welfare in the future—one must do empirical testing. Government fared poorly between 1890 and 1980 even when the rules were simple. Why should we think that regulators (including judges) will do well when the rules become complex, when strategies are designed to conceal relevant costs, and so on? If the strategies conceal matters from competitors, then they conceal from judges and other regulators too.

Just as we all insist today on proof that a given *practice* is bad for consumers,[5] so we must insist on proof that a given *legal regimen* implied by an economic model does better than the unregulated market. To point to a competitive failure is *not* to show that regulation is better. That is the Nirvana Fallacy. Government has its own costs and errors, which may be worse (and harder to correct) than the problems of markets. Do not invoke a theory of market failure unless you also have a theory of regulatory failure—and a way to show that the costs of the former exceed the costs of the latter.

So where are the tests? Ever since William Baxter became Assistant Attorney General for Antitrust in 1981, the dominant program of the federal government in the U.S. has been: challenge cartels and big mergers, but otherwise let markets alone. Microsoft is one of the rare exceptions.

Every time Baxter or his successors declined to challenge a practice, this set up a natural experiment. Would strategic conduct and low prices today lead to higher prices tomorrow? Consider, for example, the models suggesting that price-matching programs reduce welfare by excluding rivals. The idea is that if Southwest Airlines enters the market and United matches its price, then United gets the business and Southwest is unable to capitalize on its lower costs; the implication is that discount carriers will be foiled. A similar prediction is made for price-matching programs by retailers. Best Buy may say something like: "If you find a lower price within 30 days, we'll match it." That reduces rivals' incentives to lower their prices and makes it especially costly for Best Buy to reduce its own prices, because it owes an immediate rebate to old customers. Thus the device *could* be used to facilitate or enforce a cartel.

The national antitrust enforcers in the United States have not filed suit against these price-matching systems, and private or state litigation against them has been

[5] *See, e.g.*, Spectrum Sports, Inc. v. McQuillan, 506 U.S. 447 (1993).

unsuccessful. So have average prices per seat-mile risen? No, they have not; they have fallen and continue to fall. Southwest is the fastest growing carrier, while United is bankrupt. A recent exploration in retailing showed that the chains offering price-matching guarantees are not the high-price outlets; they are generally the lowest price outlets in the market, and markets with more price-matching guarantees are characterized by lower average prices.[6] This is understandable through the lens of a different model: low-price outlets need to identify themselves to consumers, and a price-matching guarantee is a good way to do so. If you offer (and plan to continue offering) the lowest prices in the market, then the guarantee is cheaper for you to make than it is for a rival to make. Your offer is credible and profitable; consumers act on the information by inferring that you are the low-price seller. This solves an important problem in the economics of information at the same time as it drives down average prices.

Let me give you a few more characteristic examples from the history of antitrust in order to pose the question whether fancy-pants theories of exclusionary conduct will lead to a brighter tomorrow. I invite you to think of bottleneck monopolies. Today we might be tempted to name a computer operating system. The old story is one of natural monopoly in the telephone switch, or of unnatural monopoly via merger (as when Jay Gould bought the two bridges and the ferry system in St. Louis and thus acquired a chokehold over train traffic across the Mississippi River).[7]

The antitrust response to bottleneck monopolies has been to create either joint ownership or a must-carry duty (for example, to "wheel" power or information over copper lines,

[6] *See* Sridhar Moorthy & Ralph A. Winter, *Price-Matching Guarantees* (Aug. 2002), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=357600.

[7] United States v. Terminal R.R. Ass'n of St. Louis, 224 U.S. 383 (1912); *but see* Curtis M. Grimm, Clifford Winston & Carol A. Evans, *Foreclosure of Railroad Markets: A Test of Chicago Leverage Theory*, 35 J.L. & ECON. 295 (1992).

which were called "essential facilities").[8] Joint ownership, the approach taken to the Mississippi River bridges, proved to be monopoly fortified by law. A duty to wheel leaves the price term open, so it fails to handle monopoly unless the court becomes a rate regulator—and few think that the isolated examples of judicial rate regulation, such as the blanket license decree for copyrights,[9] have been successful. The only other apparent judicial solution is dis-establishment, but that is a loser if the reason for the bottleneck is either natural monopoly or efficiency, for then the cost savings are squandered.

If handling claims of bottlenecks is not something that antitrust has traditionally done well, it has done even worse when the bottleneck concerns information and developing technology. Do any of you remember the IBM case that ran from 1969 to 1982? The Antitrust Division's fundamental claim was that IBM had become a monopolist in computing services, and that its platform was a bottleneck to vendors of complementary products, such as disk drives.[10] The bottleneck was not only IBM's mainframe computers, but also the devices used to move information in and out of them—devices (and protocols) called interfaces. A central claim in both the government's suit and a cloud of private litigation was that IBM monopolized the market for peripherals, such as disk drives and printers, by continually changing its interfaces. Peripherals vendors no sooner figured out how to connect their disk drives to IBM's mainframes than IBM changed the interface specification and made the vendors start all over again. The supposed consequence was that IBM

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[8] *E.g.*, Otter Tail Power Co. v. United States, 410 U.S. 366 (1973).

[9] I refer to the consent decree to which the performing rights societies are subject. This decree is discussed by the Supreme Court's decision in *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1 (1979).

[10] *See generally* FRANKLIN M. FISHER ET AL., FOLDED, SPINDLED, AND MUTILATED: ECONOMIC ANALYSIS AND U.S. v. IBM (1983). Fisher was IBM's principal economic expert, and the book reflects his perspective, but the book still has the best story of the case and the industry during the 1960s and 1970s.

maintained a huge share of both mainframes and peripherals. Plaintiffs sought judicial decrees that would produce stability in the interface, so that third party vendors could have a level playing field with IBM in selling peripherals. Suits lasted until it became clear that IBM mainframes were no longer a large share of any interesting market; and of course IBM's share was eroded by technological developments, not legal rules.

But the claim of "interface predation" (today it would be called "raising rivals' costs") never identified a reduction in output, and thus it did not identify any allocative loss in the economy. What the Antitrust Division wanted the court to enjoin was progress. Newer protocols were faster or had other benefits. Most of you have observed the process with your own computers. Ten years ago computers came with RS-232c serial interfaces, a port that could transfer data at a blazing 256 kilobits per second. These interfaces were superseded by several generations of SCSI (small computer serial interface) ports with increasing speeds. Newer machines are likely to come with USB-2 (universal serial bus) and 1394 (FireWire). Both are faster than SCSI; both are more than a thousand times as fast as the old serial ports and have other advantages. Improvements to both protocols are in the works; almost before the installed base of the first generation of USB was widespread, USB-2 came out, and FireWire 800 (a third generation of that protocol that is four times as fast as the original) appeared on some computers in January 2003. Such restless change is exactly what IBM was accused of doing. That firms in competitive markets revise interfaces even faster than the bad old "monopolist" shows the danger of believing that we can identify exclusionary practices. IBM's problem may have been that it did not change *fast enough* and thus could not keep up with the competition!

One other story illustrates the ability of antitrust to identify bottleneck monopolies in information technologies. I know of only one case in which such a monopoly has finally been identified in litigation.[11] The offender was an operating system, which the court concluded was a monopoly. No one software or hardware manufacturer could compete, the court held, without access to that operating system, which the owner therefore had to open to the general use without regard to its copyrights and contracts. And who is that vicious monopolist that bestrides the information age? Why, it is the Data General Corp. ("DG"), and the bottleneck is DG's RDOS, an operating system for the NOVA chip that DG included in a line of mini-computers! Yes, you heard me right. The court of appeals was confident that NOVA chips were a separate market, that DG was a monopolist, and that it therefore had to license its operating system for use on chips made by Fairchild Instruments. I must confess bias because I was involved in that case as a lawyer, but this seemed fantastic to me even in 1984, when the decision was made. If anyone had market power in mini-computers, it was Digital Equipment Corp. ("DEC"), not DG. But from the perspective of hindsight, the court's decision seems merely quaint. DG soon went into bankruptcy; the segment of the market in which both DG and DEC competed was overtaken by workstations such as those now made by Sun, if it ever was a distinct segment. Perhaps the court's decision contributed to that demise; perhaps the demise was inevitable. Confident conclusions about who is a monopolist and what is a bottleneck in operating systems were converted to a source of humor in a few years. As Santayana observed, those who fail to learn from the past are condemned to repeat it. We need to learn from IBM and DG just how acute the legal system's senses in detecting technological monopolies are.

The Department of Justice has learned (with the possible exception of *Microsoft*), and the Supreme Court has done nothing in the past decade to give any comfort to exclusionary-practice claims. In the tobacco predatory

[11] Digidyne Corp. v. Data Gen. Corp., 734 F.2d 1336 (9th Cir. 1984).

pricing case,[12] the Court essentially held that no predatory pricing claim can succeed unless the industry has entered the recoupment period. That is the best way to separate wheat from chaff: accept the low prices and wait to see whether the monopoly ensues.

The Court gave a ray of hope to raising rivals' costs theories by refusing to toss out the third-party repair suit against Kodak in the copier market. Some have read *Kodak*[13] as embracing the search, through litigation, for raising rivals' costs. I do not think that this is right. A series of decisions in the courts of appeals[14] has held that *Kodak* is about nasty surprises—about a change in policy that took advantage of customers and rivals' sunk costs—and does not create any obligation to sell parts to one's rivals.[15] It extends no further than an obligation to live by one's promises. A firm that promises cheap replacement parts cannot pull the rug out from under those who took advantage, but a firm that has consistently sold high-price peanuts at basketball games, or otherwise engaged in price discrimination, remains on the right side of the law.[16] For reasons I have already covered, a duty to *assist* rivals has been a bust in earlier antitrust cases[17] and, if adopted, would do more to dampen than to promote competition.

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

[13] Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451 (1992).

[14] For one of them from my court, see *Digital Equipment Corp. v. Uniq Digital Techs., Inc.*, 73 F.3d 756 (7th Cir. 1996).

[15] One may wonder whether *Kodak* erred in equating injury with an antitrust problem; many kinds of loss do not reflect any reduction in output or the welfare triangle that characterizes antitrust. But this is unimportant for current purposes.

[16] *See* Elliott v. United Center, 126 F.3d 1003 (7th Cir. 1997).

[17] For two good examples from my court, see *Olympia Equipment Leasing Co. v. Western Union Telegraph Co.*, 797 F.2d 370, 376 (7th Cir. 1986) (the defendant's name alone tells us something about what technological change does to "monopolists") and *MCI Communications v. American Tel. & Tel. Co.*, 708 F.2d 1081, 1132, 1149 (7th Cir. 1983) (rejecting a claim that dominant firms must sell their services to rivals).

This has not, however, stopped businesses from arguing that rivals must make their own productive capacity available. This has been heard most insistently in telecommunications and was addressed politically through the 1996 statute whose implementation the Supreme Court upheld last year.[18] Yet a parallel set of arguments, made under the banner of antitrust, contends that new entrants to telecommunications need not pay the prices that the FCC has set, or abide by the restrictions on the services that incumbent local exchange carriers ("ILECs") must make available, because back in 1890 the Sherman Act required sharing: it raises rivals' costs for incumbents to insist that new entrants create for themselves the same kinds of productive assets that the incumbents already have.

I must take care in talking about these theories, because at least two cases presenting them are in litigation.[19] But they have run their course in my circuit and I can tell you what *we* said.[20] I say "we" institutionally; I was not on the panel. What my circuit said is that (a) a claim of failure to implement the Telecommunications Act of 1996 arises under that Act and is not an antitrust problem; and (b) the Sherman Act *discourages* cooperation among rivals and does not compel it, even if this means that a new entrant must build a new plant from scratch. The contrary claim is in the nature of the old bottleneck-monopoly point, but now that we know telecommunications to be competitive—it is hard to

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[18] Verizon Communications Inc. v. FCC, 535 U.S. 467 (2002).

[19] *See* Covad Communications Co. v. BellSouth Corp., 299 F.3d 1272 (11th Cir. 2002), *reh'g en banc denied* (over three dissents), 2002 U.S. App. LEXIS 26429 (11th Cir. 2002); Law Offices of Curtis V. Trinko, L.L.P. v. Bell Atlantic Corp., 305 F.3d 89 (2d Cir. 2002), *cert. granted*, 155 L. Ed. 2d 224 (2003). In *Trinko* the Solicitor General, on behalf of the Antitrust Division and the FTC, filed a brief urging the Court to grant the petition and reverse the second circuit. Echoing the Areeda treatise, which concludes that "the 'essential facility' doctrine is both harmful and unnecessary and should be abandoned," the Solicitor General contends that dominant firms must afford access to rivals only if failure to do so leads to lower output and higher prices (citing PHILIP AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 771c, at 173 (2d ed. 2002)).

[20] Goldwasser v. Ameritech Corp., 222 F.3d 390 (7th Cir. 2000).

argue natural monopoly when we see rivals building four or five wireless networks side by side—even what little intellectual force these old cases had is gone.

My interest, though, is not so much the adequacy of legal theory[21] as it is the strength of prediction. Recall what a raising-rivals'-costs claim implies: rivals' costs are higher now; prices are up and quantity down now because elasticity of supply has been diminished; and if rivals drop out then prices will rise still further tomorrow. Well, we can test these predictions.

What do we see in telecommunications? We see considerable entry, expansion of both infrastructure and sales; we also see falling prices. There may have been *too much* entry—though maybe what dark fiber suggests is just the inevitable error in predicting future demand. We see ILECs such as WorldCom in bankruptcy, not sitting pretty with lower costs than rivals. Quite the contrary, the newer entrants with more modern equipment seem to have lower average and marginal costs. This is why the ILECs challenged the TELRIC pricing method under the 1996 Act, for TELRIC is based on replacement cost—and replacement cost is less than the sunk base.

Now maybe my understanding of these markets is bad. I certainly do not want to prejudge any claim pending in some other court. But a simple test based on information picked up from the popular press does not imply that incumbents' deeds have reduced output or raised prices.

My recommendation is that for the foreseeable future we leave raising rivals' costs to the academy. Perhaps some day a template will be generated simple enough for judges to use in the time they can spare from adjudicating cocaine conspiracies. But for now the costs of false positives in dealing with exclusionary-practices claims seem very high—for a false positive means that we will confuse real competition with exclusion, and thus harm consumers. False

[21] A subject that I have discussed elsewhere, such as in Frank H. Easterbrook, *On Identifying Exclusionary Conduct*, 61 NOTRE DAME L. REV. 972 (1986).

negatives take care of themselves as entry occurs. False positives should be handled by grouping raising rivals' costs with predation into the set of practices governed by a wait-and-see attitude. The maxim of antitrust should be: make war, not love.