NEW YORK STATE BAR ASSOCIATION

1983 Antitrust Law Symposium

A report from the Annual Meeting of the Antitrust Law Section

January 26, 1983

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Foreword

The 35th Annual Meeting of the Antitrust Law Section of the New York State Bar Association was held on January 26, 1983 at the New York Hilton, New York City.

The annual business meeting was held at 9:15 a.m. Chairman Stephen M. Axinn read the report of the Nominating Committee, which was chaired by James T. Halverson. Pursuant to the Nominating Committee's report and upon motions duly made and seconded, the following Section members were unanimously elected to the indicated offices for the year 1983-84:

Chairman .... Kimba M. Wood
Vice Chairman .... Walter Barthold
Secretary .... Barry J. Brett

Eleanor M. Fox, James T. Halverson, Henry L. King, Irving Scher and Stephen M. Axinn were elected members of the Executive Committee.

We are delighted to share with you, once again, the proceedings of the Antitrust Law Section Annual Meeting. In addition, we are pleased to include in the Symposium, for the first time, an article analyzing issues of current antitrust interest. Please forward any such article that you would like to have published in next year's Symposium to the incoming chairman, Kimba M. Wood.

The Section wishes to express its appreciation to the editor of this Symposium, Professor Barry E. Hawk of Fordham Law School, and his assistant, Amy Marasco.

Stephen M. Axinn

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CHAPTER 1
DEREGULATION: ITS MEANING AND IMPLICATIONS FOR ANTITRUST ENFORCEMENT

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Gordon B. Spivack

KIMBA M. WOOD: Good morning. I'm Kimba Wood, and I would like to welcome all of you, on behalf of the New York State Bar Association Antitrust Law Section, to the first of today's programs, which will explore the subject of deregulation and its meaning and implications for antitrust enforcement.

We have all witnessed in the last few years the inroads into regulated areas that have been made by pro-competition forces, spurred in part by a growing apprehension that free market competition may be a more effective regulator of the traditionally regulated industries in these times of substantial inflation, rising capital costs and reduced gains in productivity. We are delighted to have here with us this morning four eminent scholars and practitioners whose views of the proper roles for competition and regulation have had an important impact on the course of deregulation in recent years. To my left is our first principal speaker this morning, Fred Kahn, who is both a Professor of Economics at Cornell University and a Special Consultant to National Economic Research Associates. He graduated summa cum laude from New York University and went on to receive his Masters Degree from that University and later, his Ph.D. from Yale University. His career has included two years as a member of the Senior Staff of the Council of Economic Advisors, three years as Chairman of the New York State Public Service Commission, followed by a term as Chairman of the Civil Aeronautics Board, after which he became an advisor to the President, and Chairman of the Council on Wage and Price Stability. He also served as a member of the National Commission for the Review of Antitrust Laws and Procedures.

To my right is Paul MacAvoy. . . .

PAUL MacAVOY: Appropriately.

MS. WOOD: (Laughter). Yes, as he says, appropriately, our second principal speaker this morning, who holds a law degree, a Masters Degree and a Ph.D., all from Yale University where he now teaches Economics. Having served in the mid-1970s as a member of the President's Council of Economic Advisors, he also has taught at the University of Chicago and at M.I.T., and has published extensively on the subject of regulated industries and the economy.

To my far left is Gordon Spivack, who after having graduated first in his class at Yale Law School, went directly to the Antitrust Division, of which he became Director of Operations in 1965. He left government in the late 1960s to teach law at Yale, where he taught for several years before coming to his present firm here in New York, Lord Day & Lord. He is a Fellow of the American College of Trial Lawyers and he too served on the President's Commission for the Review of Antitrust Laws and Procedures.

To my far right is Miles Kirkpatrick, who has practiced at the Philadelphia and Washington firm of Morgan, Lewis & Bockius since 1944, with the exception of three years in Washington during which time he was Chairman of the Federal Trade Commission. He also has been Chairman of the American Bar Association Antitrust Section and is a highly respected antitrust practitioner.

The format for our program this morning will be for Professor Kahn to speak for about 40 minutes, followed by Professor MacAvoy, who will speak for an equal amount of time. Our two panelists, Gordon Spivack and Miles Kirkpatrick, will each comment for about ten minutes on those presentations. We will then have a general discussion period at which time questions from all of you will be welcome.

Without further preface, I am pleased to present Professor Kahn.

PROFESSOR ALFRED E. KAHN: Thank you, Kimba. I am afraid it is necessary to confess at the outset that I am here under somewhat false pretenses. When I accepted the invitation many, many months ago — to talk about challenges to antitrust issuing from deregulation — apart from my normal assumption which is that a date as far in advance as January 26 will never come. . .

(Laughter)

. . .I had expected I would have become sufficiently involved in the interim in instances in which specific antitrust issues had arisen, even possibly antitrust litigation, in areas in which antitrust has taken over from direct regulation general responsibility for the governance of industry, that I would have some fairly firm opinions to offer and incisive observations to make.

Both expectations have been frustrated. January 26 has come and I have not in fact been sufficiently involved in specific antitrust issues in these areas to have reached very clear-cut conclusions. I will put the best possible face on things and talk in a rather more impressionistic fashion than I had originally anticipated about a number of — how should I say it? — antitrust-like issues that have during the last year or so confronted the regulatory agencies, many of which they are going to grapple with in the year ahead. I will describe how they have been dealing with them, and offer impressions of how they should be dealing with them (in those instances in which I have an opinion). I hope by examining these problems in a variety of contexts I can make up in superficiality what I lack in depth.

(Laughter)

I plan to touch on six areas, which it might be useful to list at the outset.

First, there is the question whether the CAB should have acceded to the petition by World Airways that the CAB evoke its residual power to set a floor under transcontinental rates at something like 50% of the standard fare level. And more generally whether there has been anything like predation in the present turbulent price competition in the industry, competition that has plagued the airlines but brought a lot of bargains to travelers — unless they happen to live in Ithaca, New York, a city that I picked at random.

(Laughter)

Second, there are very sharp differences of opinion that have emerged in the Interstate Commerce Commission in the area of motor carrier rates. I will talk specifically about three kinds of cases. One involves promotional rates and the question of how the ICC should treat them. Second, a recent petition from a carrier asking to file rates on short notice — ten days rather than 30. And third, a proceeding that the ICC has undertaken to formulate standards for quantity discounts in trucking rates.

My third topic will be little more than a brief question for my legal brethren in the audience: whether there is any relevance to the pricing freedom that the railroads are asking for in dealing with captive shippers, notably of coal, of the position they are taking publicly and privately in opposing coal slurry pipelines.

Fourth, I shall discuss the continued grappling by the CAB during the last year with the question of whether it should continue various traditional consumer protections. And that will take us into the broader question of some of the controversies going on at the FTC right now, notably between Jim Miller and Mike Pertschuk.

The fifth is the toughest of all — the continuing question of how to reconcile the progressive deregulation of interexchange telecommunications with the continuing dominant role of AT&T and to what extent and in what ways AT&T is to remain subject to constraints in its attempts to meet competition.

Since I understand Paul MacAvoy is going to talk more fully about this and has in fact written at considerable length on the subject, I may merely make a few initial comments on that and hope that we shall have a chance to discuss it afterwards.

Finally — and for this topic I sincerely trust there will not be time — there is the current issue before the FCC whether to drop certain of the rules it had adopted 13 years ago prohibiting the broadcast networks from acquiring syndication rights and financial interest in programs that they broadcast.

Knowing from experience my skill in pacing myself in dividing a talk among various subjects, you may confidently expect that the amount of time devoted to each of these six topics will constitute a rapidly declining geometric progression. To the point, as I say, I hope with zero time left when I get to the last topic.

Airline pricing. You will no doubt be terribly surprised when I begin this discussion by asserting that the experience in the industry since deregulation has strongly confirmed my belief that we did the right thing. Indeed, if there were time, and I hope I shall be challenged, I would be happy to document the many ways in which what has happened in the industry has in fact demonstrably borne out something like 90% of the predictions that we made about the good things we thought deregulation would do, including giving companies, like Braniff, a fair opportunity to fail. I am delighted that Paul MacAvoy is planning to seize that opportunity as well, I hope with more success.

This assessment of mine applies, believe it or not, also to the behavior of air fares. Despite some numerous glaring, apparent anomalies, airline fare structures have in fact become economically more rational since deregulation; that is to say, on average more closely related to cost. Air fares have progressively declined relative to the CAB imposed standard with distance, reflecting the fact that the original standard of the CAB sought progressively to frustrate the economies of distance. We find, as we look at fares now, that the greater the distance, on average, the more fares have gone down relative to the CAB standard, and indeed for short distances they have gone up, which is economically proper.

Second, and similarly, there has been a tendency for fares to go down relative to the CAB standard with density of traffic, reflecting the economies of density: the larger the market the larger the planes that can be used. There are progressive economies of scale up to the very largest possible plane that the market will absorb.

Third, fares have tended to go down more in markets characterized by discretionary vacation travel than by business travel. While, as I will observe in a moment, this undoubtedly incorporates an element of price discrimination, business demand being less elastic, it also reflects the fact that it is more expensive to provide the kind of service business travelers require — convenient schedules, perferably in such a way that one can get from one city to a center city or in the opposite direction in the morning, put in six or seven hours of work and get back that night. That means relatively frequent flights, relatively small planes, and relatively low load factors so that people can get reservations on comparatively short notice. In vacation markets, in contrast, because demand is more price-elastic, travelers can be crammed into a single, huge flight, enjoying the maximum economies of scale, one time a day, even at an inconvenient time, at relatively high load factors and at lower cost. All these things have become reflected in fare structures.

But fare structures do exhibit two kinds of discrimination that might concern someone interested in antitrust. First, there is clearly a distinction on the basis of elasticity of demand, largely between so-called business and discretionary travelers, so that a business person getting on a plane on a Tuesday morning to go to the center city may well be sitting next to someone on the same plane, on the same kind of seat, who was able to obtain a supersaver fare, maybe 50% of the total fare, because he or she will be staying over a weekend; and then when that second traveler comes back the next Tuesday, he or she will be sitting next to a business person who has paid full fare. This is clearly discriminatory. The fact remains that in a kind of a broader way, service of the kind that the business traveler wants is more expensive to provide and there is a rough justice in that discrimination. It also has economic virtue, because to the extent the discretionary travelers fill seats that would otherwise be empty, they make possible lower standard fares as well. This is a familiar public utility kind of situation, in which because of economies of scale, marginal costs are below average, and therefore if you can pick up some discretionary, demand-elastic customers at below average but above marginal costs you are not exploiting the others but indeed helping them.

At the same time, there is clearly a lot of extreme geographic price discrimination being practiced, where the difference in the elasticities of demand explaining the respectively high and low geographic fares are the consequence of the presence or absence of competition. My favorite example, because I am subject to the tender mercies of U.S. Air, is that that carrier charges round trip between Buffalo and Albany, New York, $234.00, or did the last time I looked, and between Buffalo and Newark, New Jersey, $38.00, the latter, by coincidence, selected in order to meet People Express's $19.00 one way fare. That is more than a six to one differential in fares, clearly attributable exclusively to the differential presence of competition in the two markets. Now to some extent, these geographic anomalies reflect the proper functioning of a competitive market. The fact that you can fly for $79 or $89, New York to Miami, or $99 New York to California, whereas I, going to Ithaca, pay about $95 one way, in considerable measure merely reflects the presence of heavy excess capacity, particularly of wide body jets, on the long routes. That is what the market is supposed to do when you have excess capacity: prices should be driven down as close to short run marginal costs as necessary if there are seats going out that would otherwise be empty. And in the intermediate run, if they do not cover the costs of flying as compared with not flying, then these flights should be withdrawn and schedules curtailed, and that too is the way the market is supposed to operate.

I might point out incidentally, though this is irrelevant to the present discussion, that when we pressed for deregulation the opponents predicted that the skies would be filled with planes flying half full, because everybody would rush in and you would have a terrible burden of excess capacity. First of all, they should have been ashamed of themselves making that kind of prediction, because in fact under regulation planes were flying all over the skies half full. And that is precisely because fares were artifically sustained, so that carriers could break even, even with their planes half full. In point of fact, the year ending July 1, 1982 — which is the latest year whose figures I have seen — in the midst of an unprecedented depression of traveling load factors, the average percentage of seats filled on the trunk carriers — were higher than in any previous deregulation year back to 1960.

The fact of excess capacity on the long hauls seems to me the proper answer to the petition of Ed Daly and World Airways. It is painful for me to say this: remember, it was World Airways that for six to eight years pounded vainly on the door of the CAB asking for the right to come in with, I think, originally a $69 transcontinental fare. But I do not see how one could say that the competition that drove World out of the transcontinental market was directed at it, or that it was in any sense predatory. I suspect it was tripped off more by the entry of Eastern Airlines into the transcon route and I do not see how anyone could contend that there was a real danger that market would end up a monopoly.

But, finally, what about U.S. Air's $38 fare to Newark? The price wars that the industry is experiencing are in important measure, I think, explained by the emergence of an apparent determination on the part of the trunk carriers — I have no reason to argue that it is collusive — not to give an inch to the new lower price carriers. In contrast, let us say, with the historic $.02 differential in the gasoline field between the major brands and the other brands, which seemed to be broadly consistent with equilibrium, here instead the trunks seem to have decided to meet the new entrants precisely on the nose (indeed, in some instances, below the nose). And the obvious question is, is this predatory? Is it predatory in intent? Is it predatory in effect? Should it be actionable? Let me hasten to answer, I don't know.

A pertinent question here is whether these prices meet the Areeda-Turner test. The trouble is I have some difficulty knowing what is the proper measure of variable costs. I am sure that most lawyers could make a sufficient case that it is fuel and wages. But in point of fact, if you have scheduled service in a particular market and if you are to stay in that market, it is terribly important that you keep operating: in some sense, in these circumstances, all your costs in the very short run are fixed.

Moreover, there is an inescapable question: can you deny the incumbent carriers the right to meet competition? Should you say to U.S. Air, you simply have to sit there and let them pick you off? Does not the philosophy of Section 2(b) of the Robinson-Patman Act apply? I don't know the answer. But as I wrote 30 years ago in discussing the Section 2(b) defense, the expressed determination of a dominant seller to meet all competition selectively, in good faith, whenever and wherever it appears, on the nose, can be an extraordinarily powerful disciplinary force in the entire market. And that is particularly the case when there is a clear consumer preference for the established product. The result of such a policy may be to leave no niches, at least no price-competitive niches, for the new carriers. I think there is a real possibility that it may drive them out of business.

The traditional answer of people who say that there is no such thing as predation — because it would be irrational for anybody to engage in it, and what is irrational businessmen never do — their answer would be, so long as there is freedom of entry or reentry, there is no threat to the public. It is not clear to me, however, how many times investors will be willing to put up even the modest $15, $20 or $25 million necessary to bring in a low cost carrier if they have before them the experience of what happened the preceding time around.

Alternatively, may it simply lead to softer competition. I am a director of New York Air. Our costs are a fraction of the costs of the established carriers. We came into the Cleveland market when the one way fare was, I think, $127. We came in at $79, peak, and $59, off-peak. We were met on the nose by United. We then went to $59-$39, which we probably should not have done. They met us on the nose. The fare is now over $100, and it may be that we shall now have a happy regime of live and let live. Happy for the investors.

As I say, I do not know the solution to this age old problem. On balance, I do not see how the CAB could have intervened. But, it may be that there are instances here in which a selected predation suit might have been salutory, and may still on balance be salutory.

I turn to the ICC with some relief because here I really do have firm opinions. Mainly because, first, I can not think of any industry in which predation is less likely to make sense than in trucking, given the extraordinarily high ratio of variable costs to total costs, the enormous degree of mobility, and the relatively small units in which one can enter or exit. And, second, because our President has presented us here with a spectacular misfit as a Chairman who is supposed to exemplify his belief in the free market system. In view of the identity of the person who shares this podium with me, and if my understanding of the origin of this term is correct, it seems especially appropriate for me to characterize the ICC Chairman as a voodoo deregulation. Am I right in my understanding of the origin of that term, Paul, or don't you want to say?

PAUL W. MacAVOY: I need 40 minutes.

(Laughter)

MR. KAHN: This is one area in which I know Paul will not quarrel with me.

There have been at least three issues before the ICC illuminating the difference in approach of the true regulator and the advocate of free competition. One is the *Roadway Express* decision of almost a year and a half ago, in which a new carrier entering a particular western market, finding that the ratio of its traffic volumes going westward versus eastward — I don't remember which was the preponderant one — was something like six to one, introduced promotional discounts of 35% to 50%, confined to a three month period, in the offpeak direction. As a new entrant it was a very small factor in the total market. The majority of the Commission voted not to suspend the rates. The people who complained were of course the competitors.

Chairman Taylor dissented. Transportation policy, he asserted, requires the Commission to guard against destructive competitive practices. It should in this case have suspended and investigated the proposed rates on the basis that they might constitute predatory pricing. Since the issue of predation had been raised, it was incumbent on the proponent at least to deny the allegation and present supporting cost evidence. Roadway Express, he asserted, did neither. Instead, it defended its proposed discounts with "irrelevant" — observe his choice of word, "irrelevant" — analogies to retail stores, shopping centers and the airline industry.

Well, what Roadway Express did — and I have its reply to the protest here — was to point to its very small share of the market, observe that the total amount of traffic at issue was less than 2% of the complainant's total traffic, and observe that the discount was limited in time, that it was only on one-way shipments which amounted to only one-sixth of the volume of the shipments in the other direction, and that such promotional introductory offers are not confined to retail stores or shopping centers but are customary also in the transportation business. For example, when New York Air began its above-mentioned service between Cleveland and New York City, it charged a one way fare of 59 cents. That sounds like plenty of justification to a believer in competition. Chairman Taylor's concluding sentence is additionally illuminating: "Since investigation without suspension would have been meaningless, I would have suspended." So much for deregulation and competition.

The second, more recent example, was an application on October 27, 1982, by Smith's Transfer Corporation, requesting blanket authority to publish rate changes on not less than ten days rather then the currently required 30 days notice. Alternatively, Smith's asked the Commission to institute a rulemaking proceeding to consider extending this right to everybody in the industry.

A sharply divided Commission denied both requests. I paraphrase its opinion:

> As justification, the applicant says that it must be in a position to offer rate changes on short notice to meet the competitively set rates of other carriers. The thirty-day requirement, it says, imposed economic penalties on it. It is nothing more than an artificial barrier to competition.. . . Our denial . . . is based principally on the belief that approval of the application would increase the potential for violation of our policies and substantially reduce the opportunity for an interested party to file timely a petition for suspension and investigation.

Observe the reflection here of the regulatory mentality. We must examine requests like these case by case. To do so, we have to make sure people — other truckers, of course — have thirty days in which to raise their objections.

There were some dissents. Commissioner Andre — whose name I want particularly to call to your attention because I would like to say one or two words in his honor before we are through — said (again, I paraphrase):

> Smith Transfer, too, has a problem. The prices quoted to its shippers by competing carriers change virtually every day; Smith wants to remain competitive. In the past, tariff-watching services gave it some advance warning, and the stable identity of its competitors and their common attitudes about pricing allowed a fair amount of success. But times have changed. New carriers have proliferated. Rate filings outside of the multi-carrier rate-making process are now the rule of the day. Smith estimates that it lost $2 million last year because it couldn't respond fast enough. We have had identical complaints from other carriers. Regrettably, the Commission's answer is: no relief in sight. It's repugnant to me

> that a carrier such as Smith must routinely allow freight to slip from its grasp just to comply with the tariff filing rules that it clearly perceives to be outmoded and meaningless.

There has been an interesting reversal of the ICC's position on the third issue. Some time before May 1982, they received a petition for a declaratory order clarifying the lawfulness of volume discounts. By what tests would volume discounts be legal? In what circumstances illegal? In May the Commission turned down the application, in what I thought was a magnificent decision:

> The petitioners argued that because of widespread discounting they are suffering a significant loss of business and that the financial viability of the industry is in jeopardy. To encourage the establishment of reasonable rates, without unreasonable discrimination, they want us to set up guidelines for acceptable discounts. They say that if the rates are not related to costs, then they must necessarily discriminate unfairly. They ask for a proceeding to promulgate standards.
>
> We have decided to deny the petition on a number of grounds. First, we do not wish to risk interference with market-oriented adjustments to the pressures of the current recession. In addition, adequate remedies are available, if there are specific complaints of unlawful rate making. We believe that there is a high likelihood that initiation of the requested proceeding would do far more to stifle legitimate competition and retard efficiency than to eliminate predation or unreasonable discrimination. The announcement of such a proceeding, however couched, could be interpreted as a signal to the carriers to await regulatory action rather than continue the process of searching for the right mix of price and service in this recessionary period. There is no justification for taking this risk, since the likelihood of widespread predation is not great.

The Commission opinion then goes on to explain, in much the terms I have used, why there is very little likelihood that a strategy of predation would work in this industry. Sufficient entry barriers would have to be present to prevent competitors from reentering. And so on.

Chairman Taylor dissented from that decision last May, on the ground that while the widespread innovative rates in the industry — volume discounts, multiple shipment discounts and shipper allowances — are "generally consistent with the several goals of transportation policy," still, the increasing number of charges that carriers have been "abusing the Act's new pricing freedom by engaging in predatory competition" justified setting up the requested proceeding.

Interestingly then, less than six months later, on October 29, 1982, Chairman Taylor succeeded in winning a majority of the Commission over to his side. The first step in the proceeding will be the distribution of a questionnaire. Here are a few questions: In the light of the new pricing practices, are the industry and the public interest served by the elimination of inefficient carriers? Have large and small carriers and large and small shippers benefited equally from these new practices? If any group has benefited disproportionately, what, if any, corrective action should be taken?

Before leaving the ICC, I want to mention the flap that was in the papers in December, in which The Washington Post covered itself with inverse glory. It had a three column headling: "ICC Commissioner defends bribery." Maybe some of you saw it. Here is what actually happened. At a closed session of the Commission, convened to discuss enforcement activities, Commissioner Andre said: "Look, bribery and kickbacks are an inevitable response to government cartel-set prices." Which is of course precisely right. And then he also said: "Bribery — among principals, he was careful to say — is a perfect example of the free market at work. Bribery among principals is nothing but price competition." The Washington Post left out the "among principals" and left out his later statement that "Bribery of an *agent*, is, in fact, unlawful and immoral, but is it the job of the ICC to be prosecuting such activities? Shouldn't that responsibility be left to the law enforcement authorities?" That's essentially what he said. Well, of course, he was 100% right. The Washington Post sanctimoniously put this in a three column headline. They brought it to various Senators who, apparently unaware of the context, similarly covered themselves with mud, saying: "I think Commissioner Andre should be forced to resign."

On the third issue, I just want to ask this very brief question. Does it make sense for the ICC to give the railroads the unlimited pricing freedom that they are asking for in dealing with captive shippers, supported by the testimony of a very large number of extraordinarily eminent economists, when the railroads themselves are denying access to their rights of way by slurry pipelines and are also lobbying intensively, in both state legislatures and in Congress, to deny slurry pipelines the right of eminent domain? I pose the question in good faith. Well, there are really two separate questions here. First of all, can railroads legitimately deny slurry lines access to their rights of way? Second, does *Noerr*[1] leave them totally free to engage in this kind of lobbying to deny their competitors access to the market? At the very least, should the ICC ignore these facts in considering the request of the railroads for total removal of ceilings on their coal rates?

Issue four concerns Motor Carrier Rate Bureaus. The Motor Common Carrier Association commissioned a study by Booz, Allen and Hamilton, published in July of 1982, entitled, *The Impact on Transportation Management of Changes in the Collective Rate Making System.* And their finding, based exclusively, I believe, on interviews with transportation departments of shippers, was that if collective rate making were

1. Eastern R.R. Presidents Conference v. Noerr Motor Freight Inc., 365 U.S. 127 (1961).

abandoned (that is, if the antitrust exemption were removed), it would cost shippers anywhere from $4 billion to $8 billion a year in search costs.

I have not studied this report in detail myself; I did, however, have one of my associates study it, and he assures me that the impressions which I am going to present to you are correct.

First of all, these are estimates only of the cost imposed on shippers. There is no consideration of the extent to which these may be merely transfers of costs from carriers and rate bureaus to shippers.

Second, there is no consideration of the possibility that if there are indeed economies in a coordinated collection and publication of this information, rate brokers or other information vendors might spring up to supply it, at no greater cost than the rate bureaus now incur in doing so.

Third, there is no consideration of the likelihood that individual carriers would find it in their interest aggressively to publicize their charges.

Fourth, there is no recognition of the unlikelihood of any antitrust objection to originating carriers arranging for interline movements and publicizing the joint fares.

Fifth, there is no consideration of possible offsetting benefits to shippers. Presumably if shippers are going to incur the billions of dollars of costs of acquiring this information, they will do so only to the extent they feel, or conclude from experience, that the benefits in terms of bargains discovered and achieved would offset those costs. Every study I have seen of the behavior of this industry since deregulation has concluded, precisely, that there has been a great increase in price competition, and a greatly increased availability of better service, special arrangements and special rates. So that it really becomes very much like the airline case: when people come to me and complain about the profusion of fares, and how tough it is to know what the fare is, my invariable answer is, yes, it was much easier before, all the fares were the same and they were all high.

I have now reached item 5 on my list — residual consumer protections. I experienced a twinge, months ago, when I saw that the CAB was considering whether to drop its bumping rules — *my* bumping rules. I well remember the years of agonized consideration by the airline industry of what they ought to do about the practice of bumping. And I particularly remember sitting in the audience before I was confirmed, and listening to the Board trying to decide, once again, what to do about the bumping problem. Here were these four lawyers, amateur theologians, (laughter) attempting to enunciate eternal principles of justice about the proper order of bumping. One of them said, well, why don't we bump in inverse relationship to the length of time between the flight and the time when the person made the reservation — the later the reservation, the more your susceptibility to bumping. Someone else said, well, but, you know that might not be fair, because someone might have to make a reservation at the last moment, his father may be sick, it really wouldn't be fair.

Well then, another said, why don't we do it in terms of when you appear at the check-in counter? The people who want to be certain they won't be bumped need only show up early. But, another Board member remarked: that might not be fair either; a passenger might be exposed to bumping through no fault of his own because of a delay in a connecting flight. Had one of them been an economist, he would have pointed out this suggestion made even less sense because the people to whom the time is of the least value, and who would therefore be least injured by the delay consequent on being bumped would be the ones who could best afford to show up hours in advance. Then someone suggested: how about giving priority to older people; another remonstrated, what about young people? After exploring other possibilities, equally fruitlessly, they decided to send it back and ask the staff to think about it some more.

When I arrived, I said, as any, even amateur economist would say: the evil is clearly not bumping, it is involuntary bumping. And the simple answer, since you can't eliminate its occasional necessity — indeed, it would be economically undesirable to eliminate the overbooking that produces bumping — the simple solution is make them get volunteers. How? By bribing them. As a result, nobody is injured, everybody benefits. Nobody has to give up a seat to whom the value of the time lost by giving up the seat is greater than the value of the bribe. And anybody who gives up the seat gives it up only because the value of the bribe to him or her is greater than the value of the time lost. And apparently my solution has worked extraordinarily well.

The question is, however, now that we have deregulation and competition: is there any residual need for such rules? And frankly I do not know for certain. I do know that we had competition in the airline industry on many, many routes before the bumping rules were instituted and we still had involuntary bumping. Presumedly it was actionable; but I am not certain whether suits in the courts are the most efficient way to handle problems of this sort. At the bottom, it is really a question of information, I suppose. That is to say, of people being misinformed if they call up and are told they have a confirmed reservation when in fact they may not prove to have a confirmed reservation. Conceivably, the mere publicizing of that fact would suffice to put people on guard. The difficulty is, however, that in many areas there are no alternative carriers available to them. And even where there are several competitors, it is hard for me to envision Eastern Airlines publishing something like: "We bumped only 1.2 people per thousand last month, whereas American bumped 1.3, so why don't you fly us to Washington rather than American to Dallas?"

As I say, I don't know what the best solution is — whether merely requiring carriers to set up whatever rules they wish, providing only they publicize them, and leaving it to competitive pressures and/or civil actions in the courts to protect travelers, or continuing the prescriptive rules I developed. The only thing I am sure of is that mere deregulation of prices and entry does not mean we can safely abandon these kinds of consumer protections.

I have not followed the analogous Pertschuk-Miller controversy over

We are delighted to have Paul with us this morning and look forward to hearing his remarks now.

PAUL W. MacAVOY: Our accomplished moderator has indeed provided diversity of topics and ideas. I have gained a watch in the process.

. . .

(Laughter)

. . . my honorarium for the day.

(Laughter)

In the process of putting this program together, Kimba has slightly understated Fred's accomplishments and clearly overstated mine. In particular I have no Law Degree from Yale University. I have an Honorary Doctor of Laws Degree from my undergraduate college, which allows me to parade at the Yale commencement exercises in the purple robe of a lawyer which usually gets me into the front of the audience because I join the Yale law students right down front. This works out quite well because most of the graduates of the Yale Law School would rather march with the philosophers and economists towards the rear because that is where their allegiances lie; so it all works out quite well.

I promise somewhat a diverse portfolio of opinions and notions on what is going on with respect to antitrust activities in the regulated industries and in particular in those parts of the regulated industries subject to deregulation. This is the dynamic process of antitrust activities at this time. I hope that, with the incisive remarks of the Professor from Cornell, I can add some caution to how you counsel your clients with respect to what is likely to occur in the near future on antitrust as regulation falls apart or actually goes through the kind of fiction which Mr. Kahn brought forth from the Civil Aeronautics Board some years ago and which may well occur in two or three other agencies in the next five years. This is all within the context of my first exposure to deregulation.

Early in 1975, in the Oval Office of President Ford, a small Deregulation Task Force, of which I was a member, met with him with respect to his proposals for reform of trucking regulation. He asked the person who was supposed to know the most. William Coleman, the Secretary of Transportation: "Bill, what did Frank think of the trucking legislation?" Frank, I need not tell you, was Mr. Fitzsimmons. He replied, "Frank thought that the trucking deregulation bill you're proposing will destroy the union in this country." And the President stopped for a minute and then asked, "Well, what then did Dick think of the bill?" Dick requires a longer footnote, some of which I shall leave to the appendix of my remarks. But he was an authentic boyhood friend of Gerald Ford's, from Nebraska, and he also had been very successful in the trucking industry, running an ICC licensed bulk carrier to very large scale, relative to his competitors, and had stayed active in politics to the extent that he was the Chairman of the Miami Convention that had reelected Mr. Nixon. So, Dick got around. And Mr. Coleman found it necessary to speak to Dick personally rather than sending MacAvoy and Snow as he did with respect to Fitzsimmons.

And he said: "Yes, I did talk to Dick about it, and Dick thought that it would destroy the trucking industry and the republic would fall."

(Laughter)

The President said: "At least you people are beginning to produce some effective regulation reform in this country. I'm tired of these second and third class bills. I want something to happen as a result of this." That may indeed still happen. Mr. Kahn produced something along those lines in airlines as he described. That chaos is inviting to economists because the changes in the industry may be very productive in the long run for economic activity at large. There will be some very difficult issues with respect to:

The first concerns the pricing behavior of the established regulated firm on those classes of services most likely subject to deregulation. That pricing behavior is likely, indeed looks exactly, the same as what one would characterize as attempts to monopolize in violation of section 2 of the Sherman Act.

The second issue concerns the provision of service by the established regulated firms in almost all instances in electricity, in natural gas and in long distance telephone services. The established firm, subject to decades of regulation and proper procedures of the Commission for certification and licensing of service, finds itself sooner or later having to provide some aspects or classes of service to the competitors that are developing in this partially deregulated environment. The responses of the established firms again are recognized as evident attempts to monopolize.

The third issue concerns the structure of the partially deregulated industry. In most of the industries now subject to some kind of decontrol, there have been extensive mergers that on their face looked to be in violation of the guidelines for market structure conditions that cause the Antitrust Division to initiate proceedings against the merging activities as in violation of the Clayton Act.

So if you people find that the amount of antitrust legal activity in the unregulated sector has been reduced below a tolerable minimum and you miss observations of attempts to monopolize or activities that appear clearly to be that in pricing and in provision of service and in mergers, just start reading the slipsheets on regulatory firm activity subject to one of these Commissions because that will warm your heart with respect to old fashion monopolizing. These activities are totally in compliance and in accord with the practices and goals of the regulatory agencies that have developed since 1887.

Given the time that is available to me, I thought I might go back, as Gordon Spivack suggested, to engrossing, forestalling and regrading in the 14th century, but license does not take me quite that far. I would like to begin with the Act that set out regulation of transportation and of communications, such as it existed before the turn of the century, in comprehensive and ambitious goals of achieving common carrier activities on the part of the established regulated firms. They were to provide, without discrimination to the consumer, access to some system of carriage, whether it be communications or railroads or, later, barge lines and trucking lines. They were to receive these services at the same high level of quality that would be provided the so-called favorite customer; that is, a customer likely to have a bulk demand that could effectively use the regulated firms' capacity. There were to be, under regulation, further movement towards achieving goals of efficiency in resource use as well. Every economist can join the legal theologians and find philosophically or religiously certain words in the Act, whether it is the Act to regulate commerce or the Civil Aeronautics Act, which stressed the need to take the plant of the regulated firm (which is indivisible and comes in a large unit of capital), and use it to as close to capacity as possible thereby providing to consumers large volumes of cheap service. There is always some of that. But you find in each of these statutes very strong allegiance to expansion of service beyond what the market would provide at cost levels for particular classes of consumers. Particularly small consumers, rural consumers, low income consumers and the proverbial Aunt Minnie that follows AT&T around in regulatory hearings across the country, have been favored by the regulatory process as a purely political act in and of itself. Also, access to service and the continued provision of service is unique to that sector of the economy, as compared to distributing bread or the New York Times or men's three-piece suits, none of which have to be available on demand. With these peculiar characteristics, I will now skip to the 1970's from the 1880's.

We have a set of essentially the Big Seven: railroads, trucks, airlines, electricity, gas, telephone and water companies, which across the country are subject to a myriad of regulatory requirements of state and federal agencies, and sometimes municipalities. These requirements still strongly stress promotion of service, provision of service below cost to important political groups, Aunt Minnie and her cohorts, and the achievement of goals of efficiency. All of which together are not totally consistent. But there is some political tradeoff of stable rates for lifeline services or small services or rural services for efficiency losses. This structure had produced, roughly by 1970, revenues that were at that time sufficient to cover the cost of obtaining and expanding a very rapidly growing capital stock in this area. These even had higher per capita productivity growth patterns than the rest of the economy. Technological change was rapid. Profitability was, in economic standards, normal or competitive or not excessive, right about that time. There were periods when that was not true on one side or the other. So this sector was leading the rest of economy in expansion, in provision of common carrier service, in technological progress and also was highly efficient.

However, over the period of the 1970's, the catastrophic impact of various conditions ranging from the shocks of OPEC and commodity price increases to the shocks of too much Nixonian monetary and fiscal policy together not only did substantial damage to the American economy, but even more damage to the Big Seven, to this set of seven industries. There was a relative decline in constant dollar pricing in this sector, not in keeping with additional gains of productivity. Productivity growth fell from a rough average of 6% or 7% per annum to 1% or 2% per annum, well behind the industry average for manufacturing and trade and services as a whole. There was a relative decline in prices with respect to costs because the fuel cost increases that began in 1973-1974 strongly affected these Seven. Of course, water and telephone are exceptions. The adjustments through the regulatory process for rapid price increases, for cost reduced productivity growth, and for disappointing technological progress were very poor. The rate setting process of taking original cost rate base and book values of capital and retrospectively reviewing profitability in cost-of-capital terms and then projecting that forward through these horrendous inflations worked very, very poorly. As a result, this sector entered into a period of extreme relative decline in terms of access to resources. In that context, the process by which common carrier goals and promotional goals and subsidization of certain classes of consumers was subject to extreme pressure.

Where the regulated companies had opportunities within the context of achieving these goals to raise relative rates on certain classes of services, because the Commission gave them a little more margin on those classes of service, they did so. That is, the Commission was intransigent on increasing Aunt Minnie's rate. The Commission was not intransigent on eliminating the bulk discount on high volume industrial use or electricity or gas or telephone service. And, consequently, the rate structure got very badly out of line with respect to cost at the same time that the rate level was too low. So that combination of pressures produced a highly disoriented rate structure in electricity and gas and telephone and railroad services and, to some extent, in airline services. Fred did not take you through the domestic passenger fare investigation and the very archaic structure of changing the level of fares across airlines that existed before he took office. But, there was very severe concern on the part of his predecessor in the Ford administration that that agency's overall rate setting process was the worst of all of them. The airlines were subject to severe impact of fuel cost increases that were not being passed through to consumers, and consequently the airlines were running out of current cash flow.

Within that context then, the disorientation of the rate structure produced some monopoly prices for certain classes of service. The electricity company or the telephone company, where it could make additional cash flow, subject to these overall pressures of inflation and regulatory lag, had taken prices way out of line with cost on those classes and the disorientation provided an extremely powerful incentive for competitive entry into just those services. It took a wide variety of forms. The strong interest of industrial consumers of electricity in co-generation, building their own plant and selling power back to the network, was not a newfound interest in Pareto efficient theorems of marginal cost pricing. It was an interest in evading the payment of the monopoly price because prices had risen to monopoly levels on industrial use of electricity. The strong interest of other common carriers using or building microwave systems into entering just the long distance bulk telephone service was not again an interest in achieving Pareto conditions, but a marvelous opportunity to enter in just those selected classes of telephone service where the profit margins were extremely high and had gotten that high because this was the only outlet for the regulated telephone companies to pick up the cash flow they needed, given that their overall rates were foreclosed from increasing during inflation. This process of competitive selective entry into the six industries (no one wants to go in the water business, so I shall quit on water), was known widely as regulatory reform. What could be more reformist than letting a whole lot of competitors come into what had become an archaic licensed monopoly? And indeed it had become archaic because technological progress was very slow. Progress was slow because capital was not available. Capital was not available because the rates were too low. So that by coming into just part of it in creating a partially deregulated, highly competitive process, we can knock those rates down that had gotten out of line and begin to come closer to the efficiency goals that originally motivated all of this in the 1890's.

The problem with that was that the disorientation of rate structure was a response to the overall level of rates as being excessively controlled relative to costs. The Commission's use of the regulatory lag and the rate base formulas and entry just in the high profit operations left the regulated firms with the unprofitable enterprises as a social service obligation. Bringing a horrific specter out of the closet, now, I would say we could raise the image of the Pennsylvania Railroad with all its short distance, short haul, low density lines, fully intact and with political demands for immediate access to service by tens of thousands of small commercial and industrial enterprises. However, it had no high volume mainline traffic left because that had been siphoned off by the competitive entry of the trucks into those classes of service in which the Pennsylvania had been able to increase its profit margins rather than doing without entirely. Left with the common carrier obligation, without opportunities to expand and achieve high level efficiency, was a specter that stood in front of the electrics, on the issue of co-generation; the railroads on the issue of slurry pipelines or trucking competition; and on the gas companies, on the issue of bulk discounts for retail or wholesale of gas outside of regulation under the Natural Gas Act.

But mostly, more often than anywhere else, the specter affected AT&T as the source of the long distance national integrated system of providing telephone services. The issue was brought to the forefront by a series of case decisions of the Federal Communications Commission with respect to the nature of this specialized entry of other carriers into AT&T's service offerings. The line of argument of the Federal Communications Commission was highly consistent. Here I am going to talk about intercity competition. I am going to leave the equipment issue on the side because that has so many technological characteristics it would take me another half hour to describe, and I do not want to subject you to that. So, to get to the key issue: the entry of companies such as Microwave Communications, Inc., MCI or Southern Pacific into the provision of business long distance service in the high density city pairs for telephone operations. The Commission argued that they would support entry if it was narrowly prescribed only to private line service where there was no switching but just a line from a telephone on one end in a subsidiary of Exxon and the long distance services are provided from Exxon's main office.

Second, they would strongly support the development of new technology when applied to those kinds of narrowly prescribed services because, if an initiative comes from outside through a competitive process with a wide variety of new technologies, the economy can always choose the one that works out best. That process may be more efficient than leaving it to the licensed monopolist who may choose the wrong process. So those are good arguments for MCI, SPS and others to come into some of the bulk services. The pressure for expansion from them and from consumer groups, particularly business groups, was immense. The profitability of those services was extremely high, and if MCI could spread from just narrowly prescribed private line services to the switch network services of business and home consumers, about $3 billion of pure monopoly profit was at stake that was being transferred by AT&T from those long line revenues to cover the cost of basic exchange service that were not being covered under inflation by the regulatory processes of the state agencies. So we had a compact in place where the FCC allowed cross-subsidization to local service from Long Lines of $2 to $3 billion a year, which kept the Long Line rates about constant while Long Line costs were falling. Even better, it kept the rate of growth of the local basic exchange charges way below the rate of growth of inflation, so that the local commissions could say that in real dollar terms our regulation is bringing down your monthly bill of $8, $9, or $10 for the basic black phone service. All of which met the very strongly entrenched common carrier and promotional goals that are built into not only the act to regulate commerce, but also the Communications Act, the Operating Practices of the Federal Communications Commission, and the state commissions. The problem was that the courts were not consistent, and, on continuous appeal, MCI and others were able to get Judge Bazelon in Washington in the *Execunet* decision to say that the Federal Communications Commission did not have the authority to prescribe the certificate of entry to that narrow definition of private line service only.[3] That allowed the specialized common carriers to get into the heart of the $3 billion kitty of monopoly profits, and they began ripping away at an enormous rate. This group developed from a few million dollars in 1975 to a few hundred million by 1980, and now they are in the billion dollar operations. They are providing basic exchange service selectively only on the high profit margin, high density routes, and they are essentially preventing substantial transfer of funds from long distance to local service to cross-subsidize common carrier operations.

3. MCI Telecommunications Corp. v. FCC, 561 F.2d 365 (D.C. Cir. 1977), *cert. denied*, 434 U.S. 1040 (1978).

That brought about the kind of responses which I told you nostalgically you can expect to find if you no longer can find them in CCH's private sector antitrust case descriptions. That is, the response of the established regulated firm was essentially anticompetitive. If it had been practiced by an unregulated firm in the corrugated box board industry or the cotton broad wovens industry or the university teaching industry, it would have been characterized as a clear attempt to monopolize. The pricing response was to selectively cut to startling lower levels just those long distance rates on which the specialized carriers were competing. The provision of service response was to stand there first transfixed, amazed, dumbfounded but frozen in place. What are we supposed to do in attaching our own competitors to our integrated network? The question was posed to the Federal Communications Commission and the state commission, and the answers were not anymore swiftly forthcoming than they are in any regulated proceeding, so that that froze the specialized carriers out of the switching access for some period of time. If that had been in the unregulated sector, you would have said that is clearly exclusionary activity.

With respect to these processes when reviewed by the Federal Communications Commission, the Commission was itself confused or inconsistent but gradually developed, as Fred said, a process of evaluation whereby, because of the necessity now under regulation to care for the new specialized carriers, the Commission itself was responsible for the survival of these carriers. So the pricing responses when finally approved not only stopped deep competitive cuts, but required AT&T to maintain price umbrellas so that the new firms could grow at a far more rapid rate than the market as a whole. Within this context, the continued intransigence of the regulated company was more in keeping with the traditional exclusionary activities that one finds within the context of regulation where some rates are supposed to generate revenues to cover the cost of service on other classes of service. Other rates are supposed to be too low. And the Commission itself is to supervise the provision of the service, to maximize its extent and to prevent the kind of selective competitive entry that would erode these cross-subsidization patterns. In other words, AT&T acted more like the Commission than the Commission itself. The Commission itself had changed. It had become infected with the regulatory reform philosophy. It began to mistakenly characterize regulatory reform as meaning "additional number of common carriers." It was subject to the onslaughts of the *Execunet* decision. There was a certain amount of Commission turnover that caused confusion.

So within this context a good case could be made (and there were significant complainers: MCI, SPS and the Department of Justice) for initiating antitrust attacks against that regulated firm activity. I shall not take you through the full DOJ decision; that takes longer than getting from 1887 to 1970 for all the rest of regulation, but the issues that transcended all others in that decision were the same that I indicated at the beginning of my remarks. First, was the selective price cutting on long distance, high density service an attempt to monopolize when practiced by a regulated company subject to intensive rate controls by the Federal Communication and the state commissions? Second, did the state commissions and the Federal Communications Commission have primary jurisdiction over the evaluation of the competitive or anticompetitive responses of AT&T? Third, is a remedy of divestiture of the single monopoly enterprise appropriate when that enterprise is regulated and subject to diverse Commission activities, given that what is at issue is primarily a selective competitive response? Fourth, is the court process of antitrust review, which in this case led to a spectacular and remarkable settlement, an appropriate response for resolving all the issues above?

I shall give you my views which lead me very quickly into telling you what you should tell your clients.

With respect to the first issue, a customary standard for determining predatory pricing was brought forth in this context of the Department of Justice case in a totally curious and almost unique way. The fact that AT&T is a multi-billion dollar enterprise (we are talking in terms of $15-$20 billion operations in a myriad of markets, thousands of separate classes of service with hundreds of millions of transactions each day), made it practically impossible and probably theoretically impossible to determine the appropriate full cost, the average total cost, and the long run marginal cost of the provision of one class of service at issue (say the intercity long distance classes of service for business use, the so-called WATTS line class) and consequently test for the relationships between price levels and marginal cost levels that would be applied by you, and certainly sponsored and supported by me, for determining predatory activity. The approach taken by the Department of Justice was to abandon all orthodox tests for predatory pricing and to argue that the uniqueness of this enterprise was that it was regulated, and therefore a new standard of anticompetitive pricing had to be devised from scratch for a whole sector of the economy never heretofore subject to Sherman Act proceedings. The standard was: because the company was a multi-service, multi-regulated enterprise, it had the opportunity to price in one sector without regard to cost, and that in and of itself was anticompetitive. The defense was astounded. Economists circulating around Washington could not make any sense of that kind of argument. But the court took it seriously, and in response (and you have to bear the Areeda-Turner burden of responding to these allegations, if you are the defense) AT&T provided significant detailed and high quality analytical work showing that the rates or the prices on these selective competitive responses were not below short term marginal costs, average variable costs, incremental costs, or any other costs that anyone could find. So "without regard to cost" meant that pricing was carried out so that prices were above costs, however measured.

Within that context, then, the question arose as to whether the responses on interconnection of the competitors were anticompetitive. Indeed, they were slow, and your evaluations and mine are equally good here with respect to the judgment: were they deliberately, maliciously slow — using the regulatory process in violation of the *Noerr-Pennington* standards to establish a barrier to entry which greatly inhibited the development of the specialized common carriers? My judgment is the specialized common carriers grew at a spectacular rate. There is no company in the world more profitable than MCI right at this moment. This started as a two-bit operation between St. Louis and Chicago for the purpose of providing wharf-to-wharf communications for barge lines and it is now hundreds of millions of dollars of capital and approaching a billion dollar revenue figure very quickly. There was nothing done in that process, with or without expensive antitrust litigation, that in any way slowed down a 30% to 40% growth path of this company or SPS or Northern Telecom. The incursions into Bell's markets were rapid, impressive, unprecedented in almost any market in the country, except perhaps in computers and electronics where the rate of growth of entry may be a little faster. So, on the bottom line of what actually did happen, no one was kept out and indeed it does not even appear as if anyone was slowed down. But the commissions were slow and they were confused. And they did a lot of after-the-fact justification, saying, "Well, you should have put it in anyway and then come to us later," which was contrary to all their previous proceedings.

Within that context then, the remedy seems to me to be illogical. Any notion that one needs to apply existing antitrust standards where primary jurisdiction lay with the regulatory agency, where the agency was operating, where the agency was ineffective in keeping out competitive entry, where the agency was being directed by the courts to foster the competitive entrance, need not require that the company so regulated and alleged to have been monopolizing be then broken up into a variety of parts. There are other reasons for breaking AT&T up into parts and Professor Kahn provided you those reasons. But those are not antitrust reasons. It is not logical to go to remedy and remedy is the key to the Sherman Act. The Sherman Act is a remedy law. In order to achieve competitive performance in this highly regulated industry with this weirdly disoriented rate structure, the settlement is astounding, in terms of public policy standards. The settlement essentially gave the Justice Department the remedy it asked for on the initiation of the case; except for the breaking off of Western Electric, that is the only thing missing. It gave it with the free acquiescence of AT&T. AT&T took the initiative to break itself up into parts, and that is totally incomprehensible as an act of regulatory policy. It is quite comprehensible as the product of a mistaken circuit court decision in which there is a finding of monopolizing. My belief is that if that had been appealed through the system, applying an Areeda-Turner standard both to pricing and exclusion, it would have been reversed the way that Judge Cudahy reversed almost in its entirety the *MCI* private damage case[4] and certainly consistent with Judge Richey's decision

4. MCI Communications Corp. v. American Tel. & Tel. Co., 1982-83 Trade Cas. (CCH) ¶65, 137 (7th Cir. 1983).

throwing out the entire private damage case brought by *Southern Pacific.*[5] The appeals courts would have argued that this is a primary jurisdiction issue and it goes to the Federal Communications Commission, the behavior that you would call monopolizing in the private sector does not appear in the regulated sector as the primary or motivating force of regulation, and it is up to the Commission to decide.

Why the settlement then? Well, AT&T won by losing. It achieved essential freedom on the long distance bulk commodity services that are so enormously productive of net cash flow in the billions of dollars — 3, 6, 9, 12, take your choice for profits for the next ten years, where it is up to and ahead of technology; where there are economies of scale, it is no longer going to be regulated. It no longer has to give over $3 billion a year of cross-subsidy to the local operating companies. So, using the antitrust process it achieved freedom on the essential elements from the regulatory process. And no company has ever achieved deregulation any more cheaply. So this process of private settlement has produced what Fred and I would call, regulatory reform or deregulation. What I am arguing is that antitrust by intrusion into the regulated sector may be the primary motivating device by which to achieve deregulation. The same kind of arguments are applied to electricity, gas and railroads. As they move out subject to antitrust decree, particularly when the courts decide that primary jurisdiction does not reside in the ICC, they are going to have to abandon regulation far more rapidly in order to survive in this pattern of selective competitive entry. I would, however, counsel you not to invite your defendant, regulated firms, or clients to run around town and try to find somebody to bring an antitrust case against them in order to get out of regulation. First, proceedings are lengthy, costly, subject to great uncertainty, and bizarre in many ways. I find it bizarre that Judge Greene, in settlement of the DOJ case in Washington, argued in a preliminary decision, a tenth of the way through these proceedings, that primary jurisdiction over pricing issues resided with the Federal Communications Commission.[6] But he forgot to go back to the Commission and give them a full review of the record and testimony and get an opinion from them on this issue of without regard to cost, when the Justice Department submitted its case, or on the rebuttal of that by the AT&T expert witnesses as well. The bizarre element of paying tribute to primary jurisdiction and then keeping it yourself in your own court may also beset your activities as well.

But I would say, in closing then, that with respect to what is likely to happen on the incursions of antitrust into the regulated industries as these industries devolve upon the enormous pressure of competitive entry into the high profit services, that you must counsel your company to stop practicing regulatory pricing. It must price in keeping with costs across the board. Rate averaging, cross-subsidization, and provision of service at a low price for Aunt Minnie must end as soon as it possibly can end. That

5. Southern Pacific Communications Co. v. American Tel. & Tel. Co., 556 F. Supp. 825 D.D.C. 1983).

6. United States v. American Tel. & Tel. Co., 1982-2 Trade Cas. (CCH) ¶64, 900 (D.D.C. 1982).

means you have to go back to the Commission and get your whole rate structure revised. That may take only two decades, but you must get that started so that you are not pricing in a discriminatory fashion. I am using there a technical word which says that the margins between prices and costs do not vary with competitive conditions. Second, you must provide service to competitors on demand more rapidly and with more alacrity, zeal, more smiles, more good jokes, more free lunches than you would to a consumer. That will require, if you are an electric power company, that you wield power for one of your customers across your lines from Bonneville faster than you would service other customers. You must attach foreign attachments onto your system no matter what, as long as they are provided by consumers. Just as you have to bend over backwards if you are an Alcoa, you have to bend over backwards if you are a regulated enterprise subject to this kind of antitrust.

With respect to mergers, let me state that mergers for reasons of achieving regulatory goals in banking, airlines and communications companies, would involve a breaching of the Baxter-Herfindahl Index Guidelines. Those, I believe, are going to be the last vestige of the attempts of the regulated companies to provide for some cross-subsidization or common carrier obligations to deliver service. They are going to prevent bankruptcies of now inefficient partially-regulated companies. And as such, a special policy has to be devised for dealing with them. I do not see that special policy forthcoming, so I would advise your clients that they are subject to the same kind of guidelines as if they were in the cotton broad wovens industry.

Given all that good news, I would propose that if you have any spare time, that you spend it writing to or discussing with your congressman this enormous mess of incursions, illogical, inconsistent, unexpected, thoughtless, movements of antitrust into the regulated industries. The basic notion of regulation, of providing common carrier services, of preventing competition in a natural monopoly industry, of using natural monopoly capacity to efficient levels, keeping rates down too, and using the facilities as completely as one can still apply to some extent to electricity, gas and telephone companies certainly at retail, maybe at wholesale, maybe in production. They do not apply to the transportation industries which were the central subject of Alfred Kahn's remarks. But to the extent that we are to continue regulation, your congressman ought to make antitrust and regulation consistent by getting antitrust out of it. And unless he gets antitrust out of it, he is going to achieve partially disrupted, chaotic and extremely costly deregulation. And on that good note, I would like to hear what Gordon and Miles have to say about this wonderful mess.

MS. WOOD: We thank you, Paul, for your valuable perspective on how deregulation came about and how our clients can continue to function profitably in a deregulating world.

We are all heartened, I am sure, by your view that we may in the future be able to put behind us our nostalgia for antitrust enforcement and use antitrust to advance competition in deregulating industries.

Without further delay, I would like to introduce the first of our two panelists for his remarks on the presentations made earlier by our principal speakers, Miles Kirkpatrick.

MILES W. KIRKPATRICK: Clearly controversy and be-puzzlement continues with respect to the continuation of the process of deregulation. Also the scope of deregulation appropriate to such industries as communications, natural gas production, airlines, railroads, trucking, intercity buses and financial services, is a mixed bag, and other candidates for deregulation such as electricity generation have raised their heads.

As is obvious from the preceding presentations, people do not always agree on what has happened in this regard. AT&T continues to be a lightning rod for discussion. In the case of the communications industry, we had one that was the envy of the world. It wasn't broke but Bill Baxter fixed it.

What about us lawyers? For antitrust lawyers, the implications of deregulation for antitrust enforcement may be substantial. But the effect of deregulation on antitrust enforcement and the nature of its application to the affected industries are not entirely obvious.

An exploration by me at this juncture of the implications for antitrust enforcement of deregulation focusing in detail on one of the deregulated industries seems inappropriate. Instead, I would like to identify certain propositions which are applicable across the range of deregulated industries and which, I hope, may illuminate the antitrust implications of the process of deregulation.

The first of these propositions, one which is hardly startling, is that the scope of applicability of the antitrust laws varies directly with the degree of deregulation. The more that an industry is subject to deregulation, the greater the scope for antitrust law.

I am not sure that this proves my point, but the antitrust enforcement agencies, as well as private plaintiffs, have initiated a number of actions against companies in newly deregulated environments. The Transportation Section of the Department of Justice's Antitrust Division has been particularly active, with several grand jury investigations including an investigation into possible anticompetitive activity by airlines serving the Dallas/Fort Worth area, an investigation into the collective rate making activities of the carrier members of the Niagara Frontier Tariff Bureau, and a nation-wide investigation into the railroad box car supply situation. It is also known that the Division has initiated a preliminary investigation into whether airline-owned computerized scheduling systems have been used in an anticompetitive manner.

In addition, the Antitrust Division recently brought its case involving an alleged conspiracy by several railroads to restrict competition in the handling of iron ore in the northeast area. I have already referred to the Antitrust Division's litigation culminating in the AT&T divestiture.

Also, numerous private treble damage suits involving recently deregulated industries have been filed. In the trucking industry, for example, a freight forwarder has undertaken an antitrust challenge against the Rocky

Mountain Motor Tariff Bureau and 17 of its members alleging, among other things, manipulation of the tariff bureau structure. In the airline industry, three actions have been filed in recent months alleging predatory pricing behavior. In each of those cases, a small or new entrant airline has challenged the pricing activities of the major, established carriers.

Such actions may be expected to increase. As two recent articles in the *Harvard Business Review* by members of the Wharton School have indicated, the fact of deregulation requires substantial changes in the goals and methods of operation and decision-making by the leadership and staff of the deregulated company. From an antitrust perspective, deregulation puts into the antitrust arena a company (both its own staff and its advisors) that is totally unused to the structure or principles of the antitrust laws. Making a smooth transition from a "regulation" to a "market-oriented" antitrust outlook may therefore not be easy.

A second general proposition, it seems to me, is that the nature of the application of the antitrust laws will vary depending upon the degree and type of deregulation that is being applied to the industry. In the railroad industry, for example, joint rates may be the subject of collective action in rate bureaus, but single line rates may no longer be decided upon in that forum. That fact has industry implications and policy problems.

In addition, the varying degrees of industry deregulation may affect the potential scope of antitrust applicability by presenting different possibilities for assertion of various antitrust exemption doctrines. For example, the doctrine of implied immunity, the *Noerr-Pennington* immunity, and the state action immunity doctrine may apply. Such exemption doctrines will vary considerably in potential scope and applicability depending upon the nature of the vestigial regulations involved.

A third proposition, and one which may be somewhat controversial, is that it is difficult, if not impossible, to apply traditional antitrust law concepts without variation to the deregulated industries. It should be recognized that antitrust concepts did not develop in the context of industries such as telecommunications, trucking, airlines and railroads. In such industries, there is a necessary interconnection among the companies in that industry, in order to provide the industry services at all. Such an industry structure requires continuous joint activity — joint fares, interlining arrangements and the exchange of price information — among industry participants in order to have any market at all. It may be difficult to apply traditional antitrust (and antitrust precautionary measures) to these industries, and it seems possible that different antitrust concepts may be developed with respect to certain of the questions that will arise from these deregulated industries.

I might, however, note that this is probably not the Antitrust Division's position. It does seem to me, however, that certain problems presented by this necessary interconnection of the deregulated industries have been difficult to analyze; for example, there is the question of joint rates and of interlining in both the trucking and the airline industries. Questions of market definition and market segmentation have also been novel. It may be questionable to segment a portion of a communications, airline or railroad network, for example, to determine what costs are appropriately allocable to each for purposes of predatory pricing analysis.

A fourth proposition is that an effective antitrust compliance program is imperative for companies in newly deregulated industries. It must be stressed that this should not be a standard boiler plate-type program, which might be in some part irrelevant to newly deregulated industries. It is desirable that the antitrust counselor be familiar not only with the company and the structure and competitive relationships in the industry, but also with the nature and implications of the system of regulation that remains applicable to the industry.

In addition, because virtually all of the officials and employees of the deregulated company are unlikely to have had experience in a non-regulated environment (where the antitrust laws would apply as a routine matter), substantial attention must be given to the implementation of an antitrust compliance program. In particular, questions concerning the potential applicability of the antitrust laws should be dealt with in the light of the peculiarities of the industry and the extent of deregulation. The educational function of the antitrust counselor is, I believe, quite significant in the deregulated industry context.

So much for the deregulation of the kind that is the principal focus of this meeting. But there is another kind going on in the regulatory apparatus in Washington, at the FTC, for example. Whether de facto or de jure certainly that agency has slowed to a stop some of its regulatory activity — ad substantiation for example. Also, some dozen or more extensive rule — making proceedings languish. Advertising oversight is also in a state of flux with cost-benefit analyses being at the uncertain forefront of enforcement. Also there is what one commentator has called the "Baxterization" of the antitrust laws. Certainly there has been, at least, a deregulation of vertical marketing arrangements by the antitrust division.

MS. WOOD: Thank you, Miles, for your thoughtful remarks. Gordon Spivack.

GORDON B. SPIVACK: I shall be very short because we only have a few minutes.

First of all, Paul has pointed out there is an inconsistency between the theory of regulation and the theory of antitrust. And that is true in part. In part, regulation is based on the idea that we have to control monopolists because monopolists charge too high prices, they diminish quantity, they deteriorate qualities, and we need regulation to prevent such behavior. The deregulation movement is in large part based on the theory, consistent with antitrust, that that is simply not true in most industries in that it you let more competition in you will get lower prices, better quality, better service. To the extent the economics of the situation justify that, you should have complete deregulation. To the extent that they do not, you regulate part and you have deregulation where that is possible. But the whole theory is that the process of competition will reduce prices, improve quality, improve quantity, and that will occur more often than the regulators would have us believe.

On the other hand, regulation is often instituted not to control monopoly prices, quality or service but because of political and social values. To the extent that regulation is designed to do that, then antitrust simply does not apply because society has chosen a political or social value. That is a political judgment.

Second, note that the issues we are discussing are very complex. When we look at airline rates going down, service improving, more options offered, we say that is the result of deregulation. And I agree with that. On the other hand, when prices go up, service deteriorates, the options disappear, we are told to remember there was a fuel price increase, we are in the middle of a recession and there is a controller strike. So I think we ought to remember that most of this is ideology, not simply a matter of logic.

Third, a word about predatory pricing. You notice Fred points out that the real issue is not short run allocation of resources but long run maintenance of the competitive process. And if what is going on in the long run is going to result in oligopoly pricing or reduced entry, that is what we want to stop and you do not get at that by looking at some comparison between prices and cost. You get at that by looking at every relevant fact; what is it the guy is doing, is he trying to compete aggressively or is he trying to discipline the market? And I think that is what the government was talking about in the AT&T case and it shows why the Areeda-Turner test is unsound. It does not go to what we are talking about. It does not go to the goal we are trying to achieve.

Finally, the AT&T case. We cannot, of course, retry the case. If you look at Judge Greene's[7] opinion and you look at Judge Cudahy's opinion,[8] they give you a different picture of the facts than Paul gave us this morning. On the issue of jurisdiction, the Second Circuit, the Third Circuit, the Fifth Circuit, the Seventh Circuit, the Eighth Circuit, and the Ninth Circuit, have told us: there is no primary jurisdiction at the FCC. And the Supreme Court in the hospital cases and the insurance cases has told us again and again we are not going to give primary jurisdiction to these regulated agencies except in very rare situations. I do not think that is really a serious issue.

There is a serious issue as to what kind of conduct is monopolistic and Paul has pointed out why that is not a simple question. But that has nothing to do with regulated industries. That is true of anyone who has a large market position. IBM faced the same problems that AT&T does. I represent one of the only two hospitals in New Haven, Connecticut; we face the same problem when we deal with doctors. Those are very difficult problems. They are not inherently related to the regulated area. They are

7. United States v. American Tel. & Tel. Co., 1982-2 Trade Cas. (CCH) ¶64, 900 (D.D.C. 1982).
8. MCI Communications Corp. v. American Tel. & Tel. Co., 1982-83 Trade Cas. (CCH) ¶65, 137 (7th Cir. 1983).

related to what kind of conduct it is that the antitrust laws are designed to prohibit.

The relief in the AT&T case is hardly astounding. What they did was dissolve the relationship between a monopolist of the manufacturing of equipment, a monopolist of long distance service with a monopolist of local service. Well, disintegrating vertically integrated monopolies has been traditional antitrust doctrine since the *Standard Oil* case 70 years ago.[9] What probably is astounding is the Government's not insisting on some relief with respect to Western Electric.

What will be the result of the divestiture? Nobody can tell, and that is what competition is all about. Competition puts pressure on people to reduce cost, to innovate in service, to innovate in technology. No one, no court, no government planner, no economist, even at Yale, can predict what competition will result in achieving. But at least by splitting off the monopolist of the manufacturing equipment from the monopolist of the purchase of that equipment on a local basis will give competition a chance to work, and 20 years from now we shall know how much that has done to improve quality, improve service, reduce cost. The theory of the antitrust laws is that, more likely than not, costs will go down, quality will improve, technology will improve, service will improve. And if it does not work, well, when you take out insurance and you don't have a fire, it was still wise that you took out the insurance.

What process should we use? Well the courts are hardly rational institutions. Anyone who has tried a case knows that. But Congress is no better. The FCC is no better. There simply is no other alternative than to try and develop the facts in court.

MS. WOOD: Thank you, Gordon.

Paul MacAvoy has a train to catch but I would like to give him an opportunity to comment before he has to leave us.

MR. MacAVOY: It is more serious than that. I have to teach a class at two o'clock to a group of 40 Masters candidates, on issues of deregulation of the airlines, as a matter of coincidence, and since Fred Kahn is not going to be there in New Haven, I am in deep trouble. I would, however, wish to exit with two conditions. One is that since Gordon Spivack lives in New Haven, perhaps he will allow me to pursue him . . .

(Laughter)

. . . because he deserves to be pursued on some of the things he said. But I would like to leave you with an attempt to elucidate my views that differ from Gordon's and, I think, Fred's on just this single crucial issue. If a regulated firm, providing two kinds of service, is required by the commissions and agencies in control to subsidize one class with monopoly profits on the other class, the agencies have to do their part in blockading entry into that class of service providing the monopoly profit. If the agencies are inconsistent, requiring that cross-subsidy take place while not blocking entry, then the regulated company is facing a dilemma indeed. The rail-

9. Standard Oil Co. v. United States, 221 U.S. 1 (1911).

roads faced that dilemma over a 15-year period and went into a very bad decline. In the context of the telecommunications cases, AT&T was looking for some signal indicating consistency with respect to the competitive entry of the specialized common carriers which were selectively going after the monopoly profits that indeed were being earned on a long distance service. While at the same time the agencies were not letting AT&T off the hook on its necessity to provide settlements and separation or the so-called $3 billion cross-subsidy. The company reacted in the way attempting to block entry in which I would expect the agency to react. And the agency, to some extent, attempted to react that way and found itself blocked by the District of Columbia court. So indeed it is very complicated. You have to have systematic anticompetitive activities on the part of the agency and the company if you are going to practice very large scale cross-subsidization of local service.

Second, with respect to the issue of what is astounding about the settlement, I would offer the following. Indeed, the settlement is not at all astounding and makes great logical good sense, and I am quite complacent about it. If it happened that before the settlement AT&T was using monopoly profits in its basic exchange operations on local service to subsidize a competitive response to entry into long distance. . . . if the two classes of service were local and long distance, if a deep pocket of monopoly profits were being made on local to then produce a predatory response to competitive entry on long distance. . . . then it made very good sense to divest local from long distance, to prevent the flow into the competitive area of these excess profits from the non-competitive area. But actually what was happening was exactly the opposite. The flow was from the long distance, the $3 billion of separations and settlements, which went from long distance to cover below cost pricing on basic exchange service, where indeed AT&T had a monopoly. So the need to separate these two, to prevent cross-subsidization in response to entry, made no sense at all. No one was trying to enter the local service. This was not a deep pocket on long distance used to block entry into basic exchange operations. All it did was to block the cross-subsidization which is the very foundation of regulation. That is what the regulations were intended to do, to provide Aunt Minnie with $9 per month, basic exchange, black phone service. In the absence of this cross-subsidization, Aunt Minnie's rate is going to rise to $20. That is a Department of Commerce estimate — not a company estimate, not my estimate. The $20 will be for much lower class service. There will be dial tone delay; there will be installation delay; you are going to have to buy your own phone; you are going to have to buy the wires in the wall. And under these conditions there will be just the opposite of what Gordon said. There will be a deterioration of service, there will be rising pricing, there will be a loss of the integrated network, there will be a loss of economies of scope in combining the two, because the divestiture is going exactly the wrong way. Now why is it going the wrong way? Because Mr. Baxter truly believes, contrary to a massive amount of evidence and all the economic analysis I know of this industry, that indeed basic exchange is cross-subsidizing long distance. I do not know where he gets that idea, but he keeps saying it publicly. So, the Baxterization of this case is just plain wrong, and that is what is so astounding. It would have been reversed if we had allowed it to go through the court process rather than having this private settlement between him, who is mistaken, and Mr. Brown, who wants to get out from regulation.

So, I just think it is a very bad idea and unless you provide me with indication to the contrary, I shall go back to New Haven and keep telling my students that time after time.

(Laughter)

Thank you very much.

MS. WOOD: Thank you, Paul.

We have a few minutes now for questions from the audience. I would ask that if you have a question, you stand and state your name and then tell us to whom you are directing your question. Are there any questions?

I would like to ask the panelists what each of them thinks will be the major antitrust vehicles that we can expect to have replace competition in monitoring the competitive conduct of deregulated industries. Do you have a view on this Professor Kahn?

MR. KAHN: I'm sorry, I don't understand the question. What vehicles will replace antitrust for monitoring anticompetitive conduct?

MS. WOOD: Yes. We discussed this morning charges of predatory pricing that might be brought in deregulating industries and I think that will be an important focus of antitrust attention in the years to come. I am wondering if there are other ways of attacking conduct that you think will be the common attacks in these areas.

MR. KAHN: No, I can not think of other ways. I think that on the whole the monitoring of conduct that raises traditional antitrust questions is not best left to the traditional regulatory commissions. I do not think they are equipped for it. I think they come to it with a totally different set of approaches and attitudes. I think that is the problem of the ICC. I think the CAB was probably wise to get out of it and I think therefore it is best entrusted to the antitrust agencies.

May I say a word about three related points that were made very, very quickly.

I could not agree more with Gordon's general observation, which I think is along exactly the same line, that the question is one of an evaluation of conduct. That is a point of view that I have expressed for a long, long time. Obviously, conduct has to be interpreted within the context of market structures. And that is a problem that is equally a problem of regulated and unregulated industries. I think he is exaggerating when he says that regulation does not introduce any distinctive features, however, because it is perfectly clear that, as Paul points out very eloquently, to the extent regulation has as its purpose perpetuation of a regime of internal subsidization, which is pervasive in the communications industry, it definitely raises a dilemma. Whether that is a sufficient excuse for conduct which in other areas would be regarded as anticompetitive I cannot say. It is clear that AT&T enthusiastically adopted that conduct, that, as a Department of Justice lawyer suggested, it wholeheartedly embraced the position that regulation means never having to say you're sorry.

So, Paul is right, there is a terrible dilemma here. You cannot have those regimes of internal subsidization extended and also have deregulation and competition. I draw an opposing conclusion from that fact, however. One of the reasons I am enthusiastic about the antitrust suit and about deregulation is that it undermines these irrational internal subsidizations. They have had very harmful effects on the country. I think the 60% tax we now levy on interexchange usage is a major obstruction to economic progress in this country. I think that there are far better ways of subsidizing the poor people who might otherwise give up their service than the grossly inefficient methods that we use now. So, I accept Paul's premise but move from that to the precisely opposite conclusion: deregulation is a good thing because it forces us to adopt more rational, cost-based prices, and to find more pinpointed, more rational ways of administering subsidies, to the extent we want to do it.

Finally, that leads me to Miles' point. That is exactly what the opponents of airline deregulation said: "The system is not broke so why fix it?" I think that argument misconstrues the benefits of competition. Here Gordon has said it very clearly. It wasn't broke, we had a decent, reasonably adequate air transportation system, but we did not begin to understand — nobody could understand or predict — what were the possibilities if we opened the field to competition. I think there is an even stronger case for competition in communications, where the technology is so dynamic, the market so dynamic, that no regulator could begin to prescribe good service. Sure, we had good service, but the burgeoning variety of services that have been developed and that can be developed — that variety can be effectively probed only in a competitive market. I am worried that I agree with Gordon so thoroughly on this point; but I certainly agree with him on that.

(Laughter)

PAUL JASINSKI: I would just like to ask a question on predatory pricing by airlines. Let us assume that U.S. Air, under any measure of cost, prices way below its costs. Is it correct to assume the courts will ignore all various cost related tests? I would like to hear some views on it.

MR. KAHN: That is a good lawyer's question. We have got two lawyers on the panel.

MR. KIRKPATRICK: I would like to be able to answer that question, sir.

(Laughter)

I cannot.

MR. SPIVACK: Well, I think the problem is we do not know all the facts. What I would do is sit down with the guy for a couple of hours and find out what situation he is in and how he got there and what he is trying to do, what are the alternative ways of dealing with the situation and try to tell him that if what he is doing is trying to compete, then that is all right. Litigation is not predictable, we might lose. But if that is what he is trying to do, fine. If what he is trying to do, which I have heard so often from some clients, is put somebody out of business or teach them a lesson or teach the next guy a lesson, then he shouldn't be doing it. And these cost formulas that Phil Areeda and Don Turner have come up with, and the literature has come up with, do not even deal with that situation. What they do is point out one element of the overall situation, which is that often by selling below total cost you are in effect minimizing your losses. That is a very relevant fact. It simply is not the only fact.

MR. JASINSKI: So it boils down to an intent test or study.

MR. SPIVACK: Well intent and probable effect. That is true in every attempt to monopolize or every monopolization case. It is true in every rule of reason case. When the courts say, apply the rule of reason and take everything into account, what are they asking you to find after you take everything into account? What is he intending to do? What's the likely effect on the competitive process? Now, it is difficult to live in a world where we cannot tell you the answer to that. But the alternative is a large number of per se rules, and then we start saying well that is too rigid, that is irrational, I do not like your per se rule. So uncertainty is something we have to live with. We have a few per se rules; the rest of it is look at all the facts, what is the intent, what is the likely effect.

MR. KAHN: Just one suggestion that is inherent in what Gordon has said. Conduct has different consequences and different probable results and therefore probably different intent, or conduct can be judged differently depending upon the market context. If in this circumstance there is, as I think there might be in some of these cases, a dangerous probability that a carrier by doing this selectively will not be preserving a market share but driving the other person out of business, that is, really constructing barriers to entry in the sense that nobody will be likely to re-enter, or if it creatres a dangerous probability that competition will be weaker in the future, and that has to be judged again in terms of progressive changes in market shares, then I think that is part of your interpretation of conduct. And I think there are economic kinds of considerations that would have to be adduced as helping you judge conduct and its likely result.

MS. WOOD: We may get some guidance from the courts on this if Freddie Laker's suit against the IATA carriers goes to adjudication. We shall see.

I am afraid we are out of time. I want to express on behalf of the Bar Association our gratitude to our distinguished panelists for joining us today and for sharing with us their thoughts in this fast changing area of the law. Thank you all.

Chapter 2

Workshop I: Developments in Distribution

Alan J. Weinschel
I. Scott Bass
Alan F. Goott
Lawrence I. Fox
Wayne D. Collins

Appendix A (Lawrence I. Fox outline)

MR. ALAN J. WEINSCHEL: This is what has become the Antitrust Section's biannual workshop on distribution problems. We have been doing it every two years and for the last several years. My name is Alan Weinschel and I have the pleasure of being the moderator, and of working with a very fine panel which I hope will serve to illuminate what is becoming a confusing topic.

When we started these panel discussions, it was only a couple of years after *GTE Sylvania*.[1] Many of the speakers four years ago predicted that the law would settle down and be clarified by subsequent cases. We found that when we presented our workshop two years ago that no such clarification had occurred. Today we find that the subject is as hot as ever with polar extremes in the cases, vigorous debate on the question of whether the per se rule for resale price maintenance should be reexamined, and a variety of other issues being presented nearly daily.

We are very fortunate today to have a terrific panel which will deal with some of the thornier current issues. Given the fact that we only have an hour and 15 minutes, we will not be addressing all of the issues that arise in a distribution situation.

We hope this afternoon to merge the practical with the theoretical. The overwhelming majority of cases in the distribution area deal with dealer terminations. Thus, what we are going to do this afternoon is focus on what I will cautiously label a "typical" dealer termination case. I know that I may be shot for calling it typical; but we are going to try to do it nonetheless.

We will assume, for purposes of the discussion today, that we are presented with the Company which manufactures our classic widgets and sells them to consumers through a network of independent dealers located all over the country. Some of the dealers have been selling widgets at discount prices to other retailers in areas other than the area in which the dealer normally operates. The Company has been receiving complaints from some of the authorized dealers about the discounting that has occurred and the "unauthorized" sales that are occurring in their areas. We at this time do not know either the source or the number of those complaints. After receiving the complaints, however, the Company decides to terminate one of the dealers and sends it a notice of termination.

Our first two speakers will discuss their reactions to these facts as

1. Continental T.V. Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977).

related to them by their respective hypothetical clients — the terminated dealer and the Company. Our first speaker, who will be counsel for the dealer, is Scott Bass.

Scott is a 1975 graduate of the University of Michigan Law School, and is a member of Bass, Ullman & Lustigman, spending a good part of his time on antitrust as well as FDA matters. Scott, what do you do when the terminated dealer walks into your office showing you the termination letter and telling you his tale of woe?

MR. I. SCOTT BASS: The answer to that question brings to bear a number of considerations, Alan. I will be addressing the "agreement" aspect of the problem.

1982 was, as many of you know, a very big year for agreement cases.[2] It was the year in which the legal fiction of conspiracy was buried in some circuits. There now exists a proof requirement that far exceeds any understanding that we had developed as antitrust lawyers over the past decade.

The issue of agreement has evolved primarily, I believe, because of *GTE Sylvania*.[3] It is our view that *GTE Sylvania* signaled a shift in agreement analysis, despite the fact that the case itself only impliedly dealt with the agreement issue. If you look at the vertical conspiracy cases that have been decided in the last few years, you will find that the majority of those decisions resulted in judgments for defendants. What is unusual about those decisions is that many courts found that no agreement was proven under factual scenarios which clearly would have passed muster prior to *GTE*. The first factor to consider, then, is that a plaintiff in a vertical conspiracy case will have an uphill fight, especially in the increasingly active appellate courts. The facts must be compelling.

Leaving the policy question aside, the most important fact I would try to elicit from a potential client is whether there exists a causal nexus between the complaints and the termination sufficient to constitute an implied "combination" or "agreement." That determination, while certainly fundamental, is also most elusive. At the present time, there are three distinct positions taken by the circuit courts as to the issue of what constitutes adequate evidence of a combination in a "complaints" case.[4] Our potential client's success will thus depend in large part upon the situs of the case.

The first position is what we might call the *Battle/Cernuto* view,

2. *See, e.g.*, Spray-Rite Serv. Corp. v. Monsanto Co., 684 F.2d 1226, *cert. granted*, 51 U.S.L.W. 3627 (U.S. Feb. 28, 1982), Venture Technology, Inc. v. National Fuel Gas Distribution Corp., 685 F.2d 41 (2d Cir.), *cert. denied*, 51 U.S.L.W. 3362 (U.S. Nov. 9, 1982); Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d 742 (7th Cir. 1982); Schwimmer v. Sony Corp., 677 F.2d 946 (2d Cir.), *cert. denied*, 51 U.S.L.W. 3362 (U.S. Nov. 9, 1982); Battle v. Lubrizol Corp., 673 F.2d 984 (8th Cir. 1982).
3. 433 U.S. 36 (1977).
4. The hypothetical problem deals only with a "complaints" case — i.e., where the claim is that the plaintiff was terminated by a supplier because of complaints received from competitors of plaintiff. We will not be discussing the broader issue of vertical conspiracies involving terminations effected pursuant to a general conspiracy (e.g., to fix prices or allocate territories) among a supplier and its dealers.

which is that evidence of complaints and a termination — with a temporal connection between the two — will suffice under section 1. *Battle*[5] represents the Eighth Circuit's current view[6] on the agreement issue, albeit in a summary judgment context. *Cernuto*[7] is a Third Circuit decision which may or may not represent that Court's current view of the law.[8]

Standing in the opposite corner in position number two is the *Sweeney*[9]/*Schwimmer*[10] view. Those courts require that a plaintiff show: (a) complaints; (b) termination; (c) responsiveness (not just a temporal connection); and (d) independent evidence of an agreement. This position is bolstered by the unusual degree of fact-finding in which the appellate courts now engage in order to reach their desired results.[11] *Schwimmer* was followed by *Venture Technology Inc. v. National Fuel Gas Dist. Corp.,*[12] and represents the Second Circuit's latest stance. *Sweeney* ostensibly still stands in the Third Circuit.

The middle, and most sensible, position is articulated by Judge (and former professor) Posner in *Valley Liquors,*[13] and followed in *Spray-Rite v. Monsanto.*[14] Those Seventh Circuit decisions hold that a *prima facie* case has been established by proof of complaints plus a termination in response to complaints ("knuckling under").[15]

Because we have a representative of the Justice Department here today, I should mention as an aside that they do not read the *Spray-Rite* holding the same way. They claim in an amicus brief they filed in *Spray-Rite* that the decision holds that complaints plus termination are sufficient. I do not think that that is a fair reading of the opinion.

In any event, the conflict persists and it does not appear that it will be resolved soon. The Supreme Court denied petitions for certiorari in *Venture Technology, Schwimmer* and *Sweeney.* While the Court has granted *certiorari* in *Spray-Rite,* the case will probably be decided on the other issue presented: whether vertical price-related conspiracies are per se illegal.[16]

The policy underpinnings of this sharply-drawn conflict are relevant

5. 673 F.2d 984 (8th Cir. 1982).
6. *Cf.* Roesch v. Star Cooler, 671 F.2d 1168 (8th Cir. 1982).
7. Cernuto, Inc. v. United Cabinet Corp., 595 F.2d 164 (3d Cir. 1979).
8. *Sweeney* followed *Cernuto* and technically does not overrule the latter decision; indeed, the Third Circuit went out of its way to so state. But *Sweeney* does represent the probable stance of the Third Circuit in terms of the incredibly detailed factual analysis that that Court believes it is entitled to make on appeal. Such close factual scrutiny (and the inevitable parsing of the proof) never bodes well for a plaintiff's case.
9. Edward J. Sweeney & Sons, Inc., 637 F.2d 105 (3d Cir. 1980), *cert. denied,* 101 S. Ct. 1981 (1981).
10. 677 F.2d 946 (2d Cir.), *cert. denied,* 51 U.S.L.W., 3362 (U.S. Nov. 9, 1982).
11. *See* dissenting opinion of Justice White in Schwimmer v. Sony, 51 U.S.L.W. at 3362-3.
12. 685 F.2d 41 (2d Cir.), *cert. denied,* 51 U.S.L.W. 3362 (U.S. Nov. 9, 1982).
13. 678 F.2d 742 (7th Cir. 1982).
14. 684 F.2d 1226, *cert. granted,* 51 U.S.L.W. 3627 (U.S. Feb. 28, 1982).
15. The Fourth Circuit recently joined the *Spray-Rite* view in Bostick Oil Co. v. Michelin Tire Corp. 702 F.2d 1207 (4th Cir. 1983).
16. The Supreme Court did not state on which issue(s) it granted the petition for certiorari, but its denial of the petitions in the other cases, along with the Justice Department's widely-publicized interest in "reforming" the vertical per se doctrine, lead to the conclusion that the "complaints" issue will not be the focus of the case.

to the manner in which our hypothetical conspiracy case is to be analyzed. In the Second and Third Circuits, for example, we see a concern over holding manufacturers liable merely for receiving complaints and discussing them internally. These courts strongly eschew the notion that once a manufacturer receives a complaint, the manufacturer is somehow tainted and thereby can be held guilty of a conspiracy. The competing concern, expressed in *Cernuto* and many earlier cases, is that it is almost impossible for a plaintiff to prove what is in the defendant's mind when the defendant terminates the plaintiff. Inferences are thus essential.

It is, perhaps, a reaction — or overreaction — to these concerns that wrought the polar views represented by the Second Circuit's Draconian "independent agreement" rule on the one hand, and the overly permissive and somewhat confused *Cernuto* rule on the other. This reaction may also explain why it has been close to three years since the Second Circuit has affirmed a plaintiff's section 1 vertical conspiracy verdict. Whatever the true reason may be, it is clear that our prospective plaintiff would be better served with a Minnesota lawsuit rather than one in New York. In New York the case would have to be framed in a manner emphasizing the active role of the defendant and underplaying any notion that the defendant was a passive recipient of complaints.

Assuming that the hypothetical case still appears to be a viable one, a second level of inquiry is in order. The attorney must now carefully consider two aspects of his or her proof: first, the nature of the complaints; and, second, the inferences of response.

There are four areas that I believe are relevant to a judge in terms of the complaints themselves. The first factor is the number of complaints. If a single complaint is at issue, the likelihood of prevailing as a plaintiff is decreased. If, on the other hand, there are a large number of complaints, the proof becomes more convincing in terms of the complaints' effects on the defendant. A large number of complaints could also form the basis for a "*GM*" claim,[17] alleging horizontal collusion among competing dealers as well as a vertical conspiracy with the manufacturer-defendant. Such evidence could also lead to a *Parke-Davis* type of case[18] if the complaints are very frequent as well as from numerous sources.

The second factor is: who made the complaints? Was it a dealer who does $10 a year in Wisconsin or is it the largest dealer in New York? While this will not in itself be dispositive, it is highly relevant to ascertain whether the manufacturer was "knuckling under" to pressure from an important customer or whether it was simply a question of coincidence that the manufacturer received complaints and took action independently. In this vein, it is also important that the dealers who complain be dealers who are affected by plaintiff's sales. This is often overlooked by practitioners. It is difficult to prove that the plaintiff was terminated because of complaints

17. United States v. General Motors Corp., 384 U.S. 127 (1966).
18. United States v. Parke, Davis & Co., 362 U.S. 29 (1960).

from people who never felt plaintiff's presence.[19]

The third factor is the type of complaint. Was it a price complaint? Was it a complaint about service? Was it a complaint about quality? Was it a complaint about transshipping? Again, this will have a very big influence before the court. In some circuits, it may actually be dispositive of whether you get to the jury or not.[20]

Finally, how was the complaint transmitted? Was the complaint inferred from the internal records of the defendant? Was there conflicting oral testimony as to complaint discussions, or was there an undisputed written record of the complaint showing the actual message transmitted to the manufacturer? If the complaint was taken seriously by defendant, memorialized in writing and duly circulated among executives, the plaintiff's proof will be that much easier.

That concludes the first half of the analysis — the nature of the complaints. Now we come to responsiveness proof. The question of responsiveness breaks down into six factors:

1. Timing. How soon after the complaints reached their peak did the termination take place? Temporality is a crucial factor in many of the "complaints" cases.[21]

2. Was the termination consistent with the way the manufacturer ran its business? Was it consistent with not having low quality dealers who do not provide services, consistent with avoiding the free-rider effect from its dealers? If consistent, termination is less likely to have been responsive to complaints.

3. Was there a prior response from the plaintiff's perspective? This is very important to ascertain. Did the manufacturer lower the plaintiff's credit line, begin making late or incomplete deliveries, or give warnings?

4. What happened after the plaintiff was terminated? Did the manufacturer later terminate other dealers for the same reasons, or was this the only dealer ever terminated for that reason? Also, did other dealers, who were previously offending a policy of the manufacturer, suddenly jump into line right after the termination and accede to the manufacturer's wishes?

5. The mixed motive question: was there an independent reason, a strong one, that was in the defendant's mind when it terminated the plaintiff? And if so, which reason was more important for the termination? A manufacturer can be held liable if the illegal reason was the major factor

19. Another factor upon which defendants may rely is whether the complaints named the plaintiff specifically. This is by no means a dispositive factor but has been mentioned at times.

20. The per se nature of price complaints is the challenged aspect of the *Monsanto* case currently pending before the Supreme Court. While it makes no difference what type of complaint is at issue in terms of whether conspiracy can be inferred, some courts appear to construe the evidence more strongly against defendants when price complaints are involved.

21. *See, e.g.*, H.L. Moore Drug Exchange v. Eli Lilly and Co., 662 F.2d 935 (2d Cir. 1981), *cert. denied*, No. 81-2215 (Oct. 4, 1982), Cernuto v. United Cabinet Corp., 595 F.2d 164 (3d Cir. 1979).

for the termination even if two reasons were involved.[22]

6. Was the termination against the manufacturer's economic interest? I personally do not consider this factor very important. From the defendant's perspective, however, it is often a good argument to make. In almost every case — in fact, I have yet to see a termination case where it is not true — the manufacturer can say that it was in its economic interest to terminate the offending dealer. Economic interest is always a mixed question. By eliminating a large discounting dealer, the manufacturer may hurt intrabrand sales but may please another large non-discounting customer that does heavy advertising and promotion. The evidence is, in short, of marginal value but considered nonetheless.

Applying all of these factors to the hypothetical, Alan, we not surprisingly came out with conflicting results. Does the case go to the jury as you stated it? The Department of Justice would say no. They say that complaints are so common that they are totally devoid of competitive significance.[23] No doubt Mr. Goott agrees.

I would say that it depends. It depends on whether or not there is other evidence to make that hypothetical stronger. I believe, and a number of circuits still believe, that the better rule is to let the jury still make the decision, not the judge. That is still the rule in horizontal parallel conduct cases. There is every reason to keep inference-drawing in vertical cases as well.

Let us assume, for example, that there were 15 complaints in December naming the plaintiff. All concerned his pricing practices. There was a headquarters meeting by the defendant about the complaints, and the termination took place in January. I believe that that evidence goes to the jury and would survive a j.n.o.v. motion if plaintiff won. It does, however, leave open the question of a new trial motion. If the defendant has other proof — that the dealer was doing something bad, that there was another motive for cutting off the dealer — then that might be enough to sustain a new trial motion. But it would not sustain a reversal of the verdict.

Thank you.

MR. WEINSCHEL: Thank you, Scott. I think I would add one factor. I think I would want to know whether the manufacturer had a policy of suggesting resale prices, and if he did, whether there had been any efforts in the past to enforce that policy. This is so because there are at least two grounds on which to find an agreement. There is the possibility of a resale price maintenance policy itself as being the agreement; there is also the possibility of agreement with the other dealer. For the plaintiff, one would look for either one.

Our next speaker is going to address our hypothetical from the standpoint of the defendant. He is Alan Goott who is a member of the

22. *See, e.g.*, Osborn v. Sinclair Refining Co., 286 F.2d 832, 837 (4th Cir. 1960), *cert. denied*, 366 U.S. 963 (1961).

23. *See* Brief For the United States As Amicus Curiae in *Monsanto*.

Kaye, Scholer firm and is a very able pinch hitter for Ira Sacks who unfortunately was unable to be here today.

Alan is a 1973 graduate of Harvard Law School, and has practiced in the antitrust area for the last ten years. Alan, what do you do when your client, the manufacturer, calls you up and says: "I've just gotten a threatening letter from some lawyer named Bass on behalf of the dealer that we just sent the termination letter to. What do I do with it?"

MR. ALAN F. GOOTT: Ideally, a supplier should consult antitrust counsel before terminating a dealer. In many cases, however, this does not happen — probably in large measure because it is a routine thing for a supplier to get complaints about dealers and to terminate them for one reason or another. Precisely because such conduct is routine marketplace activity, courts should be very hesitant to make it the basis of treble damage liability.

This is particularly true when there is no evidence that the challenged termination flowed from the complaints. In such a case, there are several arguments why antitrust liability should not be imposed. One likely place to make these arguments is in a motion for summary judgment.

The first argument is the very fundamental proposition that a supplier, at least if he is not a monopolist, has the right to deal with whom he chooses. This goes back to *Colgate*.[24] The *Colgate* doctrine has been enjoying a resurgence in recent years, and to me at least has great appeal.

A second argument where there is no evidence of causal connection between complaints and the termination is to accuse the plaintiff of engaging in the post-hoc fallacy. The post-hoc fallacy is to assume, just because something follows something else in time, that the second event is a result of the first. There is no logical basis for such an assumption. I would argue that to permit a jury to infer causation, where the plaintiff's only evidence is a temporal relationship, is an invitation to the jury to speculate. In fact, there is no way the jury can make such an inference other than by speculating, and to permit that is probably a violation of due process. The court in *Sweeney* makes that argument effectively, as do one or two other recent cases as well.

Another argument I would make in the absence of evidence of causation is to draw an analogy to the section 1 parallel conduct cases. Conscious parallelism typically occurs where a number of competitors raise prices together, but they have no explicit agreement to do so. The law in this area seems to be that in addition to showing parallel conduct, a plaintiff who claims price-fixing must show one of several possible "plus factors" which indicate that there really is some kind of an agreement. An example is *First National Bank v. Cities Service Co.*, [25] decided by the Supreme Court in 1968. The Court held that where the alleged price fixer had different business interests from its alleged co-conspirators, and would not have benefitted from the conspiracy, then the jury would not be permitted to infer its participation in the absence of other evidence. That

24. United States v. Colgate & Co., 250 U.S. 300 (1919).

25. 391 U.S. 253 (1968).

logic is equally applicable to proof of a purported agreement to terminate a dealer where the supplier's business interests are not generally the same as those of the complaining dealer or dealers.

Perhaps the most fundamental argument of all which can be made is that whatever happened was normal market behavior. It is normal for dealers to complain about other dealers. It is normal for suppliers to terminate dealers for a variety of reasons. There is just nothing unusual about complaints; and, therefore, the fact that a supplier gets a complaint is no reason to infer that he is conspiring with the complaining dealers.

For this reason I disagree with Scott about many of the factors which he says go to an inference of conspiracy, such as the number of complaints, how they were transmitted, whether they came from big dealers or small dealers, and whether they were price or non-price related. I believe that none of those factors makes any difference, for the simple reason that they all represent perfectly normal types of conduct and, therefore, are not a rational basis for inferring conspiracy without some other evidence.

Things become more complicated, however, if the termination did flow from the complaints. Suppose that your client — the supplier — tells you that he terminated the dealer in response to the complaints; and suppose further that there is some evidence to that effect, which the plaintiff can be expected to get. In that case, depending on the precise nature of the supplier's response, he might well find himself in trouble.

I submit that there is still no basis for antitrust liability if the termination was merely in response to information which the supplier obtained from the complaining dealers. The logic of this goes back to what I was talking about a minute ago. A supplier has a right to select his dealers. If he wants restricted distribution, if he wants to require his dealers to provide services, or whatever else he wants, he has a right to enforce his policies — subject to certain limits, of course. When a dealer violates those policies, the supplier has a right to terminate the dealer. That right cannot depend on how the supplier learned of the dealer's misbehavior.

I think it is agreed that if the supplier were to send his own observers into the field, then any termination resulting from information they obtained would be lawful, unilateral action. Given that assumption, would it make any sense to declare the termination unlawful under section 1 simply because the supplier instead obtained his information from a complaining dealer? The illogic of such a result is obvious. It would create a situation where once the supplier had received a complaint from another dealer, he could not terminate the misbehaving dealer. I do not believe that is or should be the law.

On the other hand, there is a dictum in the *Sweeney* case which suggests that if a plaintiff shows that the termination was in response to a complaint, but then rests, he can never get to the jury. If that is what the court meant to say, I believe it goes too far. To me, the *Valley Liquors* case in the Seventh Circuit has the right answer to this. It depends what you mean by "response."

If in terminating a dealer the supplier merely acts for legitimate reasons on information which has come to his attention, then the fact that the source of the information was another dealer should make no difference. That kind of "response" to a complaint is unilateral action and should not be unlawful.

On the other hand, if the supplier is "knuckling under" to complaints from the other dealer, then you have a different issue. Suppose the complaining dealer says: "This guy is cutting my price and I don't like price competition. I'm going to stop carrying your goods, or stop featuring your goods, if you don't terminate him." If the termination occurs because the supplier wants to avert such action by the complaining dealer, then I would be very hesitant to say that the jury could not find a section 1 violation.

Let me stress, however, that I would require the plaintiff to *prove* such "knuckling under." I would not let the jury infer it merely from a temporally related complaint and termination.

I would not dispense with this requirement of proof, notwithstanding that the evidence may be mostly in the defendant's mind, and may be hard for the plaintiff to get. It is a fundamental proposition in any civil litigation that the plaintiff has the burden of proof. He must prove that his case is more likely true than not. The plaintiff is not meeting that burden if he merely cites complaints, and asks to go to the jury. We cannot impose treble damage liability at the whim of a jury simply because it is difficult for the plaintiff to get evidence.

Moreover, if the dealer is right, very often he will be able to get evidence. There may be a former employee of the supplier, or somebody else who will be able to give testimony.

For these reasons I reject some of the factors which Scott says go to proof of response, such as the timing of the termination after the complaints, and subsequent adherence by other dealers to the supplier's policy. Those are just as consistent with no conspiracy as with conspiracy and, therefore, I do not think they get you to the jury.

On the other hand, if the dealer can show that the supplier took actions against his interests — or, to be more precise, actions against his interest absent a conspiracy but in his interest if there was a conspiracy — then I think that is fair evidence. That is the same kind of evidence to which courts look in conscious parallelism cases. Similarly, if the termination was contrary to the supplier's long-term stated policy, that too might be good evidence of conspiracy.

As a practical matter, regardless of how weak the dealer's evidence of causal connection may be, the supplier should still prove affirmatively why the termination occurred. As defendant's counsel, you should try to document the long-standing policy which the terminated dealer violated, as well as the extent of the violation. You should try to show that the supplier terminated other dealers because of that policy, or that after being warned, other dealers — unlike the plaintiff — complied with the policy. If you submit such evidence to the court as part of your summary judgment motion, it should make a favorable ruling much more likely than if you simply rely on the plaintiff's failure of proof.

I would just like to comment very briefly on one other thing Scott said. I do not see a distinction between the standard for judgment notwithstanding the verdict and the standard for a new trial. The inference of conspiracy is either permissible on the evidence, or it is not. If it is not, then the plaintiff should not be allowed to get to the jury at all. To grant a new trial while denying judgment n.o.v. subjects the defendant to repeated trials based on the jury's speculation. I do not think that is a proper rule.

MR. WEINSCHEL: Thank you, Alan. To move the discussion along now, we are going to assume that the manufacturer has moved for summary judgment and that the motion has been denied. Thus, we are all faced now with that wonderful prospect of going through discovery and getting ready for trial. To help us to determine how to approach those issues, Larry Fox will speak, from the standpoint of both the plaintiff and the defendant, about the factors that each would be trying to develop in the course of discovery and to present at trial.

Larry is a 1973 graduate of Georgetown Law School. He spent some time with the Federal Trade Commission and is now a partner in Berger, Steingut, Weiner, Fox & Stern. Larry, get us ready for trial.

MR. LAWRENCE I. FOX: Thank you, Alan.[26] Assuming that the hypothetical plaintiff has survived the defendant's motion for summary judgment, and could for the moment put aside the issue raised by the concerted action element of a Sherman Act section 1 violation, it must now address the second element of a section 1 offense — it must prove that the restraint created by the agreement *unreasonably* restrains trade. Essentially, this requires the plaintiff to demonstrate that the restraint is of the type characterized as per se unlawful and thus presumed to have the proscribed anticompetitive effect, or, that it is otherwise unlawful under the rule of reason because it unduly inhibits competition.

The Supreme Court, in its 1977 *GTE Sylvania*[27] opinion, overruled the previously prevailing *Schwinn*[28] rule of per se illegality with respect to vertically imposed territorial and customer restraints. Although the Court rejected *Schwinn's* formalistic line-drawing between vertical restraints imposed in sale as opposed to nonsale transactions, it nevertheless preserved the per se rule for continued application to horizontal restraints and price restraints.[29] Having left open a navigable channel to the safe harbor of the per se rule, it is little wonder that in almost every vertical restraint case since *Sylvania*, the plaintiff has argued that the defendant's alleged justifications for its vertical restraint are merely a subterfuge for a market allocation or a price fixing arrangement, either of which would be per se illegal. Similarly, the defendant invariably asserts that the restraint was neither horizontal nor a form of price fixing, but, rather, was a vertical,

26. An outline of Mr. Fox's remarks follow this workshop as Appendix A.
27. Continental T.V., Inc., v. GTE Sylvania, Inc., 433 U.S. 36 (1977).
28. United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).
29. Sylvania, 433 U.S. at 51 n.18.

nonprice restraint intended only to make it a more efficient interbrand competitor.

Sylvania did little to illuminate the difficult task of characterizing a restraint as either horizontal or vertical and either price or nonprice. This has been an area of a great deal of litigation — and it will likely continue to be for the foreseeable future. I will not be addressing these issues during my talk due to the constraints of time.

Assuming that the plaintiff has not proved that its termination was the result of a restraint which is per se unlawful — i.e., that the ostensibly vertical restraint was, in fact, imposed by a dual distributor seeking to allocate markets or that its termination was pursuant to a vertical price fixing agreement — how does the plaintiff proceed to demonstrate that the restraint is unlawful under the rule of reason? What evidence must the defendant marshal in a case involving a vertical, non-price restraint in order to defeat the plaintiff's action? These questions raise certain fundamental issues.

First, what factual inquiries are germane to the application of the rule of reason? Second, how is the burden of proof allocated between the parties in a rule of reason case? And finally, what are the significant economic considerations that the plaintiff and defendant must address in order to prove their respective cases?

The Supreme Court in *Sylvania* confirmed the classic formulation of the rule of reason first articulated in *Chicago Board of Trade v. United States.*[30] Basically, what is required is an analysis of whether the restraint serves to regulate and thereby promote competition or whether it suppresses and thereby destroys competition. This statement of the rule may initially appear to illuminate a great deal, but when it comes to practical application, it is of little help. Essentially, one can characterize the rule of reason as applied in the post-*Sylvania* era to be: considering all of the relevant facts, do the procompetitive effects of the challenged restraint outweigh its anticompetitive effects? Given such a general standard, many critics have argued that the *Sylvania* decision created many more problems than it solved in that it merely reiterated a list of various factors to consider in a rule of reason analysis without indicating either the priority or the relative weight to be given to those factors.[31]

Turning to the burden of proof, clearly the plaintiff must show that its termination has had the effect of reducing intrabrand competition, i.e., meaning the competition among sellers of the same product. In *Sylvania* the Court noted that a reduction in intrabrand competition is not necessarily pernicious, so long as there exists sufficient interbrand competition which acts as a significant check on the power of the remaining dealers of a particular brand of product.[32] This brings us to the issue of what evidence is required to discharge the plaintiff's burden.

The Ninth Circuit, on remand, found that Sylvania's location clause

30. 246 U.S. 231 (1918).

31. *See, e.g.*, Pitofsky, *The Sylvania Case: Antitrust Analysis of Non-Pricing Vertical Restrictions*, 78 Colum. L. Rev. 1 (1978).

32. Continental T.V., Inc., v. GTE Sylvania, Inc., 433 U.S. 36, 51-52 (1977).

would tend to harm intrabrand competition in Sacramento, the market which plaintiff sought to enter. The court, without specifically analyzing the issue at length, presumed that the mere existence of the location clause demonstrated a reduction in intrabrand competition. It specifically noted that it was not an airtight territorial restriction, nor was it adopted to inhibit price competition.[33] Having presumed the restraint had the proscribed effect on intrabrand competition, the court then analyzed its probable effect on interbrand competition.[34] Because, however, the plaintiff was unable to prove any reduction in interbrand competition, it did not ultimately prevail.

Increasingly, in *Valley Liquors, Inc. v. Renfield Importers, Ltd.*,[35] a price discounter was terminated and the discounter argued that its elimination from the marketplace satisfied the intrabrand restraint aspect of its case. The plaintiff further asserted that after it demonstrated the anticompetitive effect on the intrabrand market, it was defendant's obligation to show that there were procompetitive effects flowing from its elimination. Judge Posner rejected these arguments, specifically holding that the mere fact that a price discounter was eliminated did not require the conclusion that intrabrand competition was in fact restrained.[36] It was wrong to equate the elimination of a price discounter with a reduction in intrabrand price competition. Posner argued that the elimination of a price-cutting "free rider" will tend to increase the level of nonprice competition among the remaining distributors even though price competition will have decreased; consequently the net effect on intrabrand competition could be negative or positive.[37]

Sylvania and *Valley Liquors* are illustrative of two contrasting approaches to the assessment of the competitive effects of vertical nonprice restraints. The Posner view is tantamount to a presumption of legality for such restraints. Hence the defendant may be able to show that the plaintiff has failed on his first burden (showing a reduction in intrabrand competition), and thereby avoid having to prove an enhancement of interbrand competition (offsetting any reduction in intrabrand competition attributable to the challenged restraint).

Turning now to the interbrand restraint question, there is a split in the circuits. The Fourth, Fifth, Seventh, and Ninth Circuits clearly indicate that the burden is on the plaintiff to show that the challenged restraint has adversely affected both intrabrand and interbrand competition.[38] The FTC has also taken this position, as is evident in its *Beltone* decision.[39]

Some courts have taken a shorthand approach to the determination

33. 694 F.2d 1132, 1137 (9th Cir. 1982).
34. *Id.* at 1138-39.
35. 678 F.2d 742 (7th Cir. 1982).
36. *Id.* at 745.
37. *Id.*
38. *See, e.g.,*, Donald B. Rice Tire Co. v. Michelin Tire Corp., 638 F.2d 15 (4th Cir.), *cert. denied* 454 U.S. 895 (1981); Muenster Butane, Inc. v. Stewart Co., 651 F.2d 292 (5th Cir., 1981); Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d 742 (7th Cir. 1982); Krehl v. Baskin-Robbins Ice Cream Co., 644 F.2d 1348 (9th Cir. 1982).
39. Beltone Electronics Corp., 1982-83 Trade Cas. (CCH) ¶21, 934 (FTC 1982).

of whether a particular vertical restraint could have an inhibitory effect on interbrand competition. These courts have adopted the "market power test." Essentially, under the market power test, unless the plaintiff can show that the defendant had substantial market power (which is defined as the ability to keep prices above competitive levels for a long period of time without losing business), the plaintiff cannot succeed in showing a violation under the rule of reason:[40]

> A firm that has no market power is unlikely to adopt policies that disserve its consumers; it cannot afford to. And if it blunders and does adopt such a policy, market retribution will be swift. Thus its mistakes do not seriously threaten consumer welfare, which is the objective that we are told should guide us in interpreting the Sherman Act.

The Ninth Circuit, in *JBL v. Jhirmack*,[41] adopted this approach. In *Jhirmack* a defendant was successful in obtaining summary judgment merely on the basis of the fact that it had only a two percent market share.[42] With such a small market share, the court concluded, whatever restraint it had imposed could not possibly have had a negative impact on interbrand competition.

The Second Circuit however, although strict on the issue of what constitutes an "agreement," as Scott and Alan discussed, is somewhat more lenient on the question of what is required for a plaintiff to satisfy its burden with respect to whether competition has been restrained. In the *Eiberger* decision the court held that if the effect of a dealer's termination was merely a reduction in intrabrand competition, that would suffice to establish a Sherman Act violation.[43]

It turns out that the difficulty in this area lies not only in picking the correct circuit, but also in picking the proper panel. A month after the *Eiberger* decision, the Second Circuit in *Borger v. Yamaha*,[44] reversed a verdict for the plaintiff, saying that liability could not be based upon a mere showing of reduction in intrabrand competition, but rather, required an examination of whether the intrabrand restraint had a negative intrabrand consequence as well.[45]

Owing to differing judicial approaches, with respect to its burden of proof on the issue of whether the challenged restraint has reduced competition, a plaintiff must *always* assume that it must show a reduction in *both* intrabrand and interbrand competition. It must therefore introduce economic evidence showing the negative impact of a restraint on both intrabrand and interbrand competition. If it does not do so, it is not likely to prevail. Indeed, most of the cases that have been decided under the rule

40. Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d 742, 745 (7th Cir. 1982).
41. JBL Enterprises, Inc., dba Jhirmack of Utah v. Jhirmack Enterprises, Inc., 1982-83 Trade Cas. (CCH) ¶ 65, 199 (9th Cir. 1983).
42. *Id.* at 71,828.
43. Eiberger v. Sony Corp. of America, 622 F.2d 1068, 1081 (2d Cir. 1980).
44. Borger v. Yamaha Int'l Corp., 625 F.2d 390 (2d Cir. 1980).
45. *Id.* at 397.

of reason subsequent to *Sylvania* are difficult to analyze because, basically, their results are attributable to the failure of the plaintiff to even *introduce* evidence that the restraint in issue had a negative interbrand effect.

Given the need to assess the economic impact of the restraint, what competitive considerations are important? Critical factors include the nature of the market and the defendant's position in that market. The Supreme Court has said that relevant product and geographic markets must be defined to provide contexts within which to assess the competitive impact of a restraint.[46] This requires analysis of the product market, the geographic market, and, importantly, the market structure (the number and size of firms in the industry and the market share of each), to determine the degree of concentration. Both the plaintiff and the defendant should analyze the performance characteristics of the markets because this will indicate whether the interbrand market is competitive or not, and whether an intrabrand vertical restraint could have a negative impact on interbrand competition.

With regard to the defendant's position in the market, look not only at its percentage of sales, but also at whether it is either a new entrant or a failing company. In either of these situations, courts tend to view the imposition of a vertical nonprice restraint as more likely to be justified to enhance the defendant's ability to compete at the intrabrand level. However, in *Eiberger*, the Second Circuit held that 12 percent of the market was too much for Sony to be considered a new entrant.[47]

After one considers the nature of the market, one should also consider the nature of the product, because market power is a function of both market share and product differentiation. The greater the degree of product differentiation, the less vulnerable it will be to interbrand price competition. Product differentiation can be detected by the presence of such factors as large advertising expenditures, and distinct styling and/or packaging.

Another factor to examine is the nature of the restraint. One might argue that there is a least restrictive alternative requirement. The Supreme Court in *Sylvania*, however, was not willing to subject business determinations to such a stringent test.[48]

Finally, in applying a rule of reason analysis to determine if a restraint is permissible, you have to analyze the justifications for the restraint put forth by the defendant. Essentially, the best example of a legitimate justification is the defendant's need for vigorous sales efforts in the distribution of its product. It wants to have pre-sale advertising, or it wants to have point-of-sale services, such as knowledgeable salespeople, or a warranty service program. In order to induce its dealers to make such efforts, it has to protect them from "free riders," free riders being those who would not provide such services, but who would instead cut prices so

46. United States v. Grinnell Corp., 384 U.S. 563, 570 (1966).

47. Eiberger v. Sony Corp. of America, 622 F.2d 1068, 1080 n.23 (2d Cir. 1980).

48. Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 58 n. 29 (1977).

as to take sales from the aggressive dealers who did provide them. So, to protect its dealers, to give them the margins they need to invest, to make the pre-sale, point-of-sale and post-sale efforts, and to eliminate free riders, vertical restraints have been justified.

Other legitimate justifications for vertically imposed restraints include maximization of market penetration, the need to maintain product safety and quality, and achievement of distributional efficiencies by maintaining non-overlapping distribution networks.

In almost every challenge to a vertical nonprice restraint since *Sylvania*, the defendant has prevailed. Given this track record, it appears that absent a showing that a restraint was imposed as part of a dealer cartel or a price fixing scheme, or that the defendant had a large market share and adopted an unnecessarily restrictive vertical restraint, courts are likely to continue to uphold supplier-imposed nonprice restraints. This observation is made with the caveat, however, that this could all change if plaintiffs and defendants both begin to regularly address the economic consequences of such restraints with respect to both intra- and interbrand competition when presenting their cases.

In leaving you, I would say that with regard to the question that was addressed in the first part, whether an agreement exists, we are in the morning of uncertainty. And with regard to which agreements are likely to be found unreasonable, I think we could characterize our current position as the dawning of the age of efficiency.

MR. WEINSCHEL: Thank you very much, Larry. Our next speaker is Dale Collins. Dale is a 1977 graduate of the University of Chicago Law School. Chicago is a place with some antitrust significance today. I think Dale's remarks will lead us to reinforce that conclusion.

Dale is a Special Assistant to the Assistant Attorney General in charge of the Antitrust Division. The Antitrust Division, as most of you know, has recently filed amicus briefs in two vertical restraint cases — the *Monsanto Co., v. Spray Rite Service Corp.*[49] case in the Supreme Court and *Battle v. Lubrizol Corp.*[50] in the Eigith Circuit on issues similar to those that we have been talking about today.

Dale is here, of course, to express his own views and not those of the Department of Justice. I am sure he is going to tell us that. But perhaps we can ask him to file his own amicus brief in the case of the Dealer against the Company. Dale.

MR. DALE COLLINS: I am pleased to be here today to discuss the antitrust implications of distributor terminations. I think that the presentations of Scott, Alan, and Larry were quite enlightening, if not provocative at times, and go to the heart of the debate over the proper doctrinal framework in which to assess the antitrust propriety of distributor terminations. As much as I would like to leap immediately into the fray, I think it would be more helpful if I stepped back and sketched out the landscape of federal antitrust considerations in dealer termination cases.

49. 684 F.2d 1226 (7th Cir. 1982).

50. 513 F. Supp. 995 (E.D.Mo. 1981), 673 F.2d 984 (8th Cir. 1982).

At the same time, I would like to share with you one insider's view of the current roadmap the Antitrust Division uses to navigate over this landscape when considering whether to exercise its discretion to bring a prosecution, or more frequently of late, to participate in an amicus capacity in a private litigation.[51]

Before I begin, I should make two observations: one about the general landscape, the other about the roadmap.

First, I will limit my description of the landscape to the existence of an antitrust violation in the circumstances surrounding a manufacturer or supplier[52] of a single product. This will enable me to avoid some of the complexities introduced by manufacturers of multiple products, such as tying and full-line forcing. It also will enable me to skirt the complex questions surrounding the issue of redress should an antitrust violation be found — questions such as standing to sue, antitrust injury, conspiratorial liability, measure of damages and the fashioning of equitable relief.

Second, the roadmap I will describe as guiding the Division in its analysis is a personal view, not official Division policy, and is a preliminary one at best. While much of the antitrust law of distributor termination is not only well-settled but also well-accepted, there remain substantial areas where either the antitrust doctrine is murky or the economic theory necessary to appreciate the competitive implications of the conduct is still in its infancy. Under Mr. Baxter, the Division has devoted substantial effort to understanding both the legal and economic foundations of vertical relationships. But since this work is not yet complete, any description of Division policy in the vertical area can only be tentative.

Agreement

Enough of the preliminaries. What are the factors that should be considered in assessing the antitrust implication of a distributor termination?

To begin, is there a plurality of actors who may have combined so as to satisfy the agreement element of section 1 of the Sherman Act? The absence of concerted action eliminates the possibility of a section 1 violation, and with it the prospect of proving an antitrust violation by the

51. See Monsanto Co. v. Spray-Rite Service Corp., *cert. granted*, 51 U.S.L.W. 3627 (U.S. Feb. 28, 1982) (No. 82-914) (urging writ of certiorari be granted), *decision below*, 684 F.2d 1226 (7th Cir. 1982); Battle v. Lubrizol Corp., No. 81-1585 (8th Cir. under submission for rehearing en banc) (urging reversal of panel decision), *earlier decision*, 673 F.2d 984 (8th Cir. 1982); O.S.C. Corp. v. Apple Computer, Inc., No. CV-81-6132 (C.D. Ca. filed Dec. 2, 1981) (setting forth views of standards to be applied in disposing of defendant's motion for summary judgment).

52. For convenience, I will assume that the terminated distributor purchased from a manufacturer. Obviously, the analysis here works equally well where the terminated distributor purchased from a jobber or from any other supplier downstream from the manufacturer.

mere showing of an appropriate agreement with no need of demonstrating anticompetitive effect.[53]

This leaves at most a section 2 violation, a possibility to which I will return briefly at the end of my remarks.

The cases suggest four potential combinations which should be explored for a connection to the termination:

1. A horizontal combination among the manufacturer and its competitors
2. A horizontal combination among competitors of the terminated distributor
3. A vertical combination between the manufacturer and a single competitor of the terminated distributor
4. A vertical combination between the manufacturer and the terminated distributor itself

A combination among suppliers may result, for example, from a manufacturers' price-fixing cartel which depends on the control of distributors through manufacturer-imposed vertical restrictions in order to monitor cheating. A distributor who refuses to abide by these vertical restrictions may be terminated either by a special agreement among the cartelists or by a single cartelist acting in furtherance of the conspiracy. But whether the cartel acts directly through a collective agreement or indirectly through a co-conspirator-agent, the termination will be attributable to the horizontal combination of manufacturers, a combination clearly cognizable under section 1.[54]

53. *See* United States v. Colgate & Co., 250 U.S. 300, 307 (1919). Where plaintiffs in dealer termination cases have been unable to adduce evidence legally sufficient to permit an inference of the requisite conscious commitment to a common scheme with respect to conduct challenged under section 1, they have not been able to prevail on their section 1 claim. *E.g.*, Schwimmer v. Sony Corp., 677 F.2d 946 (2d Cir. 1982), *cert. denied*, 51 U.S.L.W. 3362 (U.S. Nov. 8, 1982) (1982) (reversing judgment for plaintiff and remanding with instructions to dismiss complaint); Roesch, Inc. v. Star Cooler Corp., 671 F.2d 1168 (8th Cir. 1982) (affirming directed verdict for defendants); Bruce Drug, Inc. v. Hollister Inc., 688 F.2d 853 (1st Cir. 1982) (vacating injunction that required supplier to continue supplying terminated dealer); H.L. Moore Drug Exchange v. Eli Lilly & Co., 662 F. 2d 935 (2d Cir. 1981), *cert. denied*, 103 S.Ct. 176 (1982) (reversing judgment after special jury verdict for plaintiff and remanding with instructions to dismiss complaint); *see also* Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d (7th Cir. 1982) (affirming denial of motion for preliminary injunction).

54. A somewhat analogous case exists where an employer fires an employee because of the employee's refusal to assist the employer in the employer's participation in an antitrust conspiracy. The law is clear that where the co-conspirators agree among themselves that the employee must be fired and that no co-conspirator will rehire the employee, the firing is subject to scrutiny under section 1 as an act of the conspiracy. *See e.g.*, Radovich v. National Football League, 352 U.S. 445 (1957); Ostrofe v. Crocker Co., 670 F.2d 1378, 1381 & n.3 (9th Cir. 1982); Solinger v. A.&M. Records, Inc., 586 F.2d 1304 (9th Cir. 1978). The law is less settled on the "agent of the conspiracy" theory. The difficulty here may be in failing to distinguish when the employer is indeed acting as an agent of the conspiracy and when it is acting unilaterally. *Compare* Ostrofe v. Crocker Co., 670 F.2d 1378, 1382-86 (9th Cir. 1982) *with* In re Industrial Gas Antitrust Litigation, 681 F.2d 514 (7th Cir. 1982).

Agreements among the competitors of the terminated distributor are a second type of horizontal combination.[55] Perhaps the distributors have a price-fixing cartel of their own, and the terminated distributor because of its price-cutting activities threatened to upset the applecart. Or perhaps the terminated distributor was perceived as infringing on the territories or customers of its competitors. These territorial or customer assignments may be contractually guaranteed in the distributorship agreements or simply defined by custom. The competing distributors may have banded together and used their collective powers of persuasion to prevail upon a common supplier to terminate the renegade and thereby eliminate its disruptive activities. Such a combination among the terminated distributor's competitors, whether or not we include the common manufacturer as a member, would be sufficient to satisfy the agreement element of section 1.

Within the reported cases, perhaps the most frequently alleged combination is between the manufacturer and one of the terminated distributor's competitors, or (a variation on this theme) multiple combinations between the one manufacturer and a number of different distributor-competitors, each acting independently of one another.[56] A single distributor may act alone because it feels it has sufficient clout to prevail on the common supplier by itself and does not need the collective participation of its competitors, or it simply may have better or at least more cautious antitrust counselling. In any event, a vertical combination between the manufacturer and a single competitor of the terminated distributor would satisfy the agreement element of section 1.

Finally, in most cases the supplier and the terminated distributor itself will be said to have combined within the meaning of the agreement element of section 1 as a result of their relationship prior to the termination. However, the distributor's termination would not have been the object of the combination as it was in the previous three cases, and so the plaintiff must look for a causal link that ties the termination to the combination. In particular, the plaintiff must look for a vertical restraint — formal or informal — restricting the resale of the manufacturer's products with which the distributor was unwilling or unable to abide and so was terminated. Granted, the manufacturer may have terminated the distributor for other reasons — poor performance, as part of a plan to integrate forward into distribution, or even arbitrarily — reasons which would not implicate the terminated distributor as part of a combination for section 1 purposes. But where the termination results from a refusal by the distributor to abide by new terms imposed by the manufacturer on the distributor's resale of

55. *See* United States v. General Motors, 384 U.S. 127 (1966); *see also* Montague & Co. v. Lowry, 193 U.S. 38 (1904).

56. *See e.g.*, Klor's v. Broadway-Hale Stores, 359 U.S. 207 (1959); Bruce Drug, Inc. v. Hollister, Inc., 688 F.2d 853, 855 (1st Cir. 1982); Spray-Rite Service Corp. v. Monsanto Co., 684 F.2d 1226, 1239 (7th Cir. 1982), *cert. granted*, 51 U.S.L.W. 3627 (U.S. Feb. 28, 1982) (No. 82-914); Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d 742, 743 (7th Cir. 1982); Battle v. Lubrizol Corp., 673 F.2d 984 (8th Cir. 1982); Roesch, Inc. v. Star Cooler Corp., 671 F.2d 1168 (8th Cir. 1982); Edward J. Sweeney & Sons, Inc. v. Texaco, Inc., 637 F.2d 105 (3d Cir. 1980), *cert. denied*, 451 U.S. 911 (1981).

the supplier's products or an unwillingness to continue to abide by old terms, then the termination has its roots in a combination between the manufacturer and the terminated distributor which is cognizable under section 1.[57]

While there may be other types of combinations, such as between the manufacturer and a new entrant distributor seeking to replace an incumbent distributor, these are the four basic possibilities most likely associated with a distributor termination. How do you determine if any one actually exists with respect to any given dealer termination? Of course, there may be direct evidence of the existence of the combination, perhaps in the form of testimony from one of the participants or in their documents. In the case of a putative combination between the supplier and the terminated distributor, there may even exist a written agreement memorializing the combination and the vertical restraint which precipitated the termination. Where there is such direct evidence, proof of the agreement element of a section 1 violation should be relatively simple.

In many cases, however, the evidence of a combination will be only circumstantial, most likely in the form of a coincidence of actions or expressed desires on the part of the alleged participants. For example, a highly skilled and successful distributor of complex products in a growth industry is terminated, and he finds that no other manufacturer in the industry is willing to sell to him. Is this evidence sufficient to permit an inference of "a common design and understanding, or a meeting of the minds" — the essence of agreement under section 1[58] — for a manufacturer combination? Although the test differs in articulation from opinion to opinion, the law is reasonably well-settled that, for horizontal combinations at least, evidence of parallel conduct, even when open and notorious, will support a finding of concerned action only when accompanied by the showing of two additional factors: (1) that the actions of each participant, if taken independently, were in contradiction of its own self-interest; and (2) that there was a motivation among the putative participants to enter into an agreement of which the parallel activity was a consequence.[59] These additional showings are required because parallel conduct (for example, in price movements) is also a manifestation of perfectly competitive markets, where each market participant is acting unilaterally

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57. *See e.g.*, Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977). The fact that the plaintiff is a party to this agreement does not affect its capacity to challenge the legality of the prohibition. *See* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134, 138-41 (1968); Greene v. General Foods Corp., 517 F.2d 635, 647 (5th Cir. 1975), *cert. denied*, 424 U.S. 942 (1976).

58. American Tobacco Co. v. United States, 328 U.S. 781, 810 (1946).

59. *See, e.g.*, Venzie Corp. v. United States Mineral Products Co., 521 F.2d 1309, 1314 (3d Cir. 1975); Bogosian v. Gulf Oil Co., 561 F.2d 434, 446 (3d Cir. 1977), *cert. denied*, 434 U.S. 1086. A slightly different articulation of the same test is to require a showing that such parallel conduct "was contrary to [the alleged co-conspirators'] economic self-interest so as not to amount to a good faith business judgment." Pan-Islamic Trade Corp. v. Exxon Corp., 632 F.2d 539, 559 (5th Cir. 1980); *cert. denied*, 454 U.S. 927 (1981); *see* Proctor v. State Farm Prescription Service, Inc. v. American Pharmaceutical Ass'n, 663 F.2d 253, 267 (D.C. Cir. 1981), *cert. denied*, 102 S.Ct. 1293 (1982); *see also* Admiral Theatre Corp. v. Douglas Theatre Co., 585 F.2d 877, 884 (8th Cir. 1978).

in its own self-interest and to exogenous changes in market conditions. Only when the parallel conduct is individually irrational in the absence of cooperation from the other participants of the alleged combination, but becomes rational with their cooperation, will parallel conduct have probative value sufficient to support a finding of agreement, and then only through a permissive inference.

The horizontal case is relatively noncontroversial. Where the controversy arises is in the vertical case that Scott and Alan discussed — a putative combination between a common supplier and a single competitor of the terminated distributor. In many if not most of these cases the only evidence of a possible combination will be that of a complaint by the competing distributor and a termination subsequent in time by a common supplier. Some cases, notably *Battle*[60] and *Spray-Rite*,[61] have held that this evidence alone is sufficient to allow a permissive inference of conspiracy. Other cases, such as *Sweeney*[62] and *Moore*,[63] hold to the contrary. It is the Division's position — expressed in some detail in its amicus brief in *Battle* on rehearing and its brief in support of the petition for certiorari in *Spray-Rite* — that mere complaint-and-termination evidence in the vertical case has no more probative significance than evidence of parallel conduct in the horizontal case and that the standards to be applied to the circumstantial evidence in both cases to permit an inference of agreement should be much the same. Distributors almost always have an interest — sometimes legitimate and sometimes illegitimate — in seeing a competitor terminated and often communicate this interest to their common suppliers. But the supplier too may have an independent interest in terminating a given distributor, particularly if the distributor is performing poorly or violating the supplier's vertical restrictions, or otherwise undermining the efficiency of the manufacturer's distribution system. In the absence of additional evidence, complaints by competing distributors and a subsequent termination by the manufacturer could be a manifestation of parallel desires to see the distribution system operate in an efficient manner as, if not more, readily than as an "agreement" between the manufacturer and complaining distributors. In particular, if it is in the self-interest of the supplier to terminate one of its distributors, and the only function played by complaining competitor-distributors is to alert the supplier to the fact that the target of the complaint is not operating in the supplier's interest, then the individual rationality of the supplier in terminating the distributor

60. Battle v. Lubrizol Corp., 673 F.2d 984, 991-92 (8th Cir. 1982). *Compare* Roesch Inc. v. Star Cooler Corp., 671 F.2d 1168, 1172 (8th Cir. 1982).

61. Spray-Rite Service Corp. v. Monsanto Co., 684 F.2d 1226 (7th Cir. 1982), *cert. granted*, 51 U.S.L.W. 3627 (U.S. Feb. 28, 1983) (No. 82-149).

62. Edward J. Sweeney & Sons, Inc. v. Texaco, Inc., 637 F.2d 105, 111, 115-17 (3d Cir. 1980), *cert. denied*, 451 U.S. 911 (1981).

63. H.L. Moore Drug Exchange v. Eli Lilly & Co., 662 F.2d 935, 941-45 (2d Cir. 1981), *cert. denied*, 103 S.Ct. 176 (1983). Other cases following *Sweeney* include Bruce Drug v. Hollister, Inc., 688 F.2d 853, 856-57 (1st Cir. 1982); Schwimmer v. Sony Corp., 677 F.2d 946, 952-53 (2d Cir.), *cert. denied*, 51 U.S.L.W. 3362 (Nov. 8, 1982); Davis-Watkins Co. v. Service Merchandise, 686 F.2d 1190, 1199 (6th Cir. 1982), *cert. granted*, 51 U.S.L.W. 3421 (filed Nov. 19, 1982); Roesch, Inc. v. Star Cooler Corp., 671 F.2d 1168, 1172 (8th Cir. 1982).

destroys the possibility that the termination was the result of concerted action between the supplier and the complaining distributors in any sense meaningful to antitrust liability.[64] It is the Division's view that complaint-and-termination evidence is sufficient to prove a combination between the supplier and a complaining distributor only with the additional showing that termination of the target of the complaint was not in the manufacturer's own self-interest if taken independently, and became in its interest only with the intervention of the complaining distributor.[65]

Unreasonable restraint of trade

Let us assume that there exists sufficient evidence to demonstrate the existence of one or more of the four types of combinations I have described. But agreement alone does not establish a section 1 violation. The agreement must be in "restraint of trade." Moreover, as Chief Justice White told us in *Standard Oil,*[66] not any restraint of trade will do — the restraint must be "unreasonably restrictive of competitive conditions."[67] As an evidentiary matter, the unreasonableness of a restraint of trade must be established by either: 1) competent evidence that the restraint is demonstrably anticompetitive (the "rule of reason"), or 2) where available, a conclusive presumption of unreasonable restraint based on the nature or character of the challenged agreement (the "per se" rule).[68]

The courts have regarded the "rule of reason" as the general test of the unreasonableness of a restraint; the per se rule is to be employed only in those limited circumstances where courts have had considerable experience with the type of conduct challenged and have consistently found the conduct to have a "pernicious effect on competition and lacking any

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64. The *Battle* majority expressly agreed with *Sweeney* that mere complaint-and-termination evidence was insufficient to support an inference of conspiracy. However, the *Battle* court held that when the termination was *in response to* the complaints, then an inference of agreement is permissible. While at first blush this may appear reasonable, upon analysis the additional "in response to" requirement is not very helpful. As with all notions of causality, the "in response to" requirement is rather slippery. In its weakest sense — the sense which the *Battle* majority apparently applied — a supplier would have terminated its distributor "in response to" the complaints of competing distributors if it were these complaints which first alerted the supplier to conduct of the distributor, conduct for which the supplier would have terminated the distributor regardless of the source of its information. To add anything probative of true multilateral conduct from complaint-and-termination evidence, a stronger causality notion is needed, one which precludes the possibility that the supplier was acting unilaterally, albeit perhaps on the basis of information first provided in the complaints of competing distributors. When this stronger causality notion is applied, the test of agreement in this vertical case reduces to the same test as in the horizontal case of conscious parallelism, at least with respect to the manufacturer.
65. Judge Posner has applied this test to a dealer termination in Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d 742 (7th Cir. 1982). The test for agreement given only circumstantial evidence of complaints and subsequent termination, although analytically distinct, is closely related to the test of anticompetitive effect. See pp. 32-35, *infra*.
66. Standard Oil Co. v. United States, 221 U.S. 1 (1911).
67. *Id.* at 58; *see* National Society of Professional Engineers v. United States, 435 U.S. 679, 690 (1978).
68. National Society of Professional Engineers v. United States, 435 U.S. 679, 687-92 (1978); Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 49-50 (1977); Northern Pac. R. v. United States, 356 U.S. 1, 5 (1958).

redeeming virtue."[69] As a result, courts have fashioned per se rules for only limited categories of restraints, including horizontal price fixing,[70] horizontal market allocations,[71] vertical price restraints (resale price maintenance),[72] and some types of group boycotts.[73] Let me take the simplest case — the termination of a distributor for its refusal to abide by the restrictions imposed by the manufacturer on the resale of the manufacturer's products, that is, what are usually called "vertical restrictions." Prior to 1977 virtually all vertical restrictions, be they resale price maintenance, territorial restrictions, point-of-sale or location restrictions, customer restrictions, or whatever, that imposed restraints on the alienation of the goods purchased by the distributor from the supplier were subject to per se scrutiny.[74] However, in its 1977 *Sylvania*[75] decision the Supreme Court overruled at least part of the prior law and held that non-price vertical restrictions — in *Sylvania* a location clause — presented sufficient procompetitive potential to be judged under the rule of reason rather than the per se rule. The Court reasoned that while such vertical restrictions "reduce intrabrand competition by limiting the number of sellers of a particular product competing for the business of a given group of buyers," they also "promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products."[76] Accordingly, the Court concluded that antitrust plaintiffs should be required to prove that non-price vertical restrictions are anticompetitive in the particular circumstances in which they are employed.

At the same time, however, the Court stressed that it was reconsidering its rule only with respect to non-price vertical restraints and that price-related vertical restraints — resale price maintenance in particular — would continue to be subject to per se scrutiny.[77] While it is understandable that the Court in *Sylvania* sought to limit the reach of its opinion to situations fairly closely related to the facts before it, the dichotomy it

69. Northern Pac. R. v. United States, 356 U.S. 1, 5 (1958); *see* Broadcast Music, Inc. v. CBS, Inc., 441 U.S. 1, 8 (1979).
70. United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940).
71. United States v. Trenton Potteries Co., 273 U.S. 392 (1927).
72. Dr. Miles Medical Co. v. John D. Park & Sons, 220 U.S. 373 (1911). It is the Division's view that the per se rule is inappropriate to test the legality of resale price maintenance for the same reasons as it is inappropriate to test the legality of non-price vertical restraints. See pp. ___, *infra*.
73. Klor's Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959); Associated Press v. United States, 326 U.S. 1 (1945). In recent years, the courts have come to recognize that even the categories of conduct traditionally regarded as per se illegal may be too broad and consequently prohibit practices which may have significant procompetitive effects. *See* Continental T.V., Inc. v. GTE Sylvania, 433 U.S. 36 (1977); *see generally* Broadcast Music, Inc. v. CBS, Inc., 441 U.S. 1 (1979).
74. *See* United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967).
75. Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977).
76. *Id.* at 54.
77. *Id.* at 51 n. 18. Subsequently, the Court has continued to assume that price-related vertical restrictions are subject to per se scrutiny. *See* Rice v. Norman Williams Co., 102 S.Ct. 3294 (1982); California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 102 (1980); *see also* Arizona v. Maricopa County Medical Society, 102 S.Ct. 2466 (1982).

created is, in the Division's view, unfortunate for two reasons. First, the dichotomy is not workable. In practice it is often difficult, if not impossible, to distinguish between "price-related" and "non-price" vertical restrictions because both types can have an impact on price.[78] Second, price-related vertical restraints can have the same types of procompetitive effects as do non-price vertical restraints.[79] Indeed, in some cases, such as where effective retail distribution requires that distributors be closely spaced, price-related vertical restraints may be the only feasible means of assuring the high gross distributor margins necessary to finance the optimal level of "free" ancillary distributor services.[80] This is not to say that price-related vertical restraints are always procompetitive on balance, or even that price-related vertical restraints and non-price vertical restraints are equivalent in anticompetitive potential. But because price-related vertical restraints do not invariably have a "pernicious effect on competition" or lack "any redeeming [competitive] virtue," application of the per se rule is inappropriate.[81] Rather, price-related vertical restraints should be judged under the rule of reason— the normal test of unreasonableness of an alleged restraint — and not the conclusive presumption of competitive unreasonableness which is the per se rule. Next term in *Spray-Rite*[82] the Supreme Court will have an opportunity to reconsider the per se rule against vertical price fixing and we hope it will see the procompetitive potential of resale price maintenance as it did in 1977 with non-price vertical restraints in *Sylvania*.[83]

Now let me turn to a combination between a single supplier and a single distributor who is a competitor of the terminated distributor. The courts are split on the level of scrutiny to be applied to this type of combination. Some cases cite *Klor's*[84] for the proposition that any vertical

78. For example, *Sylvania* squarely held that it was not per se unlawful for a manufacturer to require its dealers to sell only from a particular location — a "non-price" vertical restriction. 433 U.S. at 38, 57-59. But through "judicious spacing of dealerships the manufacturer with dealerships continuing a location clause can limit price competition among its dealers" in order to discourage free riders. *See* Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. Chi. L. Rev., 6, 11-12.

79. The similarities in purpose and effect between resale price maintenance and non-price vertical restrictions led Justice White to observe in his concurring opinion in *Sylvania* that the "effect . . . of the Court's opinion is necessarily to call into question" the per se rule against resale price maintenance. 433 U.S. at 70.

80. Posner, *supra*, 48 U. Chi. L. Rev. at 9.

81. Indeed, the Court has never examined the effect on competition or the possible competitive virtues of price-related vertical restraints. Rather, more than 70 years ago the Court simply *assumed* that vertical price fixing is equivalent in all respects to horizontal price fixing and constitutes an unlawful restraint on alienation. *See Dr. Miles Medical Co. v. John D. Park & Sons*, 220 U.S. 373, 404-09 (1911). Justice Holmes dissented from the *Dr. Miles* decision on the ground that resale price maintenance had not been shown to be anticompetitive on balance, see 220 U.S. at 411-13, and (with Justice Brandeis) continued to dissent from decisions presuming resale price maintenance to be conclusively unlawful. *See United States v. A. Schrader's Son, Inc.*, 252 U.S. 85, 100 (192); *FTC v. Beech-Nut Packing Co.*, 257 U.S. 441, 456-57 (1922).

82. *Monsanto Co. v. Spray-Rite Service Corp., cert. granted*, 51 U.S.L.W. 3627 (U.S. Feb. 28, 1982) (No. 82-914).

83. Continental T.V., Inc. v. GTE Sylvania, Inc. 433 U.S. 36 (1977).

84. Klor's, Inc. v. Broadway-Hale Stores, 359 U.S. 207 (1959).

combination designed to exclude from the market a direct competitor of one of the participants is subject to per se scrutiny.[85] Perhaps more common are those cases which applied per se analysis where the combination seeks to manipulate the resale price of the supplier's products or otherwise to impose a price-related vertical restriction.[86]

Finally, some cases have applied in one form or another a rule of reason analysis.[87] In the Division's view, all pure vertical combinations should be analyzed under the rule of reason. To the extent the vertical combination gives rise to a non-price vertical restraint, the restraint can serve the same procompetitive purposes as when the supplier effected the restriction unilaterally. And to the extent the combination gives rise to a price-related restraint, the arguments in favor of applying per se analysis fall for the same reasons I mentioned a moment ago when discussing *Sylvania*: the dichotomy between price-related vertical restraints and non-price vertical restraints is both mechanically unworkable and analytically unsound. I might also note that since there is little difference in economic effect between a joint profit-maximizing vertical combination and a "dual distributor" — that is, a supplier who is partially integrated downstream into distribution — the termination of a competing distributor by the dual distributor should be judged under a rule of reason analysis, notwithstanding some authority to the contrary.[88]

It is important to stress that to the extent the rule of reason and not the per se rule applies to test the legality of a vertical combination, it is not a rule of per se legality. The rule of reason still makes unlawful those vertical combinations which have an anticompetitive effect. But it preserves those vertical combinations which may have procompetitive influences. Perhaps the most important of these procompetitive influences is in the efficient flow of information. Distributors on the front line in the sales of a supplier's products may develop considerable insight into the inefficiencies of the supplier's distribution system — inefficiencies which may arise either from the supplier's design of its distribution system in the first instance or from the manner in which the supplier's instructions are being followed, or not being followed, by its distributors. Those distributors who would benefit from a more efficient distribution system have an

85. *See, e.g.*, Com-Tel, Inc. v. DuKane Corp., 669 F.2d 404, 411 (6th Cir. 1982); Ostrofe v. H.S. Crocker Co., 670 F.2d 1378, 1381 & n.3 (9th Cir. 1982).

86. *See, e.g.*, Battle v. Lubrizol Corp., 673 F.2d 984, 989-90 (8th Cir. 1982); Products Liability Ins. Agency, Inc. v. Crum & Forster Ins. Cos., 682, F.2d 660, 663-65 (7th Cir. 1982); Cernuto, Inc. v. United Cabinet Corp., 595 F.2d 164 (3d Cir. 1979).

87. *See, e.g.*, Oreck Corp. v. Whirlpool Corp., 579 F.2d 126, 129 (2d Cir.) (en banc, *cert. denied*, 439 U.S. 946 (1978).

88. Some courts have reasoned that "vertical restraints imposed by dual distributors in competition with their independent distributors are in fact horizontal and as such should be judged under the per se rule." Copy-Data Systems, Inc. v. Toshiba America, Inc., 663 F.2d 405, 409 (2d Cir. 1981). Central Chemical Corp. v. Agrico Chemical Co., 531 F. Supp. 533, 545 n.17 (N.D. Ga. 1982). *Compare* Marietta Packaging Co. v. Guest Supply, Inc., 1982-83 Trade Case. ¶ 65,184 (N.D.N.Y. 1982) (applying rule of reason in denying plaintiff's motion for summary judgment); Blake Associates, Inc. v. Omni Spectra, Inc., 1982-83 Trade Case. ¶ 65,155 at 71,499-54 n.1 (D. Mass. 1982) (questioning whether First Circuit would apply per se rule to dual distributorships).

incentive to communicate their ideas for improving the system's efficiency to the supplier. A per se rule of illegality for vertical combinations would greatly chill this communication, particularly where a competing distributor stands to lose from any change to a more efficient distribution, to the detriment not only of the supplier but of society as a whole. A rule of reason approach mitigates this type of error while still preserving the law's ability to reach truly anticompetitive vertical combinations.

Since the *GM* case, combinations among distributors to exclude a competing distributor have been regarded as horizontal conspiracies to which the per se rule applies.[89] For the most part this is the proper approach. Rare is the example in which a procompetitive end is served by permitting distributors to agree among themselves to take action that may result in the termination of a particular competitor that could not be accomplished equally well without concert of action, say by appealing unilaterally to a manufacturer.

However, allow me to suggest (without now endorsing) a possible exception to the per se rule against horizontal distributor conspiracies suggested by *Broadcast Music.*[90] There the Supreme Court held that a combination of horizontal competitors in the creation and licensing of musical compositions — a combination which under then-existing precedent seemed to be a per se unlawful price-fixing arrangement — was to be examined under the rule of reason where defendants had presented substantial evidence that the challenged combination was necessary to the creation and marketing of the members' products. Arguably the *Broadcast Music* reasoning would apply to a horizontal dealer combination where the members prevailed on a common manufacturer to eliminate a free-rider problem in the resale of the manufacturer's product, at least where the manuffacturer (together with any other suppliers the combination approached) lacked market power. In effect, the elimination of a free-rider problem permits the creation of a new good — the manufacturer's original product plus distributor services — where only the manufacturer's product would otherwise exist. But the elimination of the free-rider problem may also make it difficult, if not impossible, for some distributors who depended on free-riding to continue to operate. Such a dealer may argue that there its demise is the result of a per se unlawful horizontal dealer conspiracy. If confronted with a case where a plausible contention is made that the horizontal dealer combination served only to eliminate a free-rider problem and no more, the courts may wish to scrutinize the combination under the rule of reason and not the per se rule.

Finally, combinations among manufacturers to terminate a distributor of one of the members are regarded as per se unlawful.[91]

89. *See, e.g.*, United States v. General Motors Corp., 384 U.S. 127 (1966) (horizontal combination among distributors); Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d 742, 743 (7th Cir. 1982).

90. Broadcast Music, Inc. v. CBS, Inc., 441 U.S. 1 (1979).

91. There also may be a *Broadcast Music* exception to this rule, but the circumstances under which it may arise are even more difficult to imagine than in the case of a horizontal combination among distributors of a common manufacturer.

Suppose we have found sufficient evidence of a combination, but have determined that the combination in question is not subject to per se scrutiny. How should the rule of reason be applied to determine if the combination violated section 1? Notwithstanding the litany contained in *Chicago Board of Trade*[92] of types of evidence relevant to a rule of reason analysis,[93] the Supreme Court has cautioned that the rule of reason[94]

> does not open the field of antitrust inquiry to any argument in favor of a challenged restraint that may fall within the realm of reason. Instead, it focuses directly on the challenged restraint's impact on competitive conditions.

The rule of reason, therefore, requires the injury to competition that may be caused by the challenged conduct to be weighed against any enhancement of competition that may result from the conduct.[95]

As competition is the focus of a rule of reason analysis, the first step must be to define the relevant market in which an anticompetitive effect may be located. The revised Merger Guidelines contain the Division's view of how relevant markets should be defined for the purpose of merger antitrust analysis,[96] and the same rules work equally well in defining markets for section 1 rule of reason analysis. Once the relevant market is defined, the test of competitive effect is whether the challenged conduct increased or decreased the economic efficiency of that market.

Consequently, when a rule of reason analysis is required, the termination of a distributor by a manufacturer, even if this results in the distributor's exclusion from the relevant market, is not by itself sufficient evidence to prove the requisite anticompetitive effect. The terminated distributor may have been operating inefficiently and the manufacturer merely may have replaced it with a more efficient substitute distributor. Similarly, a rise in the resale prices of the manufacturer's product is insufficient to prove anticompetitive effect. The increased distributor profits resulting from the price rise may have been used to provide more or better "free" ancillary distributor services and may have actually

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92. Chicago Board of Trade v. United States, 246 U.S. 231 (1918).

93. According to the Court per Justice Brandes:

> The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; and the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of intent may help the court to interpret facts and to predict consequences.

Id. at 238.

94. National Society of Professional Engineers v. United States, 435 U.S. 679, 688 (1978).

95. The court thereby determines whether the conduct "tend[s] to restrict competition and decrease output . . ., or instead [is] designed to 'increase economic efficiency and render markets more, rather than less, competitive.' " Broadcast Music, Inc. v. CBS, 441 U.S. 1, 20 (1979).

96. U.S. Dept. of Justice, Merger Guidelines (rev. ed. 1982).

increased interbrand competition and demand for the supplier's product.

More generally, the interests of a manufacturer and of consumers in achieving an efficient distribution system for the manufacturer's goods are usually coincident. If the manufacturer imposes restraints on its distributors which create inefficiency in its distribution system and encourage its distributors to provide an inappropriate bundle of distribution services to ultimate consumers, then the manufacturer is likely to be undercut by its more efficient competitors.[97] Accordingly, the strong presumption should be that a manufacturer will choose to impose those vertical restraints, including those directly or indirectly leading to the termination of one of its distributors, that yields the most attractive package to consumer in terms of price, quality and service. Likewise, where a manufacturer has terminated one of its distributors, the strong presumption should be that the manufacturer undertook this course in order to improve the efficiency of its distribution system.

But in some cases a dealer termination may be demonstrably anticompetitive. Besides the use of dealer terminations to enforce agreements of horizontal combinations among manufacturers or among distributors which are per se unlawful (subject to a possible *Broadcast Music* exception), there are two circumstances in which the presumption of legality should be defeated in a dealer termination case: 1) where a manufacturer attempts to use distribution restrictions to raise barriers to entry or raise the manufacturing or distribution costs of its rivals and enforces these restrictions through the termination of noncomplying distributors; and 2) where a distributor, in order to exercise market power, coerces one or more suppliers to terminate certain of their dealers in order to impose inefficient distribution restrictions for the distributor's benefit.

Concern over the use of distribution restrictions to foreclose access of a manufacturer's rivals to the manufacturer's distributors has appeared frequently in the antitrust law of vertical practices. The general idea is that by imposing vertical restraints, a manufacturer can foreclose (or at least minimize) its distributors as a source of potential sales for the products of the manufacturer's rivals. Broadly speaking, the restraints may operate as a stick or as a carrot: they may contractually prevent a distributor from selling the product of its supplier's rival, as in exclusive dealing or tying arrangements, or they may make the sale of the supplier's product so attractive so as to diminish the distributor's incentives to sell rival products, as in vertical restraints which offer protection from intrabrand competition. In both cases, the restraints serve to reduce effective access by a manufacturer's rivals to the manufacturer's distributors.

While the prospect of foreclosure is well known, the conditions under which it raises a substantial possibility of an anticompetitive effect have received far less attention. But it is only in those instances where an anticompetitive effect is likely to result that foreclosure should be of antitrust concern. Since the foreclosure argument ultimately operates on the costs of supply of a competitor's product to ultimate consumers, the

97. *See* Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d 742, 745 (7th Cir. 1982).

anticompetitive effect — should it result — will occur in the raising of a barrier to entry or otherwise increasing the relative manufacturing or distribution costs of the manufacturer's rivals. Under the appropriate conditions, foreclosure through vertical restraints may increase the relative costs of the manufacturer's competitors in one of two ways.

First, the restraint may limit access by the manufacturer's competitors to scarce inputs to the production or sale of rival products. These inputs need not be limited to factors of production; for example, they also may include the specialized expertise of certain distributors. Limiting access to these inputs will directly increase a rival's cost as the input prices are bid up to reflect their new scarcity. In effect, the restraint changes the cost functions faced by the rival firms. Second, if the production or distribution technology exhibits economies of scale, a vertical restraint that diminishes the contact of potential ultimate customers of rival products will increase the marginal costs of competitors of the manufacturer to the extent each competitor sells — and therefore produces — less than it would have in the absence of the restraint. In this case, the manufacturer and its competitors may have the same cost functions, but the vertical restraints cause the competitors to operate at a more costly point of production.[98] While ultimately one of these two effects would have to be shown by the weight of the evidence in order for a plaintiff to prevail on a foreclosure theory of anticompetitive effect, a full-fledged inquiry may not — indeed, usually will not — be required in order to dispose of the case. Under either leg of the theory, in order to alter the costs of competitors the foreclosure resulting from a manufacturer's vertical restraint must act as a binding constraint in the operations of the manufacturer's rivals. If the degree of foreclosure is small, the manufacturer's competitors simply can turn to non-foreclosed inputs (or distributors) with little or no effect on their operations. Moreover, even if foreclosure appears quantitatively substantial, in the absence of barriers to entry into the market for the foreclosed input (or into distribution) the foreclosure at best can have only a slight effect. Since market power reflects both the degree of foreclosure and the magnitude of entry barriers, a necessary condition for an anticompetitive effect to result from a manufacturer's attempt to increase the costs of its competitors through the imposition of vertical restraints is that in the aggregate there exists market power in the foreclosed inputs (or that the foreclosed distributors, taken together, possess market power at the distribution level). Conversely, a manufacturer which does not possess market power in the foreclosed inputs could not create an anticompetitive effect under the foreclosure theory. Consequently, such a manufacturer should be in a "safe harbor" from which to impose vertical

98. A mixed case is when foreclosure of existing inputs requires the manufacturer's competitor to integrate vertically into the foreclosed input in order to compete with the manufacturer. For example, if the manufacturer forecloses distribution by signing all existing independent distributors to requirements contracts, a competitor would have to integrate into distribution in order to compete. Such integration may disadvantage a rival because of problems of coordination and scarce inputs (changing cost functions) as well as minimum efficient scale (operating at less than maximally efficient size).

restraints that might limit access to certain inputs by its competitors without fear of antitrust liability, although the cases are not as clear on this as we would like to see them.[99]

Likewise, similar necessary conditions (and therefore "safe harbors") exist to determine whether a vertical restraint is designed to protect one or more of the manufacturer's distributors at the expense of consumers and, for that matter, at the expense of the manufacturer through loss in the efficiency of its distribution system. The first necessary condition is that the manufacturer have market power in the goods whose resale it is restricting, or alternatively, that the favored distributor is protected by vertical restrictions from a number of competing manufacturers, who when taken together have market power. In the absence of manufacturer market power, any decrease in the efficiency of a manufacturer's distribution system cannot influence the intensity of competition in the marketplace and hence cannot affect consumer welfare. Even if a dealer was able to obtain the manufacturer's protection through the design of an inefficient distribution system, it would be of no competitive significance; the manufacturer would quickly lose market share to its more efficient rivals.[100]

Assuming that the manufacturer is found to have market power, the second necessary condition is that there be some evidence that the distributor is coercing the manufacturer into imposing the vertical restraint — i.e., that the manufacturer is a reluctant administrator of the restraint. Although, as I have noted already, it is in a manufacturer's interest to impose a restraint likely to increase the efficiency of its distribu-

99. This "safe harbor" contains among its docks one that is particularly noteworthy. Where the manufacturer does not own the foreclosed inputs, to exercise market power in these inputs the manufacturer must have some market power in the sale of its product to the restrained distributors. Vertical restraints foreclosing access by a manufacturer's competitors to its distributors equally foreclose access by the distributors to these same competitors. The manufacturer must have market power in order to prevail upon its distributors to accept this limitation on their freedom to deal with potential suppliers. The manufacturer may use this market power coercively by refusing to deal with those distributors who do not accept its restraints, or persuasively by permitting its distributors to share in its economic rents (perhaps by permitting the distributors to keep some of the gains of a more efficient distribution system). But in the absence of manufacturer market power, effective vertical restraints could not be imposed — for dealers simply would turn to alternative suppliers who would not employ such restraints — and so foreclosure would not occur.

100. Valley Liquors, Inc. v. Renfield Importers, Ltd., 678 F.2d 742 (7th Cir. 1982); Muenster Butane, Inc. v. Stewart Co., 651 F.2d 292, 298 (5th Cir. 1981); Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001, 1005-06 (5th Cir. 1981). Moreover, if the manufacturer lacks market power, dealers face a significantly diminished incentive to attempt to subvert the manufacturer's efficient distribution system through the termination of a competitor-distributor. The distributor's success could only come at the expense of the manufacturer's profits or at the expense of higher prices to consumers. But if the manufacturer has no market power, it has little ability to raise its prices to consumers significantly above those of its competitors and any efforts by a distributor to raise its margins at the expense of the manufacturer's profits would seriously impair the manufacturer's incentive to provide its distributors a product competitive in the resale market. Consequently, any successful distributor attempt to subvert the manufacturer's distribution system is likely to be counterproductive if the manufacturer lacks market power.

tion system, it is against his interest to introduce a restraint that is inefficient and he will resist to the limits of his bargaining power. Coercion of the manufacturer requirs the coercing dealer to have market power of its own which it has brought to bear against the manufacturer. The ability of a dealer to exercise market power depends on the structure of the resale market in which it operates. If concentration in that market is low, barriers to entry do not significantly impede new entry, or distributors generally are acting in a demonstrably competitive fashion, a dealer will not be able to exercise the market power necessary to coerce its manufacturer-suppliers.[101]

Finally, there must be evidence that the favored distributor used its market power to cause the manufacturer to depart from an efficient distribution system. Direct evidence of coercion may exist from the relationship of the manufacturer and the favored distributor. For example, did the distributor threaten the manufacturer with any type of retribution if the manufacturer did not terminate the target of its complaint? Was the threat credible — that is, was it reasonable for the supplier to believe that the threat would be carried out if the target was not terminated? If carried out, would the action threatened by the complaining distributor harm the manufacturer? Would this harm have been greater than any harm to the manufacturer that would result from the termination? Indirect evidence of coercion also may be very helpful, particularly evidence which indicates that the shift in the manufacturer's distribution system, resulting in the termination of an existing dealer reduces the system's efficiency and served only to benefit the favored distributor. For example, if a vertical restraint was imposed, was it appropriate to the efficient distribution of the restrained product? Was the supplier's product one which required costly pre-sale, point-of-sale, or post-sale services in order to gain maximum consumer acceptance? If so, were these services provided customarily without charge by distributors so that a "free-rider" problem might develop? Were the pre-termination gross margins of the distributors sufficient to finance the level of ancillary services which maximizes the manufacturer's profits? Did the favored distributor's gross margin go up as a result of the termination, and if so, did it rise to a point where it was excessive in light of any "free" ancillary services the distributor provided in the post-termination period?

Rule of reason analyses can be quite tricky. But by focusing first on the individual rationality of the manufacturer terminating one of its distributors and the existence of one of the possible conditions necessary for an anticompetitive effect to occur, it becomes possible to cut quickly — at least in the framing of the relevant questions if not in the gathering of evidence — to the heart of a rule of reason analysis of a dealer termination.

Finally, let us assume that we have searched for a combination connected with the distributor termination and found none. This eliminates the possibility of a section 1 violation, but a section 2 problem could

101. *See* Muenster Butane, Inc. v. Stewart Co., 651 F.2d 292, 297-98 (5th Cir. 1981); Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637 F.2d 1001, 1005-06 (5th Cir. 1981).

still remain. While as a general rule there exists no duty to deal so long as the determination is made unilaterally, an exception may exist in some situations for a supplier-monopolist.[102] Situations that the cases suggest may be of particular section 2 concern in the context of a dealer termination are where the supplier-monopolist is engaged in dual distribution and discontinues one of its competing independent distributors[103] or where the supplier-monopolist terminates an existing distributor in order to integrate vertically into distribution.[104] But as my time is more than out, the monoplist's duty to deal problems must await another day, or at least await the question period. Thank you.

MR. WEINSCHEL: Thank you, Dale. My own view is that we have had much more rationality in the last hour than we find in most decisions in this area. Many of the decisions in this area seem to be result-oriented decisions that are based on differing fundamental philosophical orientations. Some courts (or, more accurately, judges) believe that we ought to have a legal framework that permits the maximum amount of freedom on the part of all traders, especially small businessmen. Any interference on the part of freedom by the individual business person is to be looked at with some antitrust suspicion. On the other hand, there are courts which believe that the maximum amount of freedom ought to be afforded to the manufacturer in deciding how best to distribute its products and with whom to deal, the theory being that manufacturers will not choose inefficient distribution systems, and overall efficiency will be enhanced.

If you look at the cases in that light, you may be able to find some common strains, although you will likely never be able to reconcile all the cases, even all the cases within a circuit.

Having said that, we hope that there will be questions from some of you to each or all of the panelists. Are there any questions? Yes, sir.

MR. MARTIN NEVILLE: Martin Neville, New York. A question for Mr. Collins and also for the panel. On the question of determining whether a cutoff is against a manufacturer's interest, from the defendant's side of it, I think you could always argue either short or long-term cutoff might be in the manufacturer's interest, in effect, promote harmony from the manufacturer's viewpoint as to applaud a distributor. He wants him to be happy and do a good job. From the defendant's side of it, I think you can always argue at least that it's in the short term against the manufacturer's interest, because he's losing some sales from cutting off any given distribu-

102. *See* Lorain Journal v. United States, 342 U.S. 143 (1951); Associated Press v. United States, 326 U.S. 1 (1945); Eastman Kodak Co. v. Southern Photo Materials Co., 273 U.S. 359 (1927); United States v. Terminal Railroad Ass'n., 224 U.S. 383 (1912).

103. *See, e.g.*, Auburn News Co. v. Providence Journal Co., 659 F.2d 273 (1st Cir. 1981), *cert. denied*, 102 S. Ct. 1277 (1982); Poster Exchange, Inc. v. National Screen Service Corp., 431 F.2d 334, 339 (5th Cir. 1970), *cert. denied*, 401 U.S. 912 (1971).

104. *See, e.g.*, Paschall v. Kansas City Star Co., 1982-83 Trade Case. ¶65, 104 (8th Cir. 1982); Byars v. Bluff City News Co., 609 F.2d 843 (6th Cir. 1980). The Eighth Circuit's opinion in *Kansas City Star* rejected the approach urged by the Justice Department in its amicus brief and found the vertical integration by a monopolist newspaper publisher into distribution to be unlawful. However, the opinion has been vacated and the case is being reheard by the Eighth Circuit en banc.

tor. What is the test, the ultimate test, as you see it, to what is or isn't really against a manufacturer's interests?

MR. COLLINS: I think you have to look at it from a more long-run perspective. Again, you can look at evidence such as long-run changes in the manufacturer's output or profit level. There is undoubtedly some very tricky causality questions in the interpretation of this evidence. You have to relate the output shifts to the termination. But still, the difficulties of evidence aside, the type of framework I discussed earlier at least directs you to the appropriate kinds of evidence.

In a complaint-and-termination case, you also might examine changes in the profits of the complaining distributors. Because of spatial differentiation or whatever there may be what economists call monopoly rents to be gathered from the distribution of the manufacturer's product. If those rents are going to the distributors and not to the manufacturer, then the manufacturer is not profit-maximizing. That suggests that something else is going on. In particular, the manufacturer may be acting not in his self-interest but rather acting in response in a very strong causal sense to the complaints of certain of his more powerful distributors. They may have threatened to walk away from him unless the manufacturer terminates the target of their complaints. The manufacturer may decide that he would just as well give them some of the rents that come from the termination rather than keep them for himself through some more efficient, alternative distribution scheme which includes retaining the target of the complaints.

MR. WEINSCHEL: If I can, since I am the chairman, I can ask one question I think that comes up here. If I am the manufacturer and I receive a complaint from "one of my good customers" who happens not to be a discounter, who is also a major customer who accounts for, let us say, 15 or 20 percent of my volume, and he is complaining about a discounter and I then terminate the discounter in order to keep my 20 percent customer happy, am I in those circumstances doing something that is in my long-run interest, in my short-run interest? I shall tell you the clients that I deal with do not think about long-run interests and short-run interests. They say, "I've got to do what I've got to do." And they terminate the discounter because they cannot afford to lose the business of the 20 percenter who says, "If you don't get rid of these discounters, I'm not going to carry your line any more." Now is that pro-efficiency or anti-efficiency?

MR. COLLINS: You have to ask what would be in the manufacturer's profit-maximizing interest in the absence of any intervention by the complaining distributor. If the answer to that question is that it would be in his interests to terminate the target of the complaint because the target is not abiding by the manufacturer's imposed vertical restraints or is doing something else that is contrary to the manufacturer's interests, and that in effect the complaining distributor only give the manufacturer the factual information that indeed the target was acting contrary to the manufacturer's interest, then the manufacturer was operating in its own self-interest in terminating the target and there would be no section 1 problem because there would be no conspiracy. The fact that the information came from a competing distributor to me seems irrelevant.

On the other hand, if the manufacturer knew everything about the operations of the terminated distributor and its implications for the efficiency of the manufacturer's distribution system, and would have concluded independently of the complaints that the terminated distributor was actually doing what the manufacturer wanted him to do, and it is only with the intervention of the complaining distributor the manufacturer decided to terminate the target, then I think you have got enough evidence there to withstand summary judgment on the question of combination between the manufacturer and the complaining distribution. And you have probably come a long way to showing that the effect of the termination was in fact anticompetitive.

MR. FOX: Alan, can I just pick up on that for a second?

MR. WEINSCHEL: Go ahead, Larry.

MR. FOX: Assume in Dale's response that the termination is not because the complaint was informing somebody of the dealer's deviation from the supplier's policy but merely "it's him or me; he's price cutting." I believe that the termination should be viewed as per se illegal as merely the vertical expression of a horizontal desire. And that is the elimination of a price competitor and should be treated as that.

MR. WEINSCHEL: I am not sure I agree because I do not know you can rationalize that case with, for example, the *Packard Motor Car*[105] case where you have somebody who says, "I'll take on your line if you give me an exclusive," which means I have to terminate somebody else. That is an elimination of competition that is just as egregious as eliminating one discounter — giving somebody an exclusive territory. Yet there is a long line of cases that hold it is perfectly appropriate to terminate one distributor and substitute another in its place. I find these cases very difficult to reconcile if the only issue that you are looking at is — is there going to be an elimination of competition at that level?

MR. JOSEPH SPAIN: My name is Joseph Spain from New York. Following up on this example of the person that Collins said was well known by the manufacturer and only after hearing complaints did the manufacturer decide to terminate the dealer, not so much relying on your line of cases that you talked about but rather looking at the context of these cases, is that a decision that is necessarily a combination? I can imagine a sales manager who was aware of this but did not take the time to do anything about it because he was worried about something in another district. Then the president of the company says: "I've just come back from a convention and I heard four complaints about the plaintiff. That's a pain in the neck for me to hear those complaints from all our good dealers. I think we ought to terminate him." It is as simple as that. It is not the result of any agreement. You may even have on the record the testimony that everyone of those complainers was told: "That's our business. We'll have

105. Packard Motor Car Co. v. Webster Motor Car Co., 243 F.2d 418 (D.C. Cir.) *cert. denied*, 335 U.S. 822 (1957).

to decide what to do." So there is no real agreement in fact, if you look over everyone's shoulder. But in fact would that be legally an agreement even though, as viewed by the manufacturer, his unilateral actions would get annoyed dealers thinking happy again, not because of any agreement?

MR. WEINSCHEL: I can answer that one. I think it depends on what circuit you are in.

(Laughter)

I am serious. All of the circuit courts that have addressed this are using catchwords to substitute for the fact that they do not have direct evidence of a conspiracy. In looking for something other than direct evidence, we use substitutes which may permit the inference of agreement. The concept of an inferred agreement is not foreign to the antitrust laws. It may be ultimately a policy determination of whether you want to infer an agreement or whether you want to permit the manufacturer to terminate. We have gotten somewhat sidetracked in these cases on the issue of agreement because it is now the way for defendants to knock cases out quickly.

Does somebody else have a different view on that? Go ahead, Scott.

MR. BASS: In answer to that question, I would refer you to the *Moore v. Lilly* case in the Second Circuit.[106] The facts are almost precisely the same. The appellate court reversed a jury verdict on the grounds that there was no "agreement."

The second answer is that the word "agreement" did not have a separate meaning from "conspiracy" until recently. In some circuits the facts you present would be sufficient. Those courts say that if you do not allow an inference of conspiracy apart from some notion of "agreement," then you will never have a conspiracy found under section 1.

On the other hand, other circuits would hold for the defendant because, as you express it, some manufacturers simply find it in their independent interest to act consistently with their past action.

As Alan said, it really depends upon the circuit in terms of whether or not you can get to the jury with those facts. And, as I mentioned earlier, if the facts are mixed, the plaintiff might withstand a j.n.o.v. motion but collapse under the new trial standard.

MR. WEINSCHEL: Let me conclude by saying that the phrase that I heard the most of all the panelists was "on the other hand."

(Laughter)

That is pretty good shorthand for the law in this area because it still is unclear. My guess is that when we are asked two years from now to run our developments in distribution panel, we shall have an equal number of "on the other hands" from an equally distinguished panel.

We thank you all for being here, and I want to thank the panel for what I think was a superb job.

106. H.L. Moore Drug Exchange v. Eli Lilly & Co., 662 F.2d 935 (2d Cir. 1981), *cert. denied*, No. 81-2215 (Oct. 4, 1982).

APPENDIX A
OUTLINE OF REMARKS BY LAWRENCE I. FOX

INTRODUCTION

In a dealer termination case, if plaintiff has survived defendant's motion for summary judgment:

That means a genuine issue of fact exists as to the existence of an agreement.

The issue becomes: how plaintiff should proceed.

Must establish that restraint is unreasonable.

GTE may have created more problems than it solved. It preserved the distinctions between

(1) Price and non-price restraints.
(2) Horizontal/Vertical restraints.
(3) Extols the use of rule of reason, but doesn't say how it is to be applied.

Given a restraint, if price or horizontal it is per se unlawful and if non-price and vertical judged under the rule of reason the characterization of the restraint is extremely important and in most instances determinative of whether a plaintiff will prevail.

In this regard my remarks today will be focused on the following topics:

(1) WHAT ARGUMENTS SHOULD OUR HYPOTHETICAL PLAINTIFF ADVANCE IN SEEKING TO CATEGORIZE DEFENDANT'S CONDUCT AS PER SE UNLAWFUL AND WHAT ARE DEFENDANT'S RESPONSES TO SUCH EFFORTS.
(2) ASSUMING THAT A RULE OF REASON ANALYSIS IS APPLICABLE, WHAT TYPE OF EVIDENCE MAY BE INTRODUCED IN A RULE OF REASON CASE, AND WHO HAS THE BURDEN OF PROOF WITH REGARD TO DEMONSTRATING THE *INTRA*- AND *INTER*-BRAND COMPETITIVE EFFECTS OF THE RESTRAINT.
(3) FINALLY, UNDER A RULE OF REASON ANALYSIS, WHAT ECONOMIC CONSIDERATIONS SHOULD THE PLAINTIFF AND DEFENDANT ADDRESS IN THEIR ATTEMPTS TO PROVE THE *PRO*- AND *ANTI*-COMPETITIVE EFFECTS OF THE RESTRAINT.

I. *Characterization of Restraint*

Plaintiff should seek to have the court characterize the agreement as unlawful per se, by arguing that the restraint is either horizontal or if vertical, part of a resale price maintenance scheme.

Per Se Restraints defined: The court's scrutiny of the restraint will be limited to whether the unlawful agreement to impose the restraint exists, and there will be no inquiry regarding the power, purpose or business justifications for the restraint or the amount of commerce or competitive effects of the restraint.

A. *Horizontal*

1. *Horizontal Cartel* — Agreements between firms operating at the same level of distribution, performing similar economic

functions. *United States v. General Motors*, 384 U.S. 127 (1966); *see, e.g., United States v. Topco Associates, Inc.*, 405 U.S. 596 (1972). See *United States v. General Motors Corp.*, 384 U.S. 127 (1966); *Eastern States Retail Lumber Dealers Association v. United States*, 234 U.S. 600 (1914), or one whose purpose is to fix or stabilize prices. *Eiberger v. Sony Corp.*, 622 F.2d 1068 (2d Cir. 1980). *Eiberger* involved implementation of a warranty fee system which eliminated distributors' profits for extraterritorial sales in response to complaints by dealers of price-cutting by unauthorized dealers who were being supplied by outside distributors. The warranty fee was charged against a distributor automatically for extraterritorial sales and credited automatically to the authorized dealer in the resale territory regardless of whether service was performed.

2. *Dual Distributor* — If manufacturer/supplier is a dual distributor — an issue of characterization is presented: is the challenged restraint vertical or horizontal?

   a. Although cases decided before *Sylvania* found a dual distributors use of territorial or customer restrictions reduced or eliminated competition between supplier and customers and consequently per se illegal horizontal marked allocation, most courts since *Sylvania* have been willing to review such restraints under the rule of reason. The Second Circuit has recently made it clear that it will eschew the tyranny of tags and tickets and not characterize a restraint per se unlawful merely because it was imposed by a dual distributor.

      Copy Data Systems, Inc. v. Toshiba America, Inc. 1981-82 Trade Cas. ¶ 64,343 (2d Cir. 1981). In *Copy Data* the Court held that territorial restrictions imposed on Toshiba, a manufacturer of office copying equipment that also sold at wholesale in competition with its dealers, did not constitute a per se horizontal market division, but rather was subject to a rule of reason analysis. Rule of reason was appropriate because of potential for enhancing inter-brand competition. [New entrant, small market share, technologically sophisticated product, stiff inter-brand competition.]

   b. Recent decisions indicate that non-price restrictions imposed by dual distributors to promote interbrand competition will be deemed vertical.

      Donald B. Rice Tire Co. v. Michelin Tire Corp., 639 F.2d 15, 16 (4th Cir.), *cert. denied*, 102 S. Ct. 324 (1981) (restraint which "rebounds" "primarily to the benefit of the manufacturer as a result of increased interbrand competition . . . would be vertical and analyzed under the rule of reason").

      Red Diamond Supply, Inc. v. Liquid Carbonic Corp., 637

F.2d 1001, 1004-07 (5th Cir.), *cert. denied,* 102 S. Ct. 119 (1981) ("Since the allegation here is that Liquid imposed an agreement upon its distributors to abide by territorial and customer restrictions, that agreement is a vertical one, and the restrictions imposed are vertical restrictions. That Liquid also distributed some of its own goods does not alter the situation.")

Abadir & Co. v. First Mississippi Corp., 651 F.2d 422, 427 (5th Cir. 1981) ("A particular market-distributing agreement is treated as a vertical agreement if the party imposing the agreement has the potential economic advantages typically available to a supplier in a vertical market-distributing agreement.")

Westpoint Pepperell, Inc. v. Rea, 1980-2 Trade Cas. ¶ 63,341, at 75,742-45 (N.D. Cal. 1980) (rejecting the contention that a manufacturer's status as a dual distributor "*ipso facto* transforms an otherwise lawful exclusive distributorship agreement into a horizontal allocation of markets".)

However, it is important to note that price restrictions imposed by a dual distributor are likely still to be viewed as *per se* unlawful.

United States v. McKesson & Robbins, Inc., 351 U.S. 305 (1956).

Interphoto Corp. v. Minolta Corp., supra, 295 F. Supp. at 718 n.2 ("proof of the existence of unlawful resale price maintenance, where the manufacturer is also a distributor . . . makes the antitrust violation even more pernicious.")

Amway Corp., 93 F.T.C. 618 (1979) (contractual requirement to comply with a "sale and marketing plan" which specified resale prices).

Chock Full O'Nuts Corp., 83 F.T.C. 575 (1973) (unlawful to require franchisees to sell at same prices as company stores).

c. *In the matter of General Motors Corp.,* No. 9077 slip op. (June 25, 1982):

"As is usually the case in vertical restraint cases, complaint counsel alleged a horizontal conspiracy between GM and its franchised dealers to exclude IBS from distributing crash parts knowing that by proving a conspiracy the case would fall under the per se test. However, the Commission quickly disposed of this allegation. Findings that GM's only presence at the dealer level through its Motor Holding Division which financed a small number of GM dealers the FTC ruled that GM never exceeded 3 percent of the market. The FTC rejected the horizontal allegation by noting that in its crash parts distribution system, 'GM acted in its own self-interest, rather than at dealer behest.' "

B. *Vertical Restraints*

1. *Vertical price fixing illegal per se: Dr. Miles Medical Co. v. John Park & Sons*, (1911).

n.18:

"The per se illegality of price restriction has been established firmly for many years and involves significantly different questions of analysis and policy [than non-price restraints]."

Sylvania, 433 U.S. at 52 n.18: "resale price maintenance is not only designed to but almost invariably does in fact, reduce price competition not only *among* sellers of the affected product, but quite as much between that product and competing brands."

See also California Retail Liquor Dealers Association v. Midcal Aluminum, 1980-1 Trade Cas. (CCH) ¶ 63,201 (1980) where the court held that California's law giving producers a right to fix their wholesalers' prices was unlawful resale price maintenance and not immune by the state action doctrine.

"Such vertical controls [by the wine producers] destroys horizontal competition as if the wholesalers formed a combination and endeavored to establish the restriction with each other."

Further, the Court's decisions in *National Soc'y of Prof. Eng'rs v. United States, 435 U.S. 679* (1978), *Arizona v. Maricopa,* and *Catalano Inc. v. Target Sales,* 446 U.S. 643 (1980) although involving horizontal price fixing, made it clear that the Court is not likely, at least in the near term, to accept economic arguments addressing the potential pro-competitive effects which may result from vertical price restrictions.

3. What is a "price" restraint (v. "non-price")?
   a. Not every restraint that affects price is a "price restraint."
   b. There is no clear-cut dichotomy between these "categories." *See, e.g., Eastern Scientific Co. v. Wild Heerbrugg Instruments,* 1978-1 Trade Cas. ¶ 61,926, wherein the First Circuit *rejected* the contention of a terminated scientific equipment dealer that a supplier-imposed restriction that sales outside of its assigned territory not be below the list price, was a resale price restriction, and therefore a per se violation of § 1 of the Sherman Act. Instead, the Court reasoned that the supplier's policy was no more anticompetitive than a pure territorial restriction and it should therefore be analyzed under the rule of reason.

c. "NON-price" restraints typically involve:
   (1) territorial restraints
   (2) customer restraints
   (3) location restraints
   (4) area of primary responsibility
   (5) profit pass-overs
   (6) sales quotas
   (7) requirements governing methods of doing business: hours of operation; physical lay-out.

   Even if restraint is non-price; if it's used to enforce a price restraint, it will be illegal per se — *Eiberger v. Sony Corp.*, 692 F.2d 1068 (2d Cir. 1980).

II. *The Rule of Reason*

A. Standard Rule To Be Applied: If plaintiff fails to convince the court to characterize the challenged agreement as illegal per se, the rule of reason is invoked. *Standard Oil Co. v. United States*, 221 U.S. 1 (1911). Considering all relevant facts do procompetitive effectives outweigh anticompetitive effects?

B. Statement of the rule of reason: The court analyzes "whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraints were imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained — all are relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of the intent may help the court to interpret facts and to predict consequences." *Chicago Board of Trade v. United States*, 246 U.S. 231, 238 (1918).

   1. *GTE* departure from the Rule of Reason must be based upon demonstrable economic effects.

      Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. at 51-57 (analysis of non-price vertical restrictions under the rule of reason requires a balancing of effects of intrabrand competition with effects on interbrand competition).

C. Implementation of the rule: Vague rule still remains ill-defined. In *Sylvania* the Court merely quoted the factors mentioned in *Chicago Board of Trade* without indicating what priority or weight should be accorded each factor. What the court did make clear, however, is that it is insufficient to merely show that a restraint has a negative impact on intrabrand competition. To establish a restraint is unreasonable it is necessary to establish its impact on overall competition in a particular industry.

1. Recent Commentary on the Rule of Reason
   a. Pitofsky, *The Sylvania Case: Antitrust Analysis of Non-Price Vertical Restraints*, 78 Colum. L. Rev. 1,34 (1978) ("There is no existing analytical framework for applying a rule of reason generally, and certainly none for applying it to non-price vertical restraints. The technique of the *Sylvania* majority — quoting a long list of factors without any indication of priority or weight to be accorded to each factor — unfortunately is standard operating procedure.").
   b. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. Chi. L. Rev. 6, 8 (1981) ("the Rule of Reason standard lacks content and so does not provide guidance . . . [T]he idea of balancing the (assumed to be anticompetitive) effects of the restriction on intrabrand competition with the (assumed to be procompetitive) effects of the restriction on interbrand competition — which is the closest thing to a concrete suggestion in *Sylvania* as to how to apply the Rule of Reason in restricted-distribution cases — is infeasible and unsound").

D. Type of Evidence To Be Considered in Rule of Reason Case
   1. *National Soc'y of Prof. Eng'rs v. United States*, 435 U.S. 679, 688 (1978) ("Contary to its name, the Rule does not open the field of antitrust inquiry to any argument in favor of a challenged restraint that may fall within the realm of reason. Instead, it focuses directly on the challenged restraint's impact on competitive conditions"; "the purpose of the [rule of reason] analysis is to form a judgment about the competitive significance of the restraint.")
   2. In the past few years cases have begun to address the competitive considerations which *GTE* required. The cases have begun to discuss, directly and indirectly, the effect of the restraint on price, production levels and product quality, and recognize the importance of service competition.

      Before addressing the economic evidence relevant to assessing whether a restraint tends to impair or promote competition, one must discuss the issue under the rule of reason of whose burden it is to demonstrate the competitive effects of a restraint.

III. What Is Each Party's Burden With Respect to Proving an Effect — Either Pro-Competitive or Anti-Competitive — on Inter-Brand Competition
   A. Must a plaintiff demonstrate both the reduction of intra- and inter-brand competition?

1. In September 1982, the Ninth Circuit in affirming on remand a summary judgment for *GTE Sylvania* stated:

   "Continental is wrong in its assertion that once it had proved the existence of a vertical restraint on trade — the location restriction in Sylvania's dealer contracts — the burden shifted to Sylvania to prove the restriction reasonable. The burden was Continental's to prove it unreasonable as part of its case in chief."

2. In the matter of *Beltone Electronics Corp.*, July 6, 1982 DK 8928 hearing aid manufacturer imposed non-price vertical restraint on its dealers:

   a. Sell Beltone products exclusively
   b. Sell such products only when assigned geographic territories
   c. Not sell Beltone to unauthorized dealers

   "It is not sufficient for a party challenging a vertical restraint to show only a resultant loss of intrabrand competition. Rather, current judicial precedent indicates that the party must show that the restraint also has a probable adverse effect on interbrand competition.

   Complaint dismissed because no showing of negative interbrand impact.

3. *Valley Liquors v. Renfield Importers:*
   In any event, the suggestion that proof of a reduction in intrabrand competition creates a presumption of illegality is inconsistent with the test that the courts apply in restricted distribution cases . . . And it is not generally true of balancing tests that the plaintiff, in order to make out a *prima facie* case, has only to show that if you put something on his side of the empty balance the balance will tilt his way. The plaintiff in a restricted distribution case must show that the restriction he is complaining of was unreasonable because, weighing effects on both intrabrand and interbrand competition, it made consumers worse off. (See what happens to output, price, timeshare.)

4. *Eiberger v. Sony Corp. of America* 1980-2 Trade Cas. ¶ 63, 328 (2d Cir. 1980) — violation could be based solely on finding adverse effect on intrabrand competition.

   The Court of Appeals in *Eiberger* stated:

   "Unless we are to conclude that an anti-competitive impact on intra-brand competition cannot alone support a finding that section one has been violated — and we see no basis for such a conclusion, [citing *Sylvania*] . . . — we must conclude that ABP has proven such a violation here."

   But see Borger v. Yamaha Int'l Corp., 1980-2 Trade Cas.

(CCH) ¶ 63, 373 (2d Cir. 1980), Court held that liability could not be based solely on reduction of intrabrand competition but required an examination of whether the restraint had an effect on interbrand competition.

5. In *Schwimmer v. Sony Corp.*, 1980-81 Trade Cas. ¶ 63,580 at 77,103 District Judge Nickerson citing the Second Circuit's *Eiberger* and *Yamaha* opinions stated that:

   "While it is improper to instruct a jury that it can find liability under section 1 without consideration of the effect of the alleged conspiracy on the market as a whole, citing *Borger v. Yamaha International Corp.*, 1980-2 Trade Cas. ¶ 63,373 (2d Cir. 1980), this does not mean that only conspiracies and restraint of inter-brand competition are illegal. Rather, all that is required is that the potential offsetting benefits to inter-brand competition must be *considered* in determining whether particular restraint on intra-brand competition is prohibited. *Where offsetting benefits are not shown, restraints on intra-brand competition alone are sufficient to constitute a violation of Section 1* of the Sherman Act". (Citing Eiberger v. Sony Corp., 622 F.2d 1068, 1081 (2d Cir. 1980).

   The Second Circuit later reversed *Schwimmer* on other grounds and did not address this aspect of Judge Nickerson's decision.

   Thus, *Schwimmer* and *Eiberger* would appear to suggest that in the Second Circuit a plaintiff may be able to sustain its burden by merely showing a reduction in intra-brand competition provided, however, that some consideration has been given to the effects of the restraint on inter-brand competition.

B. Can Plaintiff Shift the Burden of Showing Positive Inter-Brand Effect to Defendant with Substantial Market Power?

   In short, the answer appears to be no.

   1. In *Cowley v. Braden Industries, Inc.*, 613 F.2d 751 (9th Cir. 1980) the plaintiff argued that Aeromotor, the subsidiary of Braden Industries, had 70-80% of the national market for windmills, as well as 70-80% of the Arizona and Colorado market, the market in which the plaintiff did business. The court rejected the plaintiff's argument that the defendant should bear the burden of proving positive inter-brand effects concluding that the plaintiff had the burden of showing both reduction in inter- and intra-brand competition.

C. What Must Plaintiff Do to Prove the Restraint on Intrabrand Competition?

   1. It would seem that the existence of the restraint itself should

satisfy the requirement, *see GTE* on remand. But this may not be the case, see *Valley Liquors v. Renfield Importers.* (Cannot equate elimination of intrabrand price competition with elimination of intrabrand competition. Absent a showing by plaintiff that defendant has market power, presumption arises that vertical restraint has no negative impact on interbrand competition.) *See also JBL v. Shirmack* where summary judgment granted to defendant because it's had small market share.

2. *Newberry v. Washington Post Co.*, 438 F. Supp. 470 (D.D.C. 1977). Intrabrand restraint with neutral effect on interbrand not unreasonable.

   Here, a vertical territorial (i.e., non-price) restraint, which reduced intrabrand competition, was found to be reasonable, where there was apparently no effect on *inter*brand competition (the supplier was a monopolist).

   Rationale — territorial restraint promoted efficiency and therefore created the potential for enhancing interbrand competition (should it arise in the future).

   But see National Society of Professional Engineers v. United States, 435 U.S. 679 (1978) which suggests that it is the defendant who must justify, under the rule of reason, the challenged restraint (the association's canon of ethics prohibited competitive bidding by its members).

D. Economic Factors to be Considered in Performing Rule of Reason Balancing Test

   1. When analyzing a non-price vertical restraint, consideration should be given to (1) the nature of the market in which the supplier and dealer operate, (2) the nature of the product involved, (3) the nature of the supplier imposing the restraint and (4) the nature of the restraint itself.

IV. Economic factors identified as significant in a Rule of Reason analysis of a vertical, non-price restraint.

   A. *The nature of the market in which the supplier and dealer operate at the time the restraint adopted and at the time it was enforced.*

   1. *MK Definition*

      GTE: "an antitrust policy divorced from market considerations would lack any objective benchmarks" thus, "relevant product and geographic markets must be defined to provide context within which to assess the competitive effect of a restraint."

      a. *Product MK:* All products which are reasonably interchangeable considering price, use and quality; cross-elasticity and demand; products which are reasonable substitutes.

b. *Geog. MK:* MK area in which seller operates and to which buyer can practicably turn for supplies (consider transportation costs and buyers need for immediate service).

c. *Submarkets:* If product has
   (1) public recognition as separate economic entity
   (2) peculiar characteristics
   (3) distinct uses
   (4) distinct customers
   (5) unique production facilities
   (6) specialized vendors

2. *Structure of the MK*
   a. Number and size of firms in the industry
   b. Market share of each firm:
      (1) concentrated MK — few firms with substantial % of sales.
         (a) the greater the concentration the greater the likelihood that an intrabrand restraint would adversely effect interbrand competition.
      (2) unconcentrated.

3. *Performance of the Market*
   a. Have there been new entrants?
   b. Are there barriers to entry?
   c. Have companies failed in the industry?
   d. Do market shares shift among industry members; if so it shows existence of effective interbrand competition. Have small companies grown larger and large companies smaller?
   e. Have price levels remained stable over a long period of time; if so, this may show lack of competitive rigor.
   f. Is market growing and subject to proliferation of new brands and products (consumer electronics); if so, need for efficient distribution is high, and likely negative effect on interbrand competition by intrabrand restraint is law.

B. *Nature of the Product Involved*

1. *Differentiation*
   a. The focus should be on the extent to which the product at issue has successfully differentiated itself from others in the industry because the greater the differentiation, the more likely that interbrand competition will be restrained.
   b. Product differentiation refers to the perception of con-

sumers that a particular brand of product is not readily interchangeable with its competitors.

c. One of the most important guides to this phenomenon is a lack of cross-elasticity of demand between Brand X and the others, i.e., sale of Brand X will be unaffected by price reduction on competitors' brands.

d. The potential bases for product differentiation include: styling, package design, warranty(ies), point-of-sale service, e.g., the sales people are well-informed, and most frequently, advertising —

(1) look at the level of advertising
(2) look at the reasons for it

e. Another indicator of the extent to which the product has been successfully differentiated, and thus sheltered from interbrand price competition, is the extent to which it is consistently priced at higher levels than its competitors.

(1) Look at the extent to which distributors and dealers find it necessary to engage in off-price promotion — to the extent that they do, that would indicate a lack of product differentiation.

(2) Also consider the responsiveness of sales of the brand in question to lower list prices of competing brands or sales by competing brands.

(3) Further, it is helpful to compare the profit margin of the supplier imposing the restraint to those of other brands in the same market.

f. Another highly important fact is the degree of technological sophistication of the product and whether the industry is one in which new innovations occur swiftly. In such situations, product differentiation will necessarily be fleeting in nature, and unlikely to have any long-range impact on the competitive structure of the industry.

2. *New Product*

3. *Technical Product:* Is the product one which requires advertising of an information nature or point-of-sale or post-sale servicing? If so, vertical non-price restraints may be needed to insure distributors perform such services.

4. *Health & Safety:* Is the product one which carries a risk of consumer injury if used in the intended fashion? (Tires, *Rice v. Michelin Tire;* Drugs and Cosmetics, *JBL v. Shirmack, Clairol;* Sports Equipment, *Sports Center v. Riddell*).

C. *Nature of the Supplier*

1. If *new entrant or failing company* unlikely that any vertical restraint will adversely effect interbrand competition.

2. If supplier has *large share* of *relevant market* more likely intrabrand restraint will adversely effect interbrand market.

3. If established supplier is *launching a new product* — may be treated as a new entrant.

4. History of the supplier's market shares relative to other industry members; if constant, defendant may argue that restraint needed to increase market share.

D. *Nature of the Restraint*

1. What is the nature of the restraint(s) imposed: customer, areas of primary responsibility, profit pass-overs, sales quotes, or requirements as to how business is to be conducted.

2. Whether more than one such restraint was imposed. [See *GTE Sylvania* on remand where court specifically noted that case didn't involve outright restrictions nor did defendant impose exclusive dealer restraint as well as location clause.]

3. The scope of the restraint, e.g., is the territory restriction "airtight," or is there a loophole allowing it to be circumvented?

4. The duration of the restraint is also a factor to consider — if implemented at a time when defendant needed MK penetration, he may not be permitted to continue the restraint after goal is achieved.

5. *Purpose of the restraint*

   a. Do others in the industry impose similar restrictions? If so, it increases chances of cartelization.

   b. What was the sourse for institution of the restraint, i.e., was it the manufacturer, or was it suggested by one or more dealers/distributors. See *Munters v. Burgess Industries.*

6. Analysis of whether the restraint is of the type designed to achieve its ostensible purpose.

7. Whether the restraint imposed was the least restrictive alternative. Is restraint "reasonably necessary" to attainment of legitimate purpose. *GTE* specifically said that restraint need not be least restrictive form to achieve end. But see *Chicago Bd of Trade* language re: where suggests the ends and means must be related. No court has held that the existence of a lesser restraint will result in restraint being found unreasonable.

V. *Defendant's Arguments in Favor of Non-Price Vertical Restraints*

A variety of justifications could be offered.

Vertical restrictions encourage distributors to (1) engage in promotion, (2) to handle new products, (3) to maximize market penetration, (4) to protect product quality, and (5) to stimulate distributor investment.

Rather than discuss every potential justification for imposing such non-price restraints, I will instead focus on those most frquently cited as justifications.

A. Defendant's Justifications, i.e., Statements of Procompetitive Effects of Vertical Restrictions on Interbrand Competition

1. *Enhancement of Non-Price Competition*

a. This is the most frequently cited reason for the imposition of vertical non-price restraints.

b. This argument assumes that if dealers are protected from intrabrand price competition they will compete on the basis of promotion and service.

c. Thus, if their prices are higher after the restraint is imposed, they will invest the extra margin into promotion services. The higher profit margin serves as an incentive to the dealers, in theory, to do things such as — engaging in pre-sale and point-of-sale promotion; training their sales people to provide point-of-sale services; providing post-sale warranty service.

d. There are two rationales underlying this argument:

(1) If intrabrand price competition is reduced or eliminated dealers will *have to* compete on the bases of service in order to protect their respective market shares.

(2) More importantly, the imposition of such restraint will sharply curtail the inefficiencies created by "free riders" and "cream skimmers" — dealers who will not invest their own money in a product but rather who sell at lower prices and thus, take a free ride on the promotional efforts of others. They create intrabrand price competition and they simultaneously reduce interbrand competition by creating inefficiency in a manufacturer's distribution chain.

E.g., Davis-Watkins Co. v. Service Merchandise, 1982-2 Trade Cas. (CCH) ¶ 64,901 (6th Cir. 1982). (Customer and territorial restraints/Judgment for defendant-supplier following jury verdict affirmed)

This action was brought by a discount catalog retailer when Amana, the manufacturer of microwave ovens, instituted various restrictions which prevented the discounter, Service Merchandise, from continuing to sell Amana microwave ovens.

Central to the court's analysis of the reasonableness of the restraints imposed was the conflict in marketing strategies between Amana and its customer — Service Merchandise.

The former wished its dealers to provide pre-sale, point-of-sale and post-sale services: advertisements, displays, maintaining the entire line in stock, in-store demonstrations, cooking instructions, trained sales people, warranty servicing, etc.

The latter provided no services.

Thus, this case presents a classic illustration of a court recognition of the "free rider" problem as warranting imposition of product allocations and vertical and customer restrictions.

And *see Meunster Butane, Inc. v. Stewart Co.*, 651 F.2d 292 (5th Cir. 1981) (location clause/judgment for p laintiff distributor following jury verdict revised and judgment rendered for defendant supplier)

Plaintiff Meunster Butane was an authorized franchised dealer in Zenith television sets in Meunster, Texas. Defendant Stewart was the wholesaler for Zenith in a large area of Texas which included plaintiff's assigned territory.

Plaintiff began selling into Gainsville, Texas which was outside of its assigned territory, and engaged in fierce price competition with Heffley, a dealer in Gainsville.

This caused Heffley to discontinue advertising, since plaintiff had used Heffley's advertised prices in ads of its own to demonstrate that its prices were lower.

Ultimately, plaintiff was terminated.

Clearly, plaintiff's "free riding" on Heffley TV's promotional efforts was inefficient, as both ceased advertising Zenith and also added other brands to their lines. *Note:* Fierce interbrand competition existed in the TV market.

And *see Donald Rice v. Michelin Tire Corp.*, 638F.2d 15 (4th Cir.), *cert. denied,* 102 S. Ct. 324 (1981) (Customer and territorial restraints/Judgment for defendant-supplier after bench trial affirmed).

In this case, the defendant manufacturers imposed customers restrictions, which were shown to be necessary to prevent free riding by retailers on the services provided by other dealers.

Plaintiff's sales volume made it one of the largest Michelin dealers in the country, but its promotional efforts were far from commensurate with its sale volume.

2. *New Product Development or New Market Entrant*
   a. Vertical, non-price restraints can enhance interbrand competition by allowing a new manufacturer to enter a market.
   b. Without some protection from intrabrand price competition, dealers would otherwise be reluctant to invest in promotional efforts necessary to help the new entrant establish a market presence.
   c. The same rationale applies to the situation where an established manufacturer seeks to introduce a new product (line).
      (1) But *see Rice v. Michelin*, where this rationale was rejected by a Maryland District Court.

      The court therein reasoned that the quality of Michelin's tires had given it a positive reputation which resulted in dealers' desires to carry the line. In fact many dealers wanting the line were unable to get it.

      The court also cited the Pitofsky view that manufacturer-imposed vertical restraints may be indistinguishable from those imposed to implement dealer cartels.

      It upheld reasonableness on "free rider" concept.

      (2) And *Munters Corp. v. Burgess Industries Inc.*, 450 F. Supp. 1196 (S.D.N.Y. 1978), where the District Court for New York's Southern District also rejected the market penetration rationale.

      The plaintiffs in that case were dealers in gas turbine coolers.

      The defendant was the manufacturer of a patented product (fill) used in making such coolers.

      Plaintiff Buffalo was granted an exclusive license for the fill.

      The court noted that the initiative for the restraint came from the licensee, *not* the licensor.

      Further, it was debatable whether Buffalo required an exclusive license in order to handle the product.

      And another firm might well have tried to exploit the new product without exclusivity.

3. *Maximizing Market Penetration*
   a. Frequently, manufacturers argue that vertically imposed

geographical limitations provide dealers with an incentive to serve low volume, less profitable accounts which would be ignored if dealers were all free to pursue any accounts.

b. In theory, consumers will benefit from greater market penetration, for the general purpose of the antitrust laws is to enhance consumer welfare through production and distributional efficiency.

c. Further, if more retailers promote the product in question, overall interbrand price competition should be stimulated.

d. In assessing the validity of this rationale, one must analyze the degree of market penetration both prior to imposition of the restraint and subsequent to it.

See The Sports Center, Inc. v. Riddell, Inc.

In this case, one defendant, Riddell, was a manufacturer of sports equipment.

The other defendant was a distributor in the same territory as plaintiff Sports Center. The restraint at issue was a prohibition of dealers sales to anyone but ultimate consumers. (Anti-wholesaling or anti-transshipping).

Plaintiff's termination occurred when the distributor defenant reported plaintiff's unauthorized sales.

Defendant manufacturer argued that its restraint was intended to improve its competitive position in the market.

Key to the court's determination that the restraint was reasonable was the fact that although it was enforced by competitors of plaintiff, it originated with the manufacturer.

4. *Control the Manner in Which the Products are Sold and Serviced in Order to Maintain the Safety and Quality of the Products*

This category of justification for vertical, non-price restraints is frequently successful.

See Clairol, Inc. v. Boston Discount Center of Berkley, Inc.

Plaintiff Clairol manufactures hair coloring and distributes it in two ways — through salons and at the retail level. Defendant was a retail pharmacy which sought to distribute Clairol's "salon" products at retail.

Since the two lines consisted of very different formulae, the actions of defendant created a serious risk of consumer injury and so the Sixth Circuit granted plaintiff Clairol's request for injunctive relief against such unauthorized sales; state statutes also required product to be properly labelled.

Sports Center v. Riddell — possible product liability from sale of sports equipment resulted in reasonableness of supplier's anti-bootlegging policy re no-wholesaling.

5. *Distributional Efficiency*

   a. Another justification for vertical, non-price restraints is to maximize efficiency by avoiding the duplication of sales efforts.

   b. This argument is particularly appropriate to service industries: milk, laundry and newspaper delivery.

   See Newberry v. Washington Post Co.

   The defendant produces the sole morning newspaper in metropolitan Washington, D.C.

   The plaintiffs were 14 newspaper distributors who sued over defendant's territorial distribution restrictions.

   The court reasoned that the exclusive territories encouraged by The Post were the result of natural monopolies.

   They encouraged maximal efficiency within a territory by discouraging duplication of efforts.

   The system in dispute was not the only one possible, or even the least restrictive alternative, but then, that is not required under *Sylvania*.

VI. Suggestions

A. Plaintiff must develop economic theory of case showing both negative intra and interbrand effects from defendant's vertical restraint, so consult economist early in case to assist in market definition.

B. Defendant, if changing distribution policy should consider seeking declaratory judgment in a favorable forum as to lawfulness of vertical restraint.

C. Plaintiff may wish to file a motion in limine to ascertain in advance of trial the court's view of whether the restraint in question is within the per se category, assuming, of course, an agreement is established.

VII. Conclusions

In almost every challenge to a non-pricing vertical restraint since *Sylvania* the restraint has been upheld. Given this track record it appears that absent a showing that a restraint was imposed as part of a dealer cartel or a price fixing scheme, courts will continue to uphold such resale restraints.

Chapter 3

Workshop II: The Implications of Deregulation on Antitrust and Exemptions

Paul R. Koepff
Harry First
Sidney R. Rosdeitcher
John H. Shenefield

MR. PAUL R. KOEPFF: To those of you who attended this morning's session, we tried to structure this afternoon's session to follow up on the debate between Paul MacAvoy and Fred Kahn on the implications of deregulation. Our discussion will focus on the availability of antitrust exemptions.

I would like to announce that our Exemptions Committee of the Antitrust Section is working on a rather extensive report. I expect that it will be out in the near future. Steve Axinn must review it. What it will do is examine the major express and implied antitrust exemptions such as the maritime exemption and the insurance exemption. The report will evaluate and analyze the major developments (judicial and legislative), and then it examines further some of the regulated industries and evaluates what has gone on in terms of whether or not any of the antitrust exemptions are still available.

Before I introduce my panelists, I guess the theme in the antitrust exemption area is about the same as it has been for the last two or three years. There are no surprises from 1982. Exemptions are becoming less and less available. Courts are still evidencing hostility towards them, and they analyze arguments that exemptions are available with scrutiny.

When you go to an industry that is being deregulated, the argument for an antitrust exemption is that much farther up the hill. I know Harry First will talk in that area quite a bit. He is one of the leading experts in this area. He teaches a course on regulated industries and antitrust at New York University Law School. Professor First is coming out with a two volume text. The first volume, I think, is called "Free Enterprise and Economic Organizations: Antitrust," and the second volume is "Free Enterprise and Economic Organizations: Government Regulation," and that is coming out shortly. I know the Davis Polk library is going to buy at least one set, and I would recommend that everyone else do the same.

Our other panelist is Sidney Rosdeitcher who in the exemptions field is one of the most well known practitioners. He has argued many cases in front of the United States Supreme Court. Amicus and otherwise, his briefs are just a joy to read. If you are on the side of an exemption, he has been there most recently with the *Pireno* case.[1]

John Shenefield was the leader of the presidential commission that evaluated the antitrust laws. I recommend that you read the section in that report on antitrust exemptions because I think it is a good indicator of what is happening. The reevaluation of antitrust exemptions has been

1. Union Labor Life Ins. Co. v. Pireno, 102 S. Ct. 3002 (1982).

going on and will continue to go on with the result that they will be less and less available.

With those introductory remarks, let me have Professor First take over.

PROFESSOR HARRY FIRST: The topic of today's panel discussion is the impact of deregulation on antitrust exemptions. I have been asked to talk about exemptions in the following areas: transportation, maritime, Capper-Volstead and labor. Before exploring some of the specifics of each of these areas, however, I would like to take advantage of my position as the first speaker by suggesting some general themes which I think are likely to be reflected in the remarks of my co-panelists.

I will state these general themes in the form of three propositions:

1. What we are witnessing today is not, at heart, a "deregulation" movement. It is an "unregulation" movement. Its philosophy, at other times in history, has been termed "laissez-faire" and "social Darwinism." This movement objects to any government control of business behavior, be it control by a regulatory agency or by the courts enforcing the antitrust laws.
2. When a court is faced with a choice between applying the antitrust laws or exempting the conduct in question from the antitrust laws, courts will most often (but not always) choose the antitrust rule.
3. My third proposition is a seeming paradox. The result of 1 and 2 is less antitrust enforcement. This will take two forms — fewer antitrust cases will be brought or won; courts will continue to shed the traditional antitrust concern with large firms and concentrated economic power. In a period of unregulation, courts are not ultimately over-receptive to antitrust liability.

Since my co-panelists and I have not colluded with respect to the content of our remarks, I put the challenge to all of you to listen to what each of us has to say to see whether my three propositions are borne out. Have we really entered a period of unregulation? Are courts invariably choosing the antitrust rule? Will the result be less antitrust enforcement? First, of course, let me try to advance these propositions with regard to the industries I have been assigned.

The first is transportation. The major transportation industries — rail carriage, motor carriage and air transportation — are, of course, the primary beneficiaries of legislative deregulation. With regard to railroads, the Railroad Revitalization and Regulatory Reform Act of 1976 and the Staggers Rail Act of 1980 both significantly weakened the ICC's authority to control railroad pricing. Among the major changes were: "reasonable" minimum rates are required for all carriers, but rates are conclusively presumed reasonable if they exceed the variable costs of the service; there is no maximum rate regulation for carriers who lack "market dominance" (i.e., when there is "effective competition" for the transportation from other railroads or other modes of transportation); even with market dominance, railroads are allowed a "zone of rate flexibility" for rate increases, and the burden of proving a rate unreasonable shifts to the shipper attacking it if the rate is within this zone. In addition, the Staggers Rail Act also eased restrictions on abandonments and allowed railroads to enter into long-term contracts with shippers. The purpose of all of this legislation, said Congress, was "to allow, to the maximum extent possible, competition and demand for services to establish reasonable rates for transportation by rail."

Motor carriage regulation was also significantly reduced, in some way more fundamentally than with regard to the railroads. Entry regulation has been substantially eased, but not ended since there is still a requirement that the service proposed "will serve a useful public purpose, responsive to a public demand or need." Like the railroads, motor carriers have been given increased freedom from government supervision of rates; the Motor Carrier Act of 1980 established a "zone of ratemaking freedom" within which carriers could lower or raise rates 10 percent a year without ICC approval.

Finally, the most sweeping deregulation has come in the airline industry. After a period of transition rules, easing restrictions on pricing and entry, the airlines find themselves in a legal environment in which a certificate of public convenience and necessity is no longer required to enter routes within the United States, and carriers are no longer regulated with regard to rates. Thus the airlines, at least with regard to domestic routes, have truly been placed within the "free enterprise" sector of our economy.

Now, what of my three propositions? There are two areas in which to test the propositions — rates and mergers. With regard to rates, at least for railroads and motor carriers, the major action has been focused on rate bureaus. These rate bureaus have essentially been the mechanism for the carriers to join together as a cartel and fix prices. They were legalized in 1948 in the Reed Bulwinkle Act, passed in response to the Supreme Court's decision in *Georgia v. Pennsylvania Railroad.*[2] Both the Staggers Act of 1980 and the Motor Carrier Act of 1980 have taken some steps to cut back on the antitrust immunity granted to rate bureaus under the 1948 Act. For railroads, the Act removes antitrust immunity with regard to discussions and votes on single-line rates and restricts discussions of joint rates to carriers which participate in the movement. With regard to motor carriers, no single-line rates may be discussed after January 1, 1984, if the rate bureau is to retain antitrust immunity. Further study of rate bureaus is also mandated.

The movement to strip away the antitrust immunity for certain rate-setting agreements is, of course, perfectly consistent with our traditional view of "deregulation" — a policy of moving industries out of the regulated sector into the antitrust sector. This seems to cut against my proposition 1; but the tentativeness of Congressional movement, particularly with regard to motor carriage, lends support to "unregulation" — there is neither full government control nor antitrust control. I should conclude

2. 324 U.S. 439 (1945).

here by adding that there has been some recent litigation attacking rate bureaus formed under state legislative mandates and the results support my proposition 2. The case to note in this regard is *United States v. Southern Motor Carrier Rate Conference,*[3] a decision of the Fifth Circuit in 1982, in which the court of appeals found that these rate bureaus not only were subject to the Sherman Act, but that their rate setting function constituted per se unlawful price-fixing.

What I have described to this point with regard to a growing legislative and judicial hostility toward rate bureaus mainly supports my second proposition — given a choice, the antitrust rule will be opted for. Examination of legislative and, this time, administrative attitudes with regard to mergers, though, supports propositions one and three. Congress, when it passed deregulatory legislation for railroads made some changes with regard to the standard for approving mergers. The changes, basically, were designed to speed smaller mergers and allow more ready approval of such smaller mergers and non-merger transactions. Mergers involving Class I railroads, however, were basically unaffected. As for motor carriers, Congress made no change with regard to the standard of "public interest" for approving such mergers. With airlines, on the other hand, Congress did make some significant statutory changes, cutting back the antitrust immunity for merger approvals and emphasizing a Clayton Act standard for evaluating mergers.

The net effect of all these changes, however, has not been an increased antitrust vigilance with regard to mergers in transportation. Rather, what we are witnessing, particularly with regard to the ICC, is an encouragement of mergers. The ICC has recently approved a number of large mergers — the Southern, Norfolk & Western Railways, covering 18,000 miles in 22 states, and the merger of the Union Pacific, Western Pacific and Missouri Pacific to create the third-largest railroad system in terms of route miles and first largest in terms of revenues. What is significant about these decisions, I think, is the ICC's emphasis on rationalization and restructuring of rail systems so that we will be left with only a few large systems, hopefully competing against each other.

As for motor carrier mergers, in one of the first decisions under the new Motor Carrier Act the Commission emphasized the Act's policy to encourage entry. But instead of forbidding the merger and thereby encouraging each of the partners to invade the hitherto protected markets of the other, the Commission approved the merger and created the eighth largest trucking company in the United States. Parenthetically, less than one year later, the merged firm (Spector-Red Ball) filed for protection under Chapter 11.

Finally, with regard to airlines, the CAB's record does not look much different from the ICC's. Although mergers have not been sought on the grand scale of the railroad mergers — perhaps because of the ill-fated Pan Am-National merger — the CAB has been willing to approve the mergers for which approval has been sought. The latest economic theories — in

3. 467 F.Supp. 471 (N.D. Ga. 1979).

this case, the theory that where airline routes are "instantly" contestable, airline routes with even just one firm should not be considered non-competitive — have been employed. Thus, for example, in the *Continental-Western Merger Case,* which had been tentatively disapproved by the CAB in 1979 but subsequently approved in 1981, the Board noted that it takes a "functional approach" to mergers instead of the "more traditional market share analysis" because the "mobility of airline resources" allows firms that do not serve particular city-pairs to ensure competitive performance on those routes. Higher concentration, says the Board, does not necessarily mean a reduction in competition. The likely effect of such a functional approach, of course, is to allow most airline mergers to go forward unhindered since it is hard to conceive of any airline route not potentially enterable, particularly given the surplus of used aircraft currently available in the United States.

I note, however, that the views of the CAB with regard to airline mergers are now somewhat "academic," if you will pardon using this term as a pejorative. The jurisdiction to approve mergers, and immunize them from antitrust, was transferred to the Department of Justice on January 1, 1983. It remains to be seen whether the Department will take a dimmer view of airline mergers if any are presented to it. I would point you in the direction of the Department's analytical process for defining product markets, which I think favors the continuation of the contestability theory.

My quick tour through mergers in the transportation industry, exempt from the antitrust laws upon approval, illustrates the strength of the unregulation movement and the trend toward less antitrust enforcement in the traditional sense. Consolidations are being approved under the banner of rationalizing our transportation system and investments and reducing excess capacity. It is assumed, I think, that large firms will be better competitors, more efficient in their operations. It is assumed that intermodal competition, or potential competition, or competition among the few, will be adequate.

Moving on to my second assigned area, maritime, I would suggest that we can again observe support for my three propositions.

Here we have a somewhat different situation from the other transportation areas, at least on its face. The regulatory statute, the Shipping Act of 1916, comes closer to the model of legalized cartels than either the Interstate Commerce Act or the Federal Aviation Act, providing, basically, for federal oversight of agreements entered into by members of ocean shipping conferences. Thus, the Federal Maritime Commission's role has been one of reviewing the terms of conference agreements, and conferring antitrust immunity on those agreements which it approves.

This Act has always seemed particularly obnoxious to traditional antitrust enforcers, and there have been frequent skirmishes through the years over the question whether given anti-competitive practices had actually been incorporated in approved conference agreements. As a general matter, plaintiffs have been fairly successful in convincing the courts either to apply the antitrust laws to such disputed conduct, or to interpret the Shipping Act in a way which would foster competition (e.g., *Isbrandsten,*[4] *Carnation*[5]). This movement reached its high point, perhaps, when indictments were handed down in 1979 against several European shipping companies and 13 executives for fixing freight rates on container shipments. Several of the corporations paid one million dollars each in fines; each of the executives was find $50,000. Following the litigation, more than 30 private class actions were filed; by 1982, this litigation was settled for over fifty million dollars.

This little history seems to be consistent with the approach taken toward rate conferences, that is, rate bureaus, in rail and motor carriage. But the history after the ocean shipping litigation actually bears out propositions one and three. There has been no effort in this area to deregulate. Instead, efforts were made in the past Congress to expand the scope of antitrust immunity given to conference agreements. This legislation was supported by the Reagan administration, although not by the Justice Department, and a version of it passed the House. The Justice Department, while not supporting such legislative efforts, has not maintained its previous high profile in this area, endeavoring instead to patch up differences with our trading partners who had been extremely upset over the application of United States antitrust law to foreign shipping countries. For maritime, therefore, the shift legislatively is to one and three — unregulation and no antitrust.

My third and fourth areas, Capper-Volstead and labor, can be discussed together, for they both support proposition two — courts will most often choose the antitrust rule.

The Capper-Volstead Act, passed in 1922, gives an immunity to persons engaged in the production of agricultural products to form cooperative associations to process and market their products. Where there has been a doubt as to exemption, however, the recent trend has been to find against such an exemption. I give as examples here the *National Broiler Marketing Association* case,[6] in which the Supreme court took a restricted view of what constitutes a "farmer" in the broiler chicken industry. Another more recent case, *Alexander v. National Farmers Organization*[7] decided by the Eighth Circuit in August of 1982, upheld an antitrust verdict against three dairy coops for conspiracy to monopolize by engaging in various predatory tactics. Even the Second Circuit's 1980 decision in *Fairdale Farms v. Yankee Milk,*[8] which permits agricultural cooperatives to grow to monopoly "willfully," does not provide a significant difference between these associations and normal business corporations when it comes to proving section 2 liability. In either case, mere market position will not suffice and the courts have shown a clear desire to look for some "use of monopoly power."

4. 524 F. Supp. 7 (S.D.N.Y. 1980).
5. Carnation Co. v. Pacific Westbound Conference, 383 U.S. 213 (1966).
6. 436 U.S. 816 (1978).
7. 687 F.2d 1173 (8th Cir. 1982).
8. 635 F.2d 1037 (2d Cir. 1980), *cert. denied*, 102 S. Ct. 98 (1981).

As for labor, the tension between antitrust and labor is hardly new. Supreme Court decisions applying the Sherman Act to labor unions were responsible for passage of section 6 of the Clayton Act in 1914. The Supreme Court's 1975 decision in *Connell Construction Company,*[9] however, has set off a new round of antitrust litigation, with the Supreme Court not hesitating to apply the antitrust laws to conduct which has occurred outside a collective bargaining agreement and which could constitute an unfair labor practice. I should point out that the court record is not unmixed. For example, there is the Supreme Court's 1981 decision in *H.A. Artists & Associates v. Actors' Equity,*[10] in which the Supreme Court immunized a union licensing system which fixed the fees that agents could charge its members and which required union members to boycott non-licensed agents. The following year, however, the Court reverted to the trend with its decision in *Kaiser Steel v. Mullins,*[11] in which the Court allowed a party to a collective bargaining agreement to raise, in a suit for breach of that agreement, the argument that the contractual provision attempting to be enforced was illegal under the Sherman Act. This decision should go a long way toward placing the shadow of antitrust over collective bargaining negotiations.

I would like to close with a question which I think may tie in with the remarks of my co-panelists, and which ties in with my third proposition. In looking at the cases in which there was a conflict between applying the antitrust laws or exempting the activity, I think that we find the courts opting for the antitrust rules, as in the labor area or the agricultural cooperative area. But what happens after that? Once the plaintiffs are successful in arguing that the defendants' conduct is covered by the antitrust laws, are they successful in proving liability? My suggestion is that they have not been particularly successful. The Court, while covering much conduct with the antitrust laws, has at the same time made standing requirements more restrictive, relaxed the standard of liability by opting for a rule of reason analysis, and taken a more critical view toward damage theories (a trend which is far more pronounced in the lower courts). So, for example, we see that in the lower courts a number of labor-antitrust cases which were allowed to remain in the antitrust court came out in favor of the defendants. Looking at this trend more generally, I would suggest we again find support for my third proposition. Paradoxically, the application of the antitrust laws does not mean, in the end, more antitrust enforcement. In a period of unregulation it means, instead, no liability.

Thank you.

MR. SIDNEY S. ROSDEITCHER: Harry, thank you for leaving me with a question hanging over me.

I shall talk a good deal on insurance because it is an area with which I am particularly familiar. My first insurance antitrust case goes back to

9. 421 U.S. 616 (1975).
10. 451 U.S. 704 (1981).
11. 642 F.2d 1302 (D.C. Cir. 1980), *rev'd*, 102 S. Ct. 851 (1982).

about 1968. Those were the halcyon days of the McCarran-Ferguson Act. If you looked through the reports from 1968 to about 1977, you would rarely see an insurance company not winning a McCarran-Ferguson Act defense. Since 1977 I think you will find that the reverse is virtually true — that it is rare that a McCarran-Ferguson Act defense succeeds.

The topic is a broad one, as Harry mentioned. However, in looking at the three substantive areas that I was asked to talk about — insurance, banking and securities — there are relationships and common themes which emerge.

Indeed, one theme that clearly begins to emerge is that as regulatory restrictions are eliminated, the lines between these industries are blurred and new competition appears. In reality, a single industry is developing, involving the managing and investing of other people's money, encompassing the banking, securities and insurance industries.

Let me talk for a moment about banking.

There are no real antitrust exemptions for banking. Of course, there is a procedure, with respect to bank mergers, which requires the pertinent banking regulatory agency to review a merger and to apply antitrust considerations among others. But ultimately many of the bank mergers end up in court with the Antitrust Division free to seek de novo review. What happens before the Comptroller of the Currency or the Federal Reserve Board matters very little in such situations.

Many of the bank merger cases of the last decade have turned on market definitions which are slowly becoming obsolete because of deregulation. For example, cases like the *Phillipsburg Bank* case [12] and the *Connecticut National Bank* case[13] which turned on distinctions between a market for commercial banking services and a market for thrift banking become less and less realistic, although, in the *Connecticut National Bank* case the Supreme Court did hold to that distinction notwithstanding changes in bank regulatory laws which permitted thrift institutions to compete in substantial respects with commercial banks. But in 1980, and again in 1982, Congress passed statutes which, by enabling thrift institutions to offer checking services and commercial institutions to offer such savings devices as money market funds and NOW accounts, further reduce the distinctions previously drawn between these two areas of banking.

The result is that the distinctions reflected in the 1970's banking merger cases in the Supreme Court in the section 7 merger area are no longer realistic. It has already had some effect in some district court cases recently, and I think it will eventually be reflected in cases that reach the Supreme Court. Indeed, the courts will have to recognize that there no longer is a commercial banking industry and a thrift banking industry, and indeed that the banking industry is not limited to banks, but includes investment funds traditionally considered part of the securities industry.

12. 399 U.S. 350 (1970).
13. 418 U.S. 656 (1974).

Congress is now reexamining the Glass-Steagall Act which is a wall intended to divide the banking industry from the investment and securities industries. And while attempts to break down that wall failed last year, there is some belief that they may be more successful this year.

Thus, with respect to banking, the main impact of deregulation is that in a sense an "exemption" has been removed — that is, the exemption from competition that existed for segments of banking and segments of the investment and securities business, because of banking regulations.

Another wall, which provided some safe-harbors from competition, is coming down, with the amendment of state laws regarding branch banking. You may recall the *Marine Bancorp.*[14] case decided by the Supreme Court in 1974. There, the question was whether a banking acquisition within the State of Washington would reduce significant potential competition. That case turned primarily on the fact that potential entry into other areas of the state was not possible because of strict state restrictions on branch banking. Consequently, the potential competition doctrine was held not to apply because no one could enter local banking markets except through acquisition. That situation is now being changed, as state restrictions on branching are disappearing. Here, too, then, an "exemption" from the competitive regime fostered by antitrust is being eliminated through deregulation, and will have an effect on the application of law to bank mergers. Deregulation means that in many cases barriers to potential competition will be eliminated, thus allowing greater application of the potential competition analysis. At the same time, it means that there are more sources of actual and potential competition to be taken into account — not only within banking but from the securities and investment industries.

Let me say one word about exemptions and the securities industry, Although there are no express antitrust exemptions for the securities industry, there has been an exemption implied by the Supreme Court and other courts for self-regulatory activities of the New York Stock Exchange, other exchanges, and other industry self-regulatory bodies, to the extent those activities are supervised by the SEC and, when viewed against the legislative history, are considered necessary to make the federal securities laws work.

Deregulation has brought about one major change. One of the most significant exemption cases in the securities area was *Gordon v. New York Stock Exchange*,[15] in which the Court found that commission rates, fixed under the auspices of the New York Stock Exchange, were immune from antitrust attack because it was demonstrated that the SEC closely supervised fixed commission rates and that the history of the 1934 Act indicated that fixing commission rates was an activity which Congress expected the New York Stock Exchange to perform.

14. 418 U.S. 602 (1974).
15. 422 U.S. 659 (1975).

Shortly after the *Gordon* case, the Securities Amendment Act of 1975 prohibited the Exchange from fixing commission rates. As a result, there has been competition in commission rates and that particular implied exemption has been eliminated by deregulation.

Putting specific situations of this kind aside, I expect, that in the future, there will be greater competition between the securities industry and the banking industry, as regulatory inhibitions dividing them, are eliminated. Whether that leads to more or less antitrust, is not certain. To some extent it will lead to less antitrust in that the market will be less concentrated and, as I noted, bank merger cases will be affected. Whether it will lead to more antitrust to protect such new competition against any private efforts to restrict it, I cannot predict. But I think that Professor First's suggestion that deregulation in some cases will lead to unregulation is probably what is likely to take place in banking and securities. And you are likely to see more intensive competition among industries that previously were insulated from one another's competition.

Let me turn now to insurance.[16] Insurance is really an example of both sides of this coin of narrowing exemptions and deregulation. In insurance, you have both an explicit antitrust exemption and extensive state regulation. The exemption itself arises from a concept about regulation which had been held for many years but which is declining now and which is under attack — that insurance is an area which should be left to state regulation, particularly with regard to the fixing and approval of insurance rates.

The McCarran-Ferguson Act was the result of a decision by the Supreme Court in 1944 that insurance was "commercial," and therefore, subject to the antitrust laws. The decision was followed by a demand by the insurance industry, by insurance commissioners and others, that something be done to preserve state regulation in the area. As a result, a qualified exemption for the insurance business was enacted. It provided that the "business of insurance" to the extent "regulated by state law" would be exempt from the antitrust laws except in the case of conduct amounting to "boycott, coercion, or intimidation."

The exemption itself reflects a belief about the desirability of state regulation of the insurance business which in turn is founded on a philosophy common to many regulated industries. First, that regulation is necessary — and in particular, regulation of rates — in order to prevent insolvency and to protect insureds and give them assurance that their claims will be paid. Second, it reflects a belief that unfettered competition, an unregulated marketplace, will lead to discrimination — that is, discrimination in favor of low risks and against high risks — and that only regulation can assure the non-discriminatory availability of essential insurance services to all.

As in other regulated areas, the view that an antitrust exemption for insurance is necessary and that state regulation is desirable has been

16. For a further discussion of the insurance exemption, see Appendix A infra.

under attack, particularly by the Department of Justice. There have also been a number of attempts to repeal the McCarran-Ferguson Act and to try to centralize insurance regulation at the national level, in the hope of limiting unnecessary restraints on competition.

I would like to review what has happened to the McCarran-Ferguson Act in the courts because I think it reflects some of the current attitudes about the desirability of deregulation of insurance. First, as I mentioned, for many years the McCarran-Ferguson Act antitrust exemption lived a charmed life. It was very loosely interpreted; indeed, it was interpreted in a way that frequently seemed unrelated to its original purpose.

The main purpose of the McCarran-Ferguson Act, as reflected in the legislative debates, appeared to be to preserve the ability of insurance companies to pool their statistics and then fix rates on the basis of pooled statistics. This was based on the premise that the cost of an insurance product, unlike other products, could not be known in advance, but depended instead on prediction of subsequent claims experience and that smaller insurance companies would lack the pool of statistical experience and the knowhow necessary to make rates. It was felt, therefore, that some exemption was necessary to permit insurance companies to get together for the purpose of collecting and analyzing statistics and making insurance rates.

The insurance exemption, however, was applied well beyond this area. The first aspect of the exemption, the business of insurance, was very broadly interpreted by the Supreme Court to apply to "the relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation, and enforcement."[17] These were the "core" of the business of insurance. The Court went on to say:[18]

> Undoubtedly other activities of insurance companies relate so closely to their status as reliable insurers that they too must be placed in the same class. But whatever the exact scope of the statutory term, it is clear where the focus was. It was on the relationship between the insurance company and the policyholder.

That definition encompassed a broad variety of activities and it was applied broadly to exempt many types of activities of insurance companies from challenges under the antitrust laws. The National Commission to Study the Antitrust Laws, in its report, heavily criticized this aspect of the McCarran-Ferguson Act case law. In two recent decisions the Supreme Court has made it clear that it is no longer going to accept the very broad interpretation of the McCarran-Ferguson Act that I just read to you.

While the Court has never said explicitly that this definition no longer applies, in two cases — *Royal Drug*[19] and the *Pireno*[20] case decided last term — the Supreme Court essentially abandoned that definition of the

17. SEC v. National Securities, Inc., 393 U.S. 453, 460 (1969).
18. *Id.*
19. 440 U.S. 205 (1975).
20. Union Labor Life Ins. Co. v. Pireno, 102 S. Ct. 3002 (1982).

business of insurance. Let me read to you what the Supreme Court's definition now is and give you a little of the context of the case in which that definition arose.

Pireno was a case involving peer review, which is the practice of having health care professionals evaluate the reasonableness of claims submitted by insureds to insurance companies so that the insurance companies can enforce clauses providing that they will pay only health care claims to the extent they are reasonable and customary. In *Pireno* a chiropractor claimed that the New York State Chiropractic Association's activities in advising insurance companies on his claims and on other claims amounted to a maximum price fixing agreement because it put a limit on what the insured could get and the insured would not want to patronize a chiropractor whose fees exceeded the determination of the peer review committee.

The district court, applying the *National Securities* definition (the one I read you earlier), concluded peer review activities were plainly the business of insurance. It certainly had to do with the relationship between the insurer and insured. It related to the interpretation of the contract. Indeed, it was intimately bound up with and its sole purpose was to enable insurance companies to better interpret their insurance contracts. Therefore, the court found that this was the core of the business of insurance.

The Second Circuit disagreed and said that in *Royal Drug*, the Supreme Court, despite its quotation of the earlier definition, had in fact rejected the earlier definition of the business of insurance and replaced it with a requirement that it be shown that the practice in question itself involves the spreading and transfer of risk and that the activity must be one limited to insurance industry entities. Both *Royal Drug* and *Pireno* involved arrangements between insurance companies and health care providers. *Royal Drug* involved a participating provider agreement for druggists, under which Blue Cross would in effect reward druggists who accepted a contract which would enable Blue Cross to control the cost of drugs. *Pireno* was an arrangement in which health care professionals helped insurance companies evaluate claims.

The Second Circuit reasoned that going outside the insurance industry to enter into contracts was plainly outside the business of insurance. And that in addition, peer review, while a part of the process of claims adjustment, did not itself involve the spreading or transfer of risk.

The Supreme Court essentially agreed in a six to three decision.[21] It accepted the notion that *Royal Drug* did in fact reduce the earlier definition of the business of insurance and it laid down three criteria for the business of insurance: first, whether the practice has the effect of transferring or spreading a policy-holder's risk; second, whether the practice is an integral part of the policy relationship between insurer and insured; and third, whether the practice is limited to entities within the insurance industry.

21. *Id.*

One thing the Court left unclear was how you balance the three. It said, in effect, "We don't have to tell you whether all three have to be present or only one has to be present because in this case none of them are present." They left for another day the interesting question of what happens if one but not two or two but not three of the criteria are present.

The Court also read the legislative history as confining the "business of insurance" primarily to cooperative rate making activities. And it seems, therefore, unclear to what extent the "business of insurance" will encompass activities other than cooperative rate making.

A second area in which the exemption is likely to be reexamined is the definition of "state regulation." In another recent case, while the issue of state regulation was not before it, the Supreme Court noted that the legislative history indicated that it was contemplated that the exemption would apply only in circumstances where there was state authorization and supervision of the activity claimed to be subject to the exemption.[22] Again in the *Pireno* case, the Justice Department in its amicus brief argued that position, but the Supreme Court never reached it. Until now the lower courts have been using a very broad definition of state regulation, so as to include any type of regulation that either permits or proscribes the practice in question, including state insurance laws prohibiting unfair or anticompetitive practices.

The result of these cases is that the insurance antitrust exemption is declining in significance.

But I will now go back to the question that Harry First raised at the outset. Has this cutback in the antitrust exemption had any effect on antitrust enforcement or on the outcome of antitrust cases? If you look at the insurance experience, the answer is no. In part it results from the peculiar cases that have come to the court.

The *Royal Drug* case is an excellent example. There have been perhaps dozens of cases like *Royal Drug* and at least five or six have already been decided on an antitrust basis since *Royal Drug*. And invariably, the antitrust claims are dismissed on motions for summary judgment.

None of the cases so far have suggested there is any real antitrust violation. I think companies and their lawyers want to avoid the cost of lengthy antitrust litigation and seek exemptions. But in the end, it has mattered very little.

I think one area where the elimination of the exemption may have an impact over the next few years and which you are beginning to see is in the relationship between health insurance and health care. There is a conjunction here of the Supreme Court's unwillingness to find exemptions in the health care field, either by implication from the National Health Planning Act as in the *National Gerimedical* case[23] or by implication from peculiar circumstances of the economic market of health care as in the *Maricopa* case[24] this year where the Supreme Court found that the

22. California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97 (1980).
23. 628 F.2d 1050 (8th Cir. 1980), *rev'd*, 452 U.S. 378 (1981).
24. Arizona v. Maricopa County Medical Society, 102 S. Ct. 2466 (1982).

peculiarities of health care did not justify bending per se rules that grew up in other industries. I think as insurance companies and providers of health care services begin to look cooperatively for solutions to skyrocketing health care costs, you are going to see new and different kinds of antitrust theories proposed.

In the end, Harry, the answer is: so far it hasn't made much difference.

MR. JOHN H. SHENEFIELD: Deregulation involves the removal or modification of economic or other regulation that prevents free competition protected only by antitrust enforcement. It does not mean — as a former Secretary of Transportation seems to mean when he talks about the shipping industry — the repeal of the antitrust laws. That is not deregulation, but laissez-faire with no unfair holds barred.

Communications

Deregulation has been pressed by the Federal Communications Commission and the courts of appeals. Kaleidoscopic changes in technology are demolishing traditional industry boundaries and persuading the regulators away from pervasive regulation.

The settlement of *United States v. AT&T* in August of 1982 represents a significant step toward deregulated telecommunications. The $138 billion AT&T system is to be broken up into seven regional telephone companies on the one hand, and Western Electric, Bell Laboratories and the Long Lines Department on the other. AT&T, under the rewritten 1956 Western Electric decree, will divest itself of its less profitable basic operating companies and will be free to diversify into the data communications and processing fields. The newly divested operating companies will be able to sell the Yellow Pages service and customer premises telephone equipment along with local phone service.

One of the dividends of the decree will be the shifting of responsibility for identifying and achieving the social goals underlying the national telecommunications system from the regulatory to the legislative arena where it properly lies. The kind of communications system we as a society want will be a question to be answered on Capitol Hill and not in the halls of the Federal Communications Commission building.

After divestiture, the basic operating companies will undoubtedly be forced to raise local telephone service rates in the absence of the subsidy from AT&T's higher-rate, higher-profit long distance services. The subsidy is said to have made up on average one-third of the basic operating companies' budgets. Thus a judgment that universal phone service at affordable rates is an important goal will require legislators to take steps to achieve it directly and explicitly. Any legislative moves at the federal level, however, should be deferred until there has been ample time to see how the decree is working. Immediate congressional action runs the risk of being hasty, ill-informed and potentially stifling of innovative competitive steps in the newly deregulated environment.

Vigorous price competition in the long-distance communications market will require the FCC to avoid discriminatory rates for specialized common carriers during this transitional period. Any regulatory policy based on equal access charges for all users may amount to a determination not to protect new entrant common carriers that might preserve for the immediate future innovative alternatives to Long Lines. Accordingly, it is not clear that competition in the long run would best be served by setting equal rates for all competitors.

Moreover, it is certain that the appropriate standard for evaluating pricing policy by telecommunications companies or any other firm has by no means been settled. In the Government's suit against AT&T, the Justice Department argued that pricing a communications service without regard to its direct costs would constitute a violation of the Sherman Act. On the other hand, the FCC has signaled its intention to continue using the "fully distributed cost" measure of utility pricing in its analysis of access charges. Fully distributed cost is virtually useless as a measure of predation but it is an ascertainable ceiling for use in the regulatory process because it does not involve the more speculative forecasting of long-range developments. As the recent *MCI* case in the Seventh Circuit points out,[25] the benchmark measure of predation and a reasonable rate for a regulated company should be viewed respectively as establishing a floor and a ceiling between which prices ought to be set according to competitive pressures.

Cases such as *MCI* and *Southern Pacific Communications*[26] support the use of "long run incremental cost" as the floor below which an inference of predation can be supported. Long-run incremental costs are basically measures of the average total cost for each service or product offered by a multi-service or multi-product company because they allocate fixed costs to those products or services that cause them.

In sum, with the removal of economic regulation in the telecommunications industry, there will paradoxically be renewed responsibility placed upon the FCC and other agencies that administer the minimally necessary regulations in a new, unrestricted environment. They must ensure that competition goals figure prominently in the ongoing oversight of a streamlined AT&T and its competitors. A companion responsibility rests squarely upon the Congress to approach the new environment in a measured and thoughtful manner by refraining from hasty and superficially appealing but economically inefficient legislation.

State Action

In the state action area, the principal question under discussion, after *Community Communications Corporation v. City of Boulder,*[27] involves interpreting the Supreme Court's rule that municipalities are not exempt from the antitrust laws unless their actions amount to the actions of the state itself, or the actions are taken in furtherance or implementation of a

25. MCI Communications Corp. v. American Tel. & Tel. Co., 1982-83 Trade Cas. (CCH) ¶ 65, 137 (1983).
26. Southern Pacific Communications Co. v. American Tel. & Tel. Co., 556 F. Supp., 825 (D.D.C. 1983).
27. 455 U.S. 40 (1982).

clearly articulated and affirmatively expressed state policy. For example, in *Pueblo Aircraft Service v. City of Pueblo, Colorado*,[28] the court held that a municipality's traditionally proprietary action, which, standing alone, would not be immune, may be legislatively transmuted into a "public governmental function" and thereby obtain immunity. An interesting aspect of that case is its suggestion that, in a rule of reason defense, a municipality may be able to raise a public interest rationale for its challenged practice beyond the scope of the *Professional Engineers* rule[29] in order to establish that it is acting in the shoes of the state. Moreover, the *National League of Cities v. Usery* rule[30] that the tenth amendment exempts certain "intregral" government operations from federal statutory interference may operate to put core municipal government activities beyond the reach of the antitrust laws.

Questions have been raised as to whether the entire rationale for treble damages is missing when the defendant in an antitrust case is a municipality or a state. Any damage award will likely be paid from general revenues, without any in terrorem deterrent effect upon a potential violator. Instead, the award would actually become a tax upon the citizenry. Whether it will be possible to get around the clear language of section 4 of the Clayton Act is unclear, but there seems little doubt that municipal liability was never foreseen by Senator Sherman and his colleagues.

Note that the state action jurisprudence now is increasingly clear on a few points: adequate immunity protection demands a state policy, grounded to some extent in state legislation. The policy must at least clearly countenance that, in a specific area, not necessarily with respect to specific items of conduct or specific situations, competition may have to be displaced by regulation.

The state policy must indicate that it is the role of the city to deal with the competition-regulation issue. Active state supervision in the conventional sense will probably not be required, as it is with private firms.

When dealing with conventional or traditional government activities, the required state authorization is going to be generously inferred by trial courts, whose role will probably be circumscribed by federal legislation which seems politically irresistible.

Webb-Pomerene Exemption

As of 1981 there were only 36 Webb-Pomerene associations in the United States, accounting for less than two percent of U.S. exports. Many concluded, therefore, that the Webb-Pomerene Act had been a failure in the promotion of exports. If you accept the conventional — but erroneous — view that the antitrust laws remain a significant barrier to the formation of an effective marketing vehicle, it is understandable why Congress felt it had to act. What is not clear is whether Title III of the new Export Trading Company Act which was designed, at least in part, to improve the situation, has in fact done so.

28. 679 F.2d 805 (10th Cir. 1982).
29. 435 U.S. 679 (1978).
30. 426 U.S. 833 (1976).

For instance, there is no certainty that a company will be entitled to a certificate under the clearance program. In addition, the protection conferred by a certificate of review is somewhat more limited than the protection conferred under the Webb-Pomerene Act. It should also be noted that under Title III, the issuance of a certificate only protects an export trading company in a private action against treble damage liability.

The situation is not much better under Title IV, which provides that the Sherman Act will not apply to conduct involving trade or commerce with foreign nations unless there is a direct, substantial and reasonably foreseeable effect on U.S. commerce or export trade by a U.S. person. While the Federal Trade Commission Act is amended by Title IV, also known as the Foreign Trade Antitrust Improvements Act of 1982, it is important to note that the Clayton Act is not affected.

Under Title IV, exports that only affect foreign commerce and exports that involve entirely foreign conduct are jurisdictionally exempt from coverage under the Sherman Act. Title IV does not alter existing antitrust standards of injury or standing and has, apart from the jurisdictional variations mentioned above, no effect on comity principles or the application of the *Timberlane* test.[31]

In sum, the Act is far from a wholesale cure for such antitrust problems as actually exist in the international trade area, which can more successfully be dealt with by competent counsel.

Domestic Oil Pipelines

Domestic oil pipelines, because they comprise the basic distribution system for crude oil and petroleum products and because their natural monopoly characteristics create the potential for competitive abuse, represent an important subject for deregulation. Some have been concerned that pipeline owners could exercise economic power by charging monopoly prices, engaging in discriminatory use of existing pipeline facilities by limiting across through price changes to non-related shippers or by deliberately constructing pipelines that are smaller than the most efficient size.

A Department of Energy study concludes that pipelines have not been undersized and explains historical problems of capacity as having been caused by alterations in transportation patterns stemming, for example, from changes in export policies in Canada. Perhaps market forces, such as truck and rail shipment, can ensure competitive rates and resonably rates of return in a deregulated environment. Conversely, some contend that regulation is necessary to establish a ceiling on pipeline rates. Such a ceiling would counterbalance the effect of existing oil windfall profits taxes by creating a bar to the incentive to lower well-head prices and raise pipeline rates.

The current Antitrust Division position is that, with the exception of the Trans-Alaska Pipeline System, intermodal and intramodal competition will determine reasonable rate levels for the majority of pipelines in the

31. Timberlane Lumber Co. v. Bank of Am., 549 F.2d 597 (9th Cir. 1976).

lower 48 states. Those who oppose deregulation suggest that a number of pipelines face no competition from truck, water or rail transport, and that the alleged costs of regulation are exaggerated. Deregulators cite the general policy in favor of allowing the competitive process to determine the behavior in an industry and the availability of antitrust remedies in those cases where a pipeline owner abuses its natural monopoly.

A remaining area of controversy is construction of new oil pipelines in a deregulated environment so as to ensure that undersizing and other access limitations will not occur. While the Justice Department sees no compelling reason for regulating access to pipelines, there being no compelling reason for regulating pipeline rates, the imposition of competitive rules similar to those which were imposed in the case of *Deepwater Port Licensing* makes some sense because price is not the only possible barrier to access. A more drastic measure would be the prospective divestiture of oil pipelines which admittedly could result in at least the partial loss of currently realized economies of integration, if any exist. These difficult analytical problems demand the close attention of competition policy advocates before wholesale and crude solutions are legislated.

MR. KOEPFF: I think that Professor First's theme, at least in the state action exemption area, probably holds up as true as anything. I actually have a case in mind — a 1982 decision by the Seventh Circuit called *Omega Satellite v. City of Indianapolis*[32] where a cable company challenged Indianapolis' award of a 20-year exclusive franchise to another cable company. Because it was a motion for a preliminary injunction, the court only had to consider the likelihood of success on the merits insofar as the exemption was concerned, but if there was no exemption, then whether or not the antitrust claim would succeed. The district court had basically rested its decision on the finding that the state action exemption applied.

The law, at least at the Supreme Court level, has gone probably in the other direction. The requirements for getting state action exemption now are very tough to meet. You must have a specific state statute. Your action has to be compelled by that statute and the state has to supervise that conduct. In this case the state action exemption was not available. This was a public entity so you needed a specific statute authorizing the city of Indianapolis to do that.

But the Seventh Circuit went on to say, well, the heck with the state action exemption. Any antitrust lawyer knows that this is perfectly legitimate what they did. There is nothing per se wrong with granting a 20-year exclusive license and this is a natural monopoly situation. You can not have a second one in there. And I come back to Professor First's point. Maybe there is more antitrust, but the results are not going to be very different than that.

The only other observation I would make, before I open the panel for questions, is I think that the real challenge for antitrust practitioners now

32. 694 F.2d 119 (7th Cir. 1982).

is the question that Miles Kirkpatrick raised this morning — to what extent, if at all, do traditional antitrust principles apply in some of these areas? There will be some situations in which the normal per se treatment may not apply. And I think there is some authority from recent Supreme Court cases that if this is not one of your traditional arrangements which have no redeeming social value and have a pernicious effect, why surely the per se rule applies. But if you are at all innovative and can think of some reasons why in this particular situation traditional antitrust principles should not apply, then maybe that is the solution where the antitrust exemption is not available.

Let me open up the panel for questions. I had one question, and I shall start it off. In fact, I asked it of Professor First before we started. What exemptions are no longer going to be around and why? He said it might be a shorter question to ask if I just asked which ones are still good. I shall ask that one.

PROFESSOR FIRST: Well, that means I have to give a short answer: the industry-specific exemptions. If you ask in the end what I think should stay in terms of exemptions, just off the top of my head it seems to me that there is a strong case for a labor exemption based on our historical views towards labor, a strong case for a state action exemption defined as the Supreme Court did in *Midcal*[33] to balance regulation and antitrust where the state government picks regulation. And since I am not in favor of amending the constitution, I would say that a *Noerr-Pennington* exemption ought to stay for legitimate constitutionally protected approaches to government agencies.

But of course, Congress has changed this. The Export Trading Company Act, signed by the president in October, created marvelous new exemptions. Again, I throw that out as support for my unregulation thesis.

MR. BILL WOOLDRIDGE: Bill Wooldridge, Norfolk Southern Corporation. I'd like to ask Professor First about his reaction to the *Southern Pacific-AT&T* decision that just came down in Washington. The judge appeared to be saying there, even though there is no statutory exemption and even though the particular conduct of AT&T that was challenged was not mandated as such by the FCC, that nevertheless it was an area that was subject to FCC regulation and there was an FCC remedy if anybody wanted to complain to the FCC, and therefore there was no antitrust remedy. This is very comforting to those of us who may be defendants in the future. Do you think it is a good legal position?

PROFESSOR FIRST: I will confess my dereliction. I have not read the opinion and I quickly glanced at the description of it. But if I were to guess, I would say that case should be appealed and I would bet on reversal frankly.

Gordon Spivack mentioned it this morning. Every circuit that has ruled in AT&T cases has just tossed away AT&T's argument that the

33. California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97 (1980).

FCC had control of this. So I would not bet a whole lot on it, but then I have not read Judge Ritchie's opinion and maybe it is more persuasive than my gut reaction, which is: this cannot be right.

MS. PATTY HAHN: I'm Patty Hahn with the State of Maryland. I have a question for Professor First. You mentioned an apparent policy shift in the Civil Aeronautics board and the ICC apparently prospering over the last couple years. Could you give us a response to the following question: if the cases came to a court rather than a regulatory agency, do you think the results would have been much different?

PROFESSOR FIRST: You mean if they were brought straight as Clayton Act cases? I am not certain of the answer to that, frankly because I do not know the facts of each of them that well. I have a feeling that the Continental/Western case might have been analyzed differently. As to the railroad cases, I do not know enough about what those markets look like factually. To my knowledge, none of them has gone to the courts, that is, appealed from the commission's decisions.

MR. KOEPFF: Any further questions?

MR. JOHN DANIELS: John Daniels from New York. You made reference to the *Midcal* standard. I think the second prong is active supervision by the state. Does that create a problem where the activity ordinarily would not call for active supervision by its nature? The state does not want to become involved, so you are in a bit of a Catch-22 situation. The state has chosen not to in order to limit its regulatory activities, and yet you do not have the active supervision for the purposes of satisfying the second prong.

MR. ROSDEITCHER: Could you give me an example?

MR. DANIELS: For example, say, the price posting.

MR. ROSDEITCHER: Yes, that is *Midcal.*

MR. DANIELS: But *Midcal* was resale price maintenance. Rather than someone saying you must price at a particular price, or you must sell at the particular price posted, the state is simply saying, "Whoever wants to pick whatever price they want, they can do it; he simply has to post it."

MR. KOEPFF: I think there are some decisions that have come out on liquor price posting. There is *Rice v. Norman*[34] and the *Healy* decision[35] by the Second Circuit that came out within the last month. It is an area fraught with difficulty. But I would say that your example is a situation where it is going to be very hard to prove. You meet the *Midcal* criteria notwithstanding what the state is holding off on.

MR. DANIELS: I am just thinking of it from an analytical standpoint. Are you setting up a test that can not be met in instances where you might want to provide an exemption?

PROFESSOR FIRST: My feeling frankly is that passive regulation should not be exempt; and if there is going to be some price regulation, the state should be more actively involved. That is what the state action or government action exemption is for — to allow the state to

34. 102 S. Ct. 3294 (1982)

35. United States Brewers Assn. v. Healy, 692 F.2d 275 (2d Cir. 1982).

regulate and not to allow the private parties to regulate under the guise of state watch.

MR. ROSDEITCHER: I would think that in the absence of some state supervision, the argument for an exemption is rather weak. If the activity is truly anticompetitive and the state has no strong policy which it is exercising for the supervision, then I think the argument for exemption is weak.

In the price posting example, are you talking about a situation where you just simply have to announce your price?

MR. DANIELS: That is correct.

MR. ROSDEITCHER: What could be the antitrust violation there unless you have talked to somebody else about what you are going to announce before?

MR. DANIELS: Well, there may well be none. But the problem you run into is where you get the case knocked out at a preliminary stage based on an exemption. You would have to slog through the substantive part.

MR. ROSDEITCHER: I guess those cases, and I think that is what has been happening, for example, in the insurance cases I have been talking about. Those arguments have been made that this really is not an antitrust violation; it is a good thing. I think that is where you get back to it — this is a good thing because it really is not anticompetitive. And the court says, "Well, if it really isn't anticompetitive, then let's find out about it and let's decide it once and for all." And I think that is probably the best course.

MR. KOEPFF: That is similar to this morning's theme of reevaluation of the move towards deregulation. If the societal choice is regulation, then you will have immediate exemption. But if you do not choose regulation, then you will have to go the full route and show that it is not an unreasonable restraint or it does not have that effect.

APPENDIX A
ANTITRUST AND INSURANCE
Sidney S. Rosdeitcher

In the last two weeks of the 1981-1982 Term, the Supreme Court decided three important antitrust cases and each of them concerned activities in which insurance companies were involved.[36] Since 1978 the Supreme Court has interpreted the antitrust exemption conferred on the insurance business on three separate occasions.[37] During this period, there have been calls for the repeal of that exemption, and thoroughgoing

36. Arizona v. Maricopa County Medical Soc'y, 102 S. Ct. 2466 (1982); Blue Shield of Virginia v. McReady, 102 S.Ct. 2540 (1982); Union Labor Life Ins. Co. v. Pireno, 102 S. Ct. 3002 (1982).
37. Union Labor Life Ins. Co. v. Pireno, 102 S. Ct. 3002 (1982); Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205 (1979); St. Paul Fire & Marine Ins. Co. v. Barry 438 U.S. 531 (1978).

reviews of earlier assumptions about the incompatibility of antitrust and competition with insurance.[38]

These events seem to herald a new era in the relationship between insurance and antitrust — until recently, one of the quiet backwaters of antitrust. The change is in part a product of the era of deregulation. Insofar as it involves litigation compelling judicial reexamination of the antitrust immunity, it is in large part a reflection of tensions produced by insurance company efforts to control claims costs and the impact of these efforts on providers of goods or services which depend on insurance payments to their customers or patients to subsidize their changes in whole or in part. Somewhat ironically, the most important insurance antitrust litigation in recent years have been suits brought by providers of insured services who complain that these efforts interfer with their ability to charge *higher* prices.[39]

It is not my intention to discuss here the antitrust issues raised by these recent cases or their impact on cost containment efforts. Moreover, I am too much an advocate for one group of protagonists in insurance antitrust litigation to feel safe or prudent or sound in offering value judgments on the debates about whether the McCarran-Ferguson antitrust immunity should be repealed; whether a new and narrower type of immunity is preferable or needed; or whether state regulation of insurance rates, at least in its current form, is warranted by considerations of social policy and the special needs of the insurance industry. Instead, I thought it would be useful to take stock of where the relationship between insurance and antitrust now stands, particularly in light of the recent judicial interpretations of the McCarran-Ferguson Act.

The insurance industry is a relative newcomer to antitrust. For more than the first half-century after the enactment of the Sherman Act, the insurance industry was believed to be beyond the reach of the antitrust laws. In 1868, the Supreme Court held that insurance was not "commerce" so that state regulation of insurance was free of the Constitutional inhibitions imposed by the commerce clause.[40] The decision was also viewed as placing insurance beyond the reach of the federal regulatory statutes including the antitrust laws.

This happy era ended, when in 1944, the Supreme Court in the *South-Eastern Underwriters* case held that the business of insurance was

38. National Commission for the Review of Antitrust Laws and Procedures, Report to the President and Attorney General 225-251 esp. 232-39 (1979) [hereinafter cited as *National Commission*]; United States Department of Justice, The Pricing and Marketing of Insurance (1977).

39. *E.g.*, Union Labor Life Ins. Co. v. Pireno, 102 S. Ct. 3002 (1982) (chiropractor claiming insurance company use of peer review "fixes" ceiling on chiropractic fees); Group Life & Health Ins. Co. v. Royal Drug, 440 U.S. 205 (1979) (pharmacists claim provider agreements fix ceiling on drug prices); Proctor v. State Farm Mutual Automobile Ins. Co., 1982-1 Trade Cas. (CCH)¶ 64,606 (D.C. Cir. 1982) (suit by auto repair shops concerning agreements "fixing" auto repair prices); *cf.* St. Paul Fire & Marine Ins. Co. v. Barry, 438 U.S. 531 (1978) (doctors claim they were coerced to accept malpractice policy aimed at limiting escalating malpractice claims payments).

40. Paul v. Virgnia, 75 U.S. (8 Wall.) 168, 183 1868).

indeed "commerce" subject to the federal antitrust laws.[41] That decision, as you know touched off a shock wave of concern among insurance companies and state insurance regulators. The bulk of those concerns had nothing to do with antitrust; they related primarily to a fear by the states that their ability to regulate the business of insurance would be affected and perhaps more importantly that the states' ability to tax insurance companies would be impaired.

Concerns were also expressed, however, about the incompatibility of the insurance business with the system of free competition reflected in the federal antitrust laws. Two principal arguments were advanced in this regard. First, it was argued that unrestricted competition would lead to insolvencies, as well as to inequities to certain classes of consumers. Insolvencies would be produced by competitive rates which would be too low to provide adequate coverage of losses. Inequities would be produced because competition would cause insurers to narrow coverage to classes of insureds with lower risks and hence lower potential costs, to the exclusion or disadvantage of higher risk categories.

The other concern was that the insurance business — or at least certain segments of it — could not survive without a certain amount of cooperative activity which might be of questionable legality if the antitrust laws applied. Specifically, it was argued that insurance differed from most businesses in that the cost of the product was not known at the time of sale and that, accordingly, the calculation of insurance premiums required an adequate and large pool of statistical experience from which to make sound predictions. Such pools of statistics were said to be unavailable to single companies, particularly the smaller ones. Accordingly, cooperative action to collect these statistics and analyze them was said to be necessary. Particularly in the casualty and property area rates were in fact made by rating bureaus composed of the industry members. The rating bureaus themselves were frequently but not always authorized by state laws; state supervision of their activities is said to have been lax or nonexistent. Fears were expressed that these collective rate-making activities would be jeopardized or eliminated by application of the federal antitrust laws.[42]

These various strands of concern quickly led to the passage in 1945 of the McCarran-Ferguson Act.[43] The fears about interference with state regulation and taxation were taken care of by provisions of the Act which confirmed the authority of the states to regulate and tax the business of insurance and assured that federal laws would not supervene, impair or invalidate state laws regulating the taxing of insurance. In effect, any inhibitions on state regulation and taxation of insurance which the commerce clause imposed were eliminated.

In addition, a proviso was added to temper, but not eliminate, the application of the federal antitrust laws to the business of insurance. A

41. United States v. South-Eastern Underwriters Ass'n., 322 U.S. 533 (1944).
42. See the discussions of the history of the exemption in St. Paul Fire & Marine Ins. Co. v. Barry, 438 U.S. at 546-549, and Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. at 217-224; and in *National Commission, supra* note 37, at 229-30.
43. 15 U.S.C. §1011-1015.

proviso to section 2(b) of the Act stated that the federal antitrust laws are applicable to the "business of insurance" to "the extent not regulated by the states." Thus, to the extent that states *did* regulate the "business of insurance," that business was exempt from the antitrust laws. A moratorium was provided to enable states to enact such regulation. And an exception to the antitrust exemption was made for conduct amounting to "boycott, coercion or intimidation."

Most states responded promptly to the invitation implicit in the Act, adopting uniform rating laws for fire and casualty insurance and other uniform laws prohibiting unfair and anticompetitive practices in the insurance business.[44] And, thus, after a brief interval, it was believed for some time that by and large the insurance industry was protected from antitrust concerns.

That belief was fostered by a rather elastic view of the scope of the antitrust exemption. The requirement of state regulation was very loosely interpreted. It encompassed virtually any type of broad regulatory scheme which proscribed or permitted certain types of conduct in the insurance business, without regard to how effectively it was supervised or enforced; indeed, the effectiveness of enforcement or extent of supervision was deemed irrelevant.[45] Typically, the enactment of state unfair practices in insurance statutes, or state antitrust statutes directed at insurance, was deemed sufficient.[46]

The limitation of the exemption to the "business of insurance" was somewhat more circumscribed. It was plain it did not apply to everything that insurance companies did. Nevertheless, the Supreme Court's interpretation of that phrase as it appeared elsewhere in the McCarran-Ferguson Act was also somewhat elastic. In the *National Securities* case,[47] the term was said to encompass:

> The relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation and enforcement — these were the core of the "business of insurance." Undoubtedly, other activities of insurance companies relate so closely to their status as reliable insurers that they too must be placed in the same class. But whatever the exact scope of the statutory term, it is clear where the focus was — it was on the relationship between the insurance company and the policyholder.[48]

This definition was considered broad enough to encompass the selling of insurance and relationships between insurance companies and their agents. It was rare indeed that conduct of insurance companies

44. See FTC v. National Casualty Co., 357 U.S. 560, 564 n.6 (1958).
45. *See, e.g.*, FTC v. National Casualty Co., 357 U.S. 560 (1958); Ohio AFL-CIO v. Insurance Rating Board, 451 F.2d 1178, 1184 (6th Cir. 1971) *cert. denied*, 409 U.S. 917 (1972); Dexter v. Equitable Life Assurance Soc'y, 527 F.2d 233 (2d Cir. 1975).
46. *See, e.g.*, Dexter v. Equitable Life Assurance Soc'y, 527 F.2d 233 (2d Cir. 1975).
47. SEC v. National Securities, Inc., 393 U.S. 453 (1969).
48. *Id.* at 460.

challenged in antitrust cases failed to meet the "business of insurance" test.

Similarly, the exception for "boycotts" or "coercion and intimidation" was narrowly construed to apply only to conduct directed at other insurance companies or insurance agents of the kind involved in *South-Eastern Underwriters*: blacklists and sanctions designed to secure industry-wide conformity.[49] Thus, consumers of insurance were excluded from the class of plaintiffs who might be a fertile source of antitrust litigation.

This situation led to demands that the insurance exemption be repealed or modified by Congress. The most notable of these proposals is found in the 1979 Report of the National Commission for the Review of Antitrust Laws and Procedures. The Commission found that the exemption had been construed to apply beyond any justifiable purpose and even well beyond the specific concerns that led to its enactment. The Commission reviewed the two principal justifications offered for antitrust immunity — that difficulties in making rates required collective activity and that certain especially large risks required joint pools — to be insufficient justifications for the much broader scope given to the antitrust exemption. Moreover, the Commission expressed doubt that such collective activity as was actually justified in the rate-making process would be bared by the antitrust laws. The Commission acknowledged that joint collection of statistics about past losses in the casualty and property fields was necessary and desirable, but it considered such activity to be lawful under the antitrust laws.[50] It questioned whether other collective activities in the casualty and property industry, ranging from "trending" the statistics of promulgating rates, was necessary or justified. If found that the health and life insurance industries had little need for any collective activities in rate making, in light of widely published tables and statistics. It concluded that joint underwriting of risks, to the extent necessary, would probably be legitimate under current antitrust doctrine applicable to joint ventures. The Commission, therefore, proposed that Congress, in any event, repeal the broad immunity for the business of insurance and study whether a more limited antitrust exemption was needed for specified activities as to which joint action was found to be essential and where traditional antitrust analysis would not provide adequate protection for such activities.[51]

While these proposals for legislative action have made little progress, recent constructions of the McCarran-Ferguson Act by the Supreme Court have narrowed the antitrust exemption, and, as a result, antitrust may well play a much larger role in the insurance business. I would like to turn, therefore, to those decisions.

The first careful judicial examination of the antitrust exemption came

49. Addrisi v. Equitable Life Assurance Soc'y., 503 F.2d 725 (9th Cir. 1974), *cert. denied*, 420 U.S. 929 (1975); Meicler v. Aetna Casualty & Surety Co., 506 F.2d 732 (5th Cir. 1975).

50. *National Commission, supra* note 37, at 235.

51. *Id.* at 234-39.

in 1978, when the Supreme Court decided *St. Paul Fire & Marine Ins. Co. v. Barry*.[52] In *Barry* the Court rejected the construction given by several lower courts which limited the availability of the exception for "boycott, coercion or intimidation" to insurance companies or insurance agents who were the victims of blacklists or other similar conduct. *Barry* grew out of the medical malpractice insurance crisis of the mid-1970's. When St. Paul sought to introduce a particular type of malpractice policy designed to limit escalating and unpredictable malpractice claims, doctors dissatisfied with that policy and unable to obtain alternative malpractice insurance from other companies sued, claiming that they were the victims of a boycott by the other insurance companies aimed at forcing them to accept the new policy offered by St. Paul.

The district court dismissed the complaint, applying the then unanimous view that only insurance companies and agents could invoke the boycott exception. The plaintiff doctors conceded that the conduct alleged was the business of insurance, regulated by state law.

The First Circuit reversed and the Supreme Court affirmed the First Circuit's decision. The Court held that the conduct alleged fell within the traditional concept of a boycott and that Congress did not limit the boycott exception to boycotts of insurance companies or agents; the exception was available as well to consumers of insurance who could also be victims of a boycott. The Court indicated, however, that it would probably not tolerate attempts to convert every horizontal agreement by insurance companies about the terms of insurance into a "boycott."[53] Nor did the Court reach the question of whether "coercion and intimidation" had a broader meaning than "boycott." Hence, the decision may be of limited value to consumers. That remains to be seen.

Barry is more important for its approach to the legislative history of the McCarran-Ferguson Act exemption. The Court focused on language in the legislative debates which suggested that the exemption was primarily intended for collective rate-making activities supervised and authorized by the state. Moreover, although the Court did not address the question of whether the challenged conduct was regulated by state law (that point having been conceded below), in deciding whether the conduct was a "boycott," the Court laid emphasis on the fact that the conduct was neither required nor approved by the state and emphasized language in the legislative debates that the exemption was not intended to extend immunity to private regulation of the insurance business.[54] The references are puzzling insofar as they relate to defining a boycott, but they give rise to some speculation as to how the Court is likely to construe the "state regulation" requirement of the exemption, if it ever addresses that issue.

The spirit pervading *Barry* was carried forward in two subsequent decisions in which the Court construed the "business of insurance" requirement of the exemption. Both cases arose out of efforts by insur-

52. 438 U.S. 531 (1978).

53. *Id.* at 545, n.18.

54. *Id.* at 553-554.

ance companies to help control health care costs and to minimize the inflationary impact of health insurance on health care costs.

The first of these decisions — *Group Life & Health Ins. Co. v. Royal Drug Co.*[55] — involved a Blue Shield plan to control the cost of drugs sold to Blue Shield subscribers. Under the plan, Blue Shield and pharmacists entered into agreements by which the pharmacists agreed to dispense prescription drugs to Blue Shield subscribers at cost plus a $2 fee. Blue Shield reimbursed the participating pharmacist directly and the subscriber paid only the $2 fee. If the subscriber patronized a non-patricipating pharmacist, the subscriber had to pay for the drugs and seek reimbursement from Blue Shield. Some pharmacies claimed that only larger pharmacies which could dispense drugs profitably for a $2 markup could participate in the plan, and that the less advantageous treatment accorded subscribers of non-participating pharmacies induced subscribers to shift their business to such participating pharmacies. The complaining pharmacies sued, claiming the arrangement fixed prices unlawfully, unreasonably restrained trade and constituted a boycott of non-participating pharmacists.

The Supreme Court held that the agreements between Blue Shield and the participating pharmacies were not the "business of insurance" and that, accordingly, the antitrust exemption was unavailable.

In reaching that conclusion, the Court emphasized that the contracts at issue did not themselves spread or transfer risk and hence lacked an essential characteristic of insurance. The Court refused to accept arguments that the contracts — by limiting Blue Shield's liability to its subscribers — were so closely related to Blue Shield's reliability and solvency and its premium charges that they came within the prior, broadly worded definition of the business of insurance in *National Securities*. In the Court's view, the agreements were merely devices for reducing Blue Shield's costs and were no different from countless other arrangements which Blue Shield had with vendors, lessors and banks, which might be said to reduce Blue Shield's costs. Finally, the Court noted that these agreements were with entities outside the insurance industry, whereas the legislative history indicated that the focus of the antitrust exemption was on cooperative activity within the insurance industry.

The opinion was again notable for its approach to the McCarran-Ferguson exemption. The court emphasized that even express exemptions must be construed narrowly; it implied that it would not allow the exemption to be stretched substantially beyond the core activities discussed in the legislative history; and it appeared anxious to confine its earlier, broadly worded definition of the "business of insurance."

This approach was even more pronounced in the Court's decision in *Union Labor Life Ins. Co. v. Pireno*.[56] *Pireno* raised the question of

55. 440 U.S. 205 (1979).
56. 102 S. Ct. 3002 (1982).

whether an insurance company's use of peer review to help determine whether claims for health care services were "reasonable and necessary" within the meaning of the insurance contract constituted the "business of insurance." Under the peer review procedures involved, the insurance company could request a panel of chiropractors chosen by the New York State Chiropractic Association to review certain claims for reimbursement of chiropractic fees submitted by insureds, and to advise the insurer whether the fees and services rendered were "reasonable and necessary." The decision of the peer review committee was not binding on the insurer, but could be taken into account in deciding whether to reimburse the insured. On several occasions, the peer review committee was asked by the insurer to review charges to insureds who were patients of Dr. Pireno and the committee advised the insurer that they either reflected unnecessary office visits or excessive fees.

Dr. Pireno sued, claiming that peer review amounted to a conspiracy between the insurer and the Association to fix maximum prices and to limit the methods for practicing chiropractic. After discovery, the district court granted summary judgment for defendants, holding that the peer review activities were the "business of insurance" and were regulated by state law and therefore exempt from the antitrust laws.

The Second Circuit reversed, holding that *Royal Drug* required the conclusion that peer review was not the "business of insurance."[57] It read *Royal Drug* as limiting the "business of insurance" to activities involving the spreading or transfer of risk and found that peer review did neither, inasmuch as it took place after the risk was transferred and spread by the execution of the insurance contract. It rejected arguments that because peer review was a part of the claims adjustment process and was so intimately connected to the interpretation and enforcement of the contract, it came within the Supreme Court's previous characterization in *National Securities* of the "core" of the business of insurance. The Second Circuit read *Royal Drug* as narrowing the definition previously espoused in *National Securities*. It observed that after *Royal Drug* it was no longer clear that claims adjustment activities were part of the "business of insurance," but it held that, in any event, *Royal Drug* limited the exemption primarily to activities within the insurance industry and that since peer review involved persons outside the industry, it was not entitled to the exemption for that reason as well.[58]

The Supreme Court granted certiorari to resolve a direct conflict on the issue between the Second Circuit and the Fourth Circuit.[59] In a 6 to 3 decision, the Supreme Court affirmed the Second Circuit decision.

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57. 650 F.2d 387 (2d Cir. 1981).
58. *Id.* at 394-395.
59. Bartholomew v. Virginia Chiropractors Ass'n., 612 F.2d 812 (4th Cir. 1979), *cert. denied*, 446 U.S. 938 (1980) (holding peer review exempt); *see also* Gerimonte v. Washington Ass'n., No. C81-40R (W.D. Wash. Oct. 16, 1981), *appeal pending* in 9th Cir. (also holding peer review exempt).

In the Court's view, the decision was directly controlled by *Royal Drug*. The Court read *Royal Drug* to establish three criteria for assessing whether conduct is the "business of insurance:" 1) Whether the practice has the effect of transferring or spreading a policyholder's risk; 2) whether the practice is an integral part of the policy relationship between insurer and insured; and 3) whether the practice is limited to entities within the insurance industry.[60] The Court said that "none of these criteria is necessarily determinative in itself" as to whether a practice is the "business of insurance;" but it went on to conclude that peer review satisfied none of the characteristics.[61]

Inasmuch as the Court was unwilling to indicate how it would treat practices which satisfied only one or two of the criteria, the decision leaves many questions to the future. But the decision confirms the conclusion that it will read the exemption very narrowly. The conclusion, for example, that peer review is not an integral part of the insurer's policy relationship with the insured shows how tightly that criterion will be read. The peer review activities at issue were, after all, used as part of the process of interpretation of the insurance contract; to the extent the insurance company made use of the peer review advice, that advice determined the amount which the insurance company would pay the insured.[62]

The decision also suggests that while the Supreme Court may continue to quote the earlier, broad definition of the business of insurance set forth in *National Securities*, it in fact applies a much narrower reading.

There are still important questions about the insurance exemption which have not been answered by the Court.

The most important is the meaning of the state regulation requirement. In *Pireno*, although the question was not reached by the Supreme Court, the issue was briefed by the parties and by the Department of Justice and other amici. The Department appeared to take the position that the specific practice involved must be either required or authorized by state regulation;[63] another amicus took the position that the state regulation requirement should be given the same meaning as the "state action" doctrine — that is, the conduct must be mandated as part of an express policy by the state to displace competition with regulation and the conduct must be actively supervised by the state.[64]

Other questions relate to the extent to which conduct which extends beyond one state's borders can be said to be "regulated by the states"[65]

60. Slip opinion at 9.
61. *Id.*
62. The Court did not comment on the doubts expressed by the Second Circuit as to whether claims adjustment activities were part of the business of insurance. Rather, it appeared to assume they were, holding instead that, because peer review was non-binding and advisory only, it was not claims adjustment but at most "ancillary" to claims adjustment. It also distinguished between claims adjustment activities taking place wholly within the insurance industry and peer review, which involved entities outside the industry. Slip opinion at 13-14, n.8.
63. Brief for the United States as Amicus Curiae, 25-29.
64. Brief of the States of Arizona, et al. as Amici Curiae, 18-24.
65. See Seasongood v. K & K Ins. Agency, 548 F.2d 729 (8th Cir. 1977).

and the extent to which conduct beyond cooperative activities in the rate-making process are within the business of insurance. In *Pireno* the Supreme Court did not comment on the Second Circuit's suggestion that claims adjustment activities are beyond the scope of the "business of insurance;" rather, it concluded that peer review was at most ancillary to claims adjustment because the insurer was not bound to accept the advice of the peer review committee and differed from claims adjustment because it was not between parties within the insurance industry.

Nevertheless, this series of Supreme Court decisions should lessen the need to engage in debate about whether the McCarran-Ferguson Act should be repealed. To be sure, the important unanswered questions leave considerable uncertainty and room for argument about the remaining scope of the exemption. But the significance of the exemption has greatly diminished. As a practical matter, the insurance industry is likely to take little comfort from the Act and is likely to guide itself on the assumption that, in all but a very narrow class of cases, the antitrust laws will apply.[66]

I would expect that issues of competition policy from here on are likely to focus instead on the effects of state rate regulation and the compatibility of free competition with the concerns about solvency, social policy and equity on which those regulations are said to be based.

66. The unavailability of the exemption, of course, does not mean that current activities violate the antitrust laws. Notably, after *Royal Drug* provider agreements and similar arrangements were subjected to antitrust scrutiny in other litigation and summary judgments were entered in favor of defendants, in decisions finding no antitrust violation. *E.g.*, Medical Arts Pharmacy of Stamford, Inc. v. Blue Cross & Blue Shield of Connecticut, Inc., 5 Trade Reg. Rep. (CCH) ¶ 64,673 (2d Cir. 1982); Sausalito Pharmacy, Inc. v. Blue Shield of California, Inc., 5 Trade Reg. Rep. (CCH) ¶ 64,766 (9th Cir. 1982). In its amicus brief filed in *Pireno*, the Department of Justice said that as a "general matter" peer review arrangements do not violate the antitrust laws, and that "in most situations" peer review "would serve a procompetitive purpose. . . ." Brief of United States as Amicus Curiae, 6, 8-9, n.8; *see also* Letter from Assistant Attorney General Donald Baker to Brian J. Niederhauser, Intnat'l. Chiropractors Ass'n. (March 2, 1977).

Chapter 4

Workshop III: Are There Cases Too Complex For Trial By Jury?

Stephen M. Axinn
Hon. Edward R. Becker
Hon. Charles L. Brieant
Hon. Robert W. Sweet

MR. STEPHEN M. AXINN: We are privileged and honored this afternoon to have a panel of truly distinguished and thoughtful judges and scholars to discuss the question: are there cases too complex for trial by jury? And the hidden agenda — if so, what about it?

On my immediate right is Judge Edward Becker now of the Third Circuit Court of Appeals and famous to us all as the author of various opinions in the *Japanese Electronics* case. We know him well through his works, and we are very grateful that he has come up from Philadelphia to be with us this afternoon.

On my immediate left is a friend of this section and a judge before whom we all practice, Judge Charles Brieant of the Southern District of New York.

To his left and my far left, Judge Robert W. Sweet who was, on top of everything else, my former partner and good friend.

I would like to set the stage, if I might, by telling you that when we finish with our opening presentations and we have an opportunity for the judges to comment on one another's presentations, we will entertain questions from the floor, time permitting.

To turn to the subject at hand, we are going to discuss two sides of a coin. A lot has been written on this subject and much has been said. I would just like to frame it with two quotes which I think state both sides of the proposition reasonably well.

The first is: "Those who claim that juries cannot understand complex civil cases improperly demean the intelligence of the citizens of this nation and do not understand the jury system."

The other side was stated by Judge Frank many, many years ago: "Twelve men can easily misunderstand more law in a minute than a judge can explain in an hour."

Alexander Hamilton wrote: "The circumstances that constitute cases proper for courts of equity are in many instances so nice and intricate that they are incompatible with the genius of trials by jury. They require often such long, deliberate, and critical investigation as would be impracticable to men called from their occupations and obliged to decide before they would be permitted to return to them."

So our first question is and ought to be: are there cases too complex for trials by jury? Should there be a rule that permits the striking of a jury demand? Our first speaker who will address that subject is Judge Becker.

THE HONORABLE EDWARD R. BECKER: The ultimate question is: are there cases too complex for trial by jury? I say no, at least no cases that are not also too complex for trial by judge.

In my *Japanese Electronics* jury trial opinion,[1] reversed by my colleagues of the Third Circuit Court of Appeals,[2] I explored the policy underpinnings of the Seventh Amendment, and made extensive comments as to why trial by jury is desirable even in complex cases. And I expressed the view — it is a view to which I still adhere — that you will get a better result from twelve jurors or eight jurors than you will get from a single judge because of the crucible of the jury trial — the interaction of one on another, and the different backgrounds that they bring to the case, provided of course that the case is well managed, that the case is intelligently tried, and that all of the now available and now generally acceptable management techniques which Judge Sweet is going to talk about for simplifying issues are applied.

The critical question, of course, is not the ultimate normative judgment that I have just made but the question whether the law permits a jury demand to be struck. At least that is the first question. That is the question which Steve has asked that I devote the bulk of my time to. Does the law permit a jury demand to be struck? Well, it depends where you are. If you are not in Judge Brieant's court, or if you are not in the Third Circuit, or if you are not in the Ninth Circuit, nobody knows.

Judge Brieant will permit a jury demand to be struck on the authority of the famous footnote which I shall talk about in a minute in the *Ross v. Bernhardt* case.[3] The Ninth Circuit will not permit a jury demand to be struck believing, as do I, that there are no cases too complex, or at least that the Seventh Amendment admits of no complexity exception.

The Third Circuit, in reversing me and in what is probably the most important opinion in the field, said that the due process clause of the Fifth Amendment prohibits a trial by jury of a suit that is too complex for a jury and that this due process limitation prevails over the Seventh Amendment's preservation of the right to jury trial. What you have in the Third Circuit's *Japanese Electronics* case is a direct clash between two constitutional rights — between the due process clause of the Fifth Amendment and the more specific jury trial right of the Seventh Amendment. And in what is I think in recent constitutional history a rare decision, the Third Circuit, if you are pinochle players, said that the more general trumps the more specific — the general guarantee of the Fifth Amendment trumps the specific guarantee of the Seventh Amendment. The holding was that the due process clause of the Fifth Amendment precludes trial by jury in a suit in which a jury is unable to perform its task with a reasonable understanding of the evidence and the legal rules; and that in such circumstances the due process limitation prevails over the Seventh Amendment right to jury trial.

Now other than in the Ninth Circuit, the Third Circuit and in Judge Brieant's court, and there are one or two other district judges who follow Judge Brieant, nobody really knows what the right answer is. Let me

1. 478 F. Supp. 889 (E.D.Pa. 1979), *vacated*, 631 F.2d 1069 (3d Cir. 1980).
2. *In re* Japanese Electronic Prods. Antitrust Litigation, 631 F.2d 1069 (3d Cir. 1980).
3. 396 U.S. 531 (1970).

address the three questions, but first let me note parenthetically that they denied section 1292(b) certification in Judge Brieant's case, and that if they follow the counsel of Professor Leppert of the University of Michigan Law School and a number of other scholars, they will duck the question, as will the Supreme Court even though it is now confronted with a conflict in the circuits, until we know more about the problem and we have more experience.

The first question is whether there is any basis for reading a complexity exception into the Seventh Amendment. In my opinion in *Japanese Electronics*, and here the Third Circuit agreed with me, the answer is no. The basis most frequently invoked for reading a complexity exception is the famous footnote in *Ross v. Bernhardt* where the Supreme Court dealt with the question of a jury trial in a shareholder's derivative action.

The Supreme Court was confronted, of course, with the problem that the courts had been confronted with since the merger of law and equity in the Federal Rules of Civil Procedure. Before the merger of law and equity, you did not have a problem. You had equity cases where you did not have a jury trial, and you had law cases. The test traditionally applied was the historical test. The Supreme Court has always applied the historical test, i.e. in 1791 when the Seventh Amendment was passed, in what cases did you get a jury and in what cases did you not get a jury? There are lengthy exegeses in my opinion and other opinions about this question.

The Supreme Court was confronted with what you do with shareholders' derivative actions as they'd been confronted with similar questions in *Beacon Theatres*[4] and *Dairy Queen*.[5] As you know, the Supreme Court extended the jury trial right and said: You can't decide the equity issues first, thereby disposing of the case and depriving the party requesting it of the jury trial. But the Court in setting forth a tripartite test for what is legal and what is equitable used the phrase that you should consider: "the practical abilities and limitations of juries." Judge Brieant said that practical abilities and limitations of juries in the *Bernstein*[6] case are such that it is too complex to be tried by a jury.

I argued in *Japanese Electronics* which came after *Bernstein* that the Supreme Court in four or five cases after *Bernhardt* never used the *Ross v. Bernhardt* footnote even though they might have, and that footnote is not a basis for invoking a complexity exception to the Seventh Amendment. Therefore, in my view if you are to say that notwithstanding the Seventh Amendment there are cases in which we will strike a jury demand, you must do as the Third Circuit says and look to the Fifth Amendment, that is, look to the competing policy interests of the Fifth Amendment.

I further submit that underlying this whole question is the value judgment whether lay decision-making in the civil sphere promotes impor-

4. Beacon Theatres, Inc. v. Westover, 359 U.S. 500 (1959).
5. Dairy Queen, Inc. v. Wood 369 U.S. 469 (1962).
6. 79 F.R.D. 59 (S.D.N.Y. 1978).

tant social values. The courts will write lengthy, scholarly opinions in this area. I suspect, however, that it will all come down to the value judgment whether lay decision-making in the civil sphere promotes important social values. For myself, I think that it does. I think that lay decision-making in the civil sphere promotes important social values just as much as in criminal cases. We all have views on that, and I simply raise the question and go forward to the ultimate question under the Third Circuit analysis. That is whether the Fifth Amendment does in fact condition the command of the Seventh Amendment so that there is no right to jury trial in cases so complex that lay fact-finders cannot rationally assess the facts in light of the law. But there are three related questions.

First, can trial judges rationally make such assessments? We must consider whether trial judges sitting in a bench trial can do any better than the jury.

Second, can the jury's deficiencies be ameliorated by reasonable procedural innovation?

Third, should we thereupon retain the jury trial for significant legal issues that a jury can rationally resolve, fracturing the case, and having the judge decide the other?

In my opinion, the great mischief in the Third Circuit's approach is in the Third Circuit's view that one of the factors that you should consider in determining whether to deny a jury trial is whether severance of multiple claims, among other procedures, will enable you to simplify the case sufficiently that a jury can understand it. In my view, this approach which is a popular approach among the scholars who have written on this results in the tail wagging the dog.

We have mercifully developed in the last 20 or 30 years techniques of consolidating complex cases, having joint discovery, and using the joinder rules with respect to joinders of parties and claims so that we can bring efficiency to the litigation process. Now we get into a situation where as the result of our desire to preserve the jury trial — a very important value — we are afraid to bite the bullet. We say: "Okay, one way we can be sure to preserve the jury trial is if we make sure that we dismember the case and we sever off the multiple claims, and joined claims, and we try them separately." We use magistrates, masters and bench trials and so forth, and we just preserve the core issue for the jury trial. In my view that results in our jettisoning the great procedural gains of the last 20 or 25 years. I think that what we ought to do is bite the bullet and say, using the techniques that Judge Sweet is going to talk about, we will trust the jury. And if we say that the case is too complex for the jury, we then have to raise the question whether it is too complex for a judge.

I should note that you have got plenty of precedent on the subject. There must be 15 law review articles. There are extensive scholarly discussions. Nobody knows at this point what the Second Circuit is going to do.

There is, I note as a matter of interest, one Supreme Court justice who has declared on it. That is Justice Rehnquist, who in dissenting from the denial of certiorari in the *Berkey* case,[7] intimated that the question is very simple. It was a sort of Black/Douglas strict construction of the First Amendment analysis. In essence he said: "The Seventh Amendment says you have a right to jury trial," period. He didn't see any complexity exception in the text of the Seventh Amendment. For Justice Rehnquist, that is the end of it. And I think that is one vote that certain people were counting on, and he has virtually declared himself on the issue. Who knows whether that will be influential with the Second Circuit?

So there is some case law, and there is plenty of scholarship. Will the Second Circuit follow the Ninth, follow my opinion? Will it follow Judge Brieant's exception under *Ross v. Bernhardt*? Will it follow the Third Circuit and balance the Fifth against the Seventh? Who knows?

The critical question for you — and I shall spend my last few moments on this — is: what do you do when you are confronted with a case which might be too complex for a jury? The first thing I would tell you is, speaking as a trial judge of some 12 years' experience, don't make a frivolous motion. My grapevine tells me that the latest boilerplate motion when you have a complex case, is to move to strike the jury demand. But that is a dilatory tactic; it takes a lot of time. I'll tell you, if you bring a frivolous motion, you are going to get the judge angry. Unless it is an extreme case, unless it is a very close case, unless it is the case where your circuit might make the law, do not bring it. You are wasting everybody's time.

How do you determine whether a case is too complex? Charlie Brieant is going to talk about that. In my view, it is sort of like Potter Stewart on obscenity — you can't define it; you'll know it when you see it.

I just want to make a few comments on the procedural or, from a lawyer's point of view, strategic aspects of the matter. What do you want to do if you want to knock out the jury demand? You darn well better show the judge that this case is very, very complex. You are going to have to have, however, a separate discovery phase on that. You are going to have to have an in limine hearing on it. And I suggest that if the decision is one that you do not like, you are going to have to get your circuit to take an interlocutory appeal under section 1292(b). I think in a serious case, the court of appeals ought to grant certification, as the Third Circuit did for me.

How do you show it is complex? Well, obviously you summarize the evidence for the judge. One of the critical ways that you do it, I think, is show the judge how this case should be submitted to the jury. Make up the necessary special interrogatories. In *Japanese Electronics*, I think they made up 1200 special interrogatories. They said: "Judge, there is no way you can submit this case to the jury without these 1200 special interrogatories." They did not persuade me, but you may persuade somebody by showing with all of the claims, you are going to need 1200 special interrogatories. You may also use juror studies by psychologists, a memorandum

7. Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263 (2d Cir. 1979), *cert. denied*, 100 S. Ct. 1061 (1980).

on the technical issues in the case, an analysis of the issues. You are going to have to develop a procedure for analyzing the record and for presenting graphically to the judge in an in limine hearing — ask for an in limine hearing, a pretrial hearing on the issue — you must show why it is so complex.

How do you fend off if you are on the other side? How do you defeat the motion? Obviously, you show the judge how in four special interrogatories this case can be submitted to the jury. Usually in an antitrust case, the core issue is going to be conspiracy which is one of the reasons why the Third Circuit's approach makes little sense to me. What is the sense of severing of all of the multiple claims, the joined parties, if the core issue is a conspiracy or conspiracies which one jury could very well decide. Why not have one fact-finder decide once rather than have four, five or ten trials?

But you must be in a position to demonstrate, empirically perhaps, the jury's ability. This is what the scholars are saying, that the Supreme Court should not reach this case for the next five years — that is Professor Leppert in his Michigan Law Review article. There is a Virginia Law Review article which says we ought to study this some more. The social scientists ought to study it. We need more experience with the kind of techniques that Judge Sweet is going to talk about, that Judge Singleton and many other judges had used with respect to simplifying the issues, giving the jurors exhibit books. We need five years or ten years of empirical study in complex cases to see whether there are cases that are too complex.

But what you must do is submit to the judge a format as to how you will simplify the case, exhibit books, overlays, glossaries, and what have you, your special interrogatories that will show how this case can be made simple. So that what we do in another collateral proceeding which maybe makes this complex case even more complex, adding another stage to it, is to demonstrate why the case is not so complex.

But the critical factor in my view is developing the record, the timing of it. It seems to me that you can not do it too soon. Discovery is going to have to be well underway or perhaps complete, because otherwise you will not have a sufficient record for the judge to decide complexity.

One thing you may urge the judge to do, if you are defending this motion — this is the timing question; this is my last point — "The only way you can decide if it's too complex is to try it. You can treat the jury's verdict as advisory. You can be the ultimate fact-finder. Then when we get through it and we see how the jury did, only then will we know it's too complex."

Well, will the court of appeals reverse a jury verdict in an error-free trial on the ground that the jury did not understand it because it was too complex? Not likely. But this is the timing question that you are going to have to confront.

If I have given you some practical arguments that you can use, then maybe I have been of some help to you this afternoon.

THE HONORABLE CHARLES L. BRIEANT: I wish to start my portion of the Ed and Charlie Show, which is now the Ed, Charlie, and Bob Show, with the assumption that the court has power to strike a jury demand in a complex case and that that right did not originate in an obscure footnote of the Supreme Court in *Ross v. Bernhardt*, although frankly I do not think there is anything obscure about the footnote. This power comes from the Chancellor. It's a power which the Chancellor always had, because where there is no adequate remedy at law, equity will require the law to withhold its hand. And that includes withholding the use of a jury.

There is no need or purpose to rely on any claim of "tension" between the Fifth Amendment and the Seventh Amendment because there isn't any such tension. Recent commentators love to find tensions and contradictions within the Bill of Rights, but I submit there is none here. Just as in truth, there is no tension between the First Amendment and the Sixth Amendment in my personal view, although that is a matter for another discussion. And there isn't any because the Seventh Amendment merely preserves what our founding fathers enjoyed in the way of a right to jury trial. We can demonstrate historically that the right is properly defined within the entire scope of the footnote in *Ross v. Bernhardt*.[8] And because it was so obvious and so historically correct and sound, Justice White did not think it was necessary to elevate that footnote into the text, or to cite authority.

Now what are the standards? I had planned to invoke two clichés. One of them has been slightly preempted by the other part of the team here. I think Justice Holmes is reputed to have said: "There's nothing wrong with burning witches. The trouble is in determining whether those sought to be burned are witches." And in juxtaposition to that cliché, I was going to rely on Justice Stewart's famous comment, just mentioned by Judge Becker, "I can't define a standard for pornography, but I know it when I see it."

I am not sure that you can define a standard for a case so complex that a jury demand will be stricken, but I know it when I see it. And I submit that you will, too. I saw it first in the case of *Bernstein v. Universal*,[9] a nightmare case.

I am not going to dwell on the facts in *Bernstein* except to say that there the jury trial was sought by the plaintiffs, and resisted uniformly by all the defendants. In retrospect, I wish that at least one of the defendants, who claimed that they were not co-conspirators, at least not prior to the filing of the action, and had never been in violation of the antitrust laws, would have stood out from the crowd and also demanded a jury trial for itself. However, none did.

You will recall there was a vast plaintiff class of lyricists and composers charging conspiracy in restraint of trade and monopolization. More than a thousand individual contracts were involved, requiring a thousand

8. 396 U.S. 531, 538 n.10 (1970).
9. 79 F.R.D. 59 (S.D.N.Y. 1978).

mini-trials as to the named plaintiffs alone to determine what percentage of the performance fee each plaintiff would have received absent the alleged conspiracy.

Furthermore, the nature of the plaintiffs' proof invited the jury to find the existence of the conspiracy from an analysis of hundreds of individual contract negotiations, claimed to have a common thread to support a factual inference. There were 550 exhibits for this purpose alone, 15 fact witnesses in addition to the named plaintiffs, and accountants' worksheets (the correctness of which were in dispute) consisting of 2,500 pages. And the defendants had a few affirmative defenses which required 650 exhibits, 70 depositions and 15 sets of interrogatories. And the clerk's office literally had 15 file drawers of field papers on this litigation alone.

This case did not begin with me. It was filed long before I ever became a judge. The estimated length of trial was four months for the plaintiffs alone. Eight of the alleged conspirators were motion picture companies, two were television networks, and one was neither; and I could go on. Those who want to see a monster, which could only be the subject of a Hollywood production, should read the opinion in *Bernstein*.

Now our revered Second Circuit could have published first on this interesting topic, in light of its claimed intellectual leadership amongst the circuits, dating back to the days of the Hands. But it did not. A section 1292(b) certification was rejected. No reason for this rejection was stated and I always assumed that they thought I was correct. Then the case settled.

Since 1978 when *Bernstein* was decided, I have been looking assiduously for another witch, and we have seen some real gremlins, goblins and devils. But none of them rose or sank to the actual level of a true witch, complete with broomstick, as the *Bernstein* case was. And I suggest to you that the trend in our jurisprudence, if you forget the law review articles, is going to be something like this. First, in the trial court, the trial judge will say, yes, there is power in the court in a proper situation to strike the jury demand because of complexity. And the court will find this either based on complexity, relying on the historical exclusive jurisdiction of the Chancellor where no adequate remedy at law is found, footnoted in *Ross v. Bernhardt*, or based on this perceived tension which I deny exists between the Seventh and the Fifth Amendment in the Bill of Rights.

But the trial court will then go on to say: "Well, this is not really one of those complex cases." For example, in *City of New York v. Pullman*,[10] the case really boiled down, with all the length of trial and all the testimony and all the exhibits, to a simple question of whether lay members of the board of the New York Metropolitan Transit Authority had acted rationally and fairly in rejecting the advice of scientists. And to adjudicate this, it was not necessary for a lay jury to find out whether the scientists were in fact right or wrong.

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10. 662 F.2d 910 (2d Cir. 1981), *cert. denied*, 102 S. Ct. 1038 (1982).

Many such "complex" cases resolve themselves to simple issues of intent, knowledge, or reasonableness; underlying issues in complex cases which are really everyday fodder for a jury. And in those cases, the jury demand cannot be stricken.

I think the trend will also be that when cases such as *Pullman*, which was a complex case, but not a real witch complete with broomstick, reaches the court of appeals, the courts of appeals in those circuits, other than the Third and the Ninth in which this issue has supposedly been resolved, will tend to caution the trial judges, or inhibit them (depending on your view of the appellate judicial system) and say, for example: "Without some direction from the Supreme Court and without fuller consideration of the problem by this court, it would be premature to suggest that one view of this matter has prevailed over the other in this circuit." Of course, I am quoting to you from *Rosen v. Dick*,[11] a 1980 Second Circuit case decided in light of all the prior wisdom which Judge Becker has just mentioned.

If you would like to hear comfortable words on the issue of the standard, I would refer you to *Fowle v. Lawrason*[12] where the Court stated that in actions of a complex nature not involving an equitable accounting "great complexity ought to exist . . . or some great difficulty at law should interpose in order to induce a court of chancery to exercise jurisdiction." And by that they meant to exercise exclusive jurisdiction.

In the *Fowle* case, a family or estate dispute, the plaintiff sued the defendants for a share of rents which plaintiff claimed were due and owing. The issue of the proper amount due was resolved at trial by a commissioner, who made findings of fact on the amount and reported to the court. On appeal, the defendants argued that this proceeding had denied them their plain and adequate remedy at law. And in holding that the defendants had been so deprived of their right to a jury trial, which is what we are talking about, the court stated that there were non-accounting cases where the complexity would justify taking them away from a jury; but this was not such a case. More dictum, this time not in a footnote.

This brings me to a brief reference, if I may, to the standards set out for the Third Circuit in the decision of Chief Judge Seitz reversing the opinion by Judge Becker,[13] the senior partner in the Ed and Charlie Show. And that analysis, in a case commonly known as *Matsushita*, begins with a statement that a suit is too complex when circumstances render the jury unable to decide in a proper manner. That is sort of tautological, isn't it? I would not accuse an appellate court of writing nonsense. But "proper manner" according to whose view? And to determine in advance of trial, which is when these motions must be resolved (and that is when, historically, the Chancellor made the determination, in the advance of trial), you have to reach a conclusion as to what a jury can do with what is expected to be offered.

11. 639 F.2d 82, 86 (2d Cir. 1980).
12. 30 U.S. 5 (5 Pet. 495) (1831).
13. *In re* Japanese Electronic Products Antitrust Litigation, 631 F.2d 1069 (3d Cir. 1980).

Also considered in the *Matsushita* case are the length of the trial, the number of documents and depositions, the complexity of the issues involved. Occasionally, you will find mention, as in *Rosen v. Dick* in the district court,[14] of the inability to get a representative jury to attend. Well, I suppose the courts can compel representative jurors to go on welfare if need be, and attend the court. Courts certainly compelled attendance in the days when the Seventh Amendment was drafted.

By its definition, the Seventh Amendment did not require the use of a jury where it was not customary in 1791. And it was not customary in 1791 for a Chancellor to allow a trial at law where the issue was beyond the practical abilities and limitations of the jury.

So, as I said earlier, there is no due process issue that I see here. The only issue is, is this case so complex? Do we have a burnable witch? And essentially, the complexity has to be big; the case has to be long; it has to be so vast that six or twelve reasonable persons listening can not be expected in the nature of things to reach a fair or rational conclusion. And unfortunately, like so many things which had to do with the Chancellor, including the length of his foot, this tends to require a largely subjective and perhaps even emotional analysis.

In your presentations when any of you seek to strike a jury demand, I urge you as strongly as I can, try not to engage in elitism. We have a terrible elitist attitude about the difference between a bench trial, which is to a jury of one, finding facts, and a jury summoned from the highways and the byways. That is wrong.

We sequester a jury in a criminal case for fear they might see a headline in the newspaper. We get a motion for a mistrial if the marshal carelessly carries the defendant in handcuffs past the face of some juror so it can be seen that he is in custody. However, we allow criminal trials to proceed before judges in those cases where there is no right to a trial by jury, or in cases where a jury is waived, where the judge who is trying the facts has already held a bail hearing and a suppression hearing in the same case, read the grand jury minutes, and knows all about the prior criminality of the accused. And we assume that judges, by their oath of office, will (and I think they do) put those things out of their mind and give a fair verdict. But we are unwilling or unable for some reason to give the same benefit to our jurors honoring their oath. That is elitism of the worst kind.

And I suggest to you that motions to strike a jury demand which are based on elitism, relying on the higher judicial educational level, or greater judicial impartiality or greater judicial patience, are doomed to fail. The basic difference, and what I think justifies taking these complex cases from the jury, is that a bench trial can be recessed, can be prolonged, it can be interrupted to study issues as they arise. But most of all, the difference between the bench trial and the jury trial is that a trial court, as the Chancellor did in the formative years of our judicial system, will make detailed findings of fact and conclusions of law. These have to stand as an

14. 83 F.R.D. 540, 543-44 (S.D.N.Y. 1979).

integral decision. They have to be logical, they have to be connected. They are capable of being sifted, inspected, tested, and weighed by an appellate court and by public opinion. And there, the logical reasoned cohesiveness which ties them together leads us to what we call justice, subject to adequate review on appeal.

When the foreman of a jury, after a six, eight, twelve month trial stands up and says, "We find for the plaintiff," and mentions a number, which is thereupon immediately trebled in certain actions, there is simply no way of finding out whether the jury did its work at all, or whether they did it properly. And if the parties have thrown at the jury such a myriad of matters over such a length of time that no reasonable listener could be expected to comprehend and analyze them and come up with a fair conclusion, we must assume that it was reached in a manner other than fair; by compromise, or as the result of emotion, bias, or perhaps a preference for the personality of the successful litigator.

Now I know that you can use interrogatories with juries. A case which is amenable to jury interrogatories is not in truth a complex case. But if you are going to talk about a thousand interrogatories, the drafting of them will omit some logical possibility which the jurors will find for you — they do that even in maritime personal injury litigation — or the answers will come up inconsistently in spite of the best jury instructions. And in a truly complex case, for a jury which has heard a lengthy trial to answer a thousand or two thousand interrogatories, I think that is frivolous on its face.

If the totality of what is being presented to the jury is going to be so vast that a reasonable judge acting reasonably must conclude from what is being thrown at the jury that no reasonable jury could achieve a fair and rational resolution of the fact issues, then it is the duty of the court to regard it as a case where there is no adequate remedy at law. You can not answer that question by simply saying that the jury can not decide it in a "proper manner," because that is too much of a subjective value judgment, with all respect to the highly regarded Third Circuit of which my senior partner in the Ed and Charlie Show is a recently appointed member. He arrived after the damage was done.

The thought has appeared in the literature that to find out if the case is too complex, a jury trial should first be held. I think that suggestion ignores reality. If the case is not properly triable before a jury, then why should the court conduct a lengthy and expensive charade of attempting to do so? I do not think it is a viable answer to the problem to say, "Well, we'll try it with a jury. At the end of the jury trial when I see what a mess it's been, I'm going to say 'Well, it was too complex for the jury anyway. I'm granting your motion *nunc pro tunc* and deciding the facts differently.' " The Chancellor would not have allowed that in 1791 and I do not see why we should.

I would like to make a couple of cautionary comments. The complexity can't be a court-created complexity. This is not touched upon in *Bernstein*. It is in the Ninth Circuit opinion in *In re U.S. Financial*

Securities Litigation.[15] If the complexity exists because a court has made an improvident class action certification, or because the court has consolidated for trial a number of separate cases which were filed separately and could have been tried separately . . . or perhaps putting it a little differently, if the complexity is not created by the party demanding the jury, you cannot strike the jury demand. Of course, I suppose a litigant can't have it both ways. If the litigant says, "I want a class action and I want to consolidate all these parties and consolidate all these different claims," maybe the court can say to him, "Well, that's discretionary, all of that. I'm not going to let you do it unless you waive your jury demand." But where it is court-created complexity, I do not think that is the kind of complexity to which this historical basis for striking the jury applies.

I think as juries change, standards of what is too complex will also change. One of the ancient cases, somewhat questioned as to the authenticity of its report by the Third Circuit in *Matsushita,* is *Clench v. Tomley.*[16] In *Clench* a jury of illiterate freeholders was prevented by the Chancellor from adjudicating the title to real property where the case was based entirely upon documents. It is important to note that in *Clench* the party was suing for ejectment, a common law action. The Third Circuit claims the case is not reported correctly or something. Even assuming that is so, it is easy to imagine other such cases arising in the 17th century. For example in *Blad v. Bamfield,*[17] a case not cited in *Bernstein*, the meaning of a treaty was held by the Chancellor to be inappropriate for consideration by the jury in a common law trespass case.

Now you might almost regard *Bamfield* as a summary judgment case under our modern practice where we take out a particular legal issue which is controlling. The court could have said: "Assuming there was a trespass, which the plaintiff offers to prove, the trespass as a matter of law was justified by the terms of the treaty with Denmark." So some of the complex cases, where in the 17th century chancery practice they were taken away from the law court, are now taken away from the jury simply by motion. There are, of course, many reasonable changes in the mode of presentation of a case to a jury, involving visual aids and the like. However, I suggest to you these improvements don't help very much in the truly complex case which is so bad it should not be tried in front of a jury at all.

Moreover, and I would like to just raise this point without urging it, doesn't the Seventh Amendment mean "jury trial" as our forefathers knew a jury trial? And when you put too many frills and furbelows on a jury trial, and you clutter it up with notebooks and slide projections and copies of the charge, and mini-summations and mini-verdicts and a lot of other things, you are changing the dynamics of the trial so much that perhaps we are not talking about the jury trial as it was known to common law in 1791. And such improvements or changes may be a cop-out, and the wrong way to approach the problem of a complex case. I suggest that such extensive

15. 609 F.2d 411 (9th Cir. 1979).
16. 21 Eng. Rep. 13 (Ch. 1603).
17. 3 Swans. 604, 36 Eng. Rep. 992 (Ch. 1674).

trial judge participation, with all those mini-summations, mini-verdicts, and instructions given throughout the trial, may sometimes tend to produce an unjust result, just as much as attempting to try the case in the traditional fashion might produce an unjust result. Fortunately, the bench has lost those judges whom I remember as a young lawyer, who, willfully and knowingly and deliberately and intentionally and maliciously, if you will, used to breathe on your jury. They would lean over to the jury. They would say, "Members of the jury, I'm obliged to tell you that this defendant is presumed innocent." Then from there, it was all downhill.

I think if we really looked at it, we would find that in many civil cases the jury comes out with what they perceive to be the judge's view of the case in their verdict. This happens even if the judge is playing straight, and not being an activist, and not doing any dirty business. I hear lawyers tell, "Such-and-such a famous case we all know was assigned to Judge X, and he was regarded as an activist, pro-plaintiff judge, so the defendant demanded a jury." Well, what happened? The jury came in with boxcar numbers. Why? I leave that to you.

But I suggest the more complex the method of the trial is, and the more we have of mini-charges and explanations of everything by the judge, as the case goes along, the more likely that the jury is to regard him as their guide in this strange land. *He* is going to take them through this jungle, and show them how to find the truth. And depending on who your guide is may determine where you wind up.

So I think that all those things may be good up to a point. But they are a cop-out when it comes to this question of the very rare case that is so complex it ought not in fairness to be tried by a jury.

MR. AXINN: Are there any questions? Please raise your hand, stand up please and state your name and location.

MR. WILLIAM J. UNGVARSKY: Judge Brieant. Bill Ungvarsky, New York City. What weight do you believe should be given to a case that is complex for technical reasons? For example, a patent case that involves a truly complex organic chemical process. I go back to the early case that you mentioned about the freeholders who couldn't read and were disqualified from interpreting a land grant.

JUDGE BRIEANT: Traditionally those cases were tried at common law by using experts. And one expert looks much more attractive, he is more of a matinee idol than the other, and he is more glib and his fee is larger. And the jurors decide which expert they believe. We have done that for many years. We never felt that that was improper.

But answering your question, I think patent litigation gives you a separate problem.

If you will try that case, I submit to you that you will attempt to teach chemistry to the trier of the fact. I think you can make an argument to the effect that lawyers who have become judges and who have at least graduated from college for the most part are better potential students assuming they have the willingness to learn.

If you want to come in and teach organic chemistry, what really happens is you teach organic chemistry, the judge renders a decision, and a year from now he knows no chemistry, because he would had to wipe it out of his mind. If you are going to teach a jury and get a majority of them to absorb your learning, it may be harder. Also, I agree that starting at ground zero, the judge knows no more organic chemistry than the six welfare mothers from the Bronx who constitute a typical Southern District Jury.

MR. AXINN: I was going to say speak for yourself, judge. I went to law school precisely to avoid organic chemistry. I think we all did. Other questions please.

MS. HARRIET GUBER MULHERN: I'm Harriet Guber Mulhern of the Federal Trade Commission. In your opinion, what should the role of the judge be during the course of a jury trial?

JUDGE BRIEANT: Well, I come from the New York Bar. And in the New York Bar, it was believed that the judge ought to be a bump on the log and he ought to preserve decorum in the courtroom and observe the greatest possible silence. The tradition in our federal system is far different from that, and there are reported cases that say a judge need not be and should not be a bump on a log. A judge is permitted in our federal jurisprudence to comment to the jurors so long as he does not preempt their function. He could even go so far as to say to the jurors, "I don't believe that witness; but, of course, it's all up to you, members of the jury."

Now the tendency here, in the New York federal courts, because of our New York State background, has been for a rather limited participation. The judge, when he is not a trier of the fact today in the local federal district courts, tries to be as detached and stay out of it as far as he can. And I suppose that that is the more comfortable way to do it. I do think that if you assume the judge is to be a more activist role in a complex case, by interrupting, explaining everything, examining the witnesses a lot, butting into the trial as a true activist, then by the time the trial has gone a few days — you know, most of us are sometimes wrong but never in doubt — we may be getting a mental set or a viewpoint, and we may, consciously or unconsciously, influence the outcome with the jury. And I think a very strong argument can be made that you do not want that. You would rather have a bench trial, a chancery trial, than have a jury trial where the judge willingly or unwillingly, intentionally or unintentionally is manipulating this jury.

When the initial cases arose the automobile was not understood by most jurors. Today it is. You have no trouble explaining to a jury facts sufficient to adjudicate an intersection accident. And maybe within a few years, computers, and organic chemistry, and some of the other things will be known to juries. So it is an elastic definition, like the Chancellor's foot unfortunately. But I think the judges know pretty well what a jury can do and cannot do, just as they know hard-core smut when they see it.

As I said, cases where the jury demand should be stricken, or rather, where it will be stricken, because litigation is the art of the possible, will be, and in my judgment should be extremely rare: And I know that for me the

Bernstein case was a once in a lifetime case. I have had motions to strike the jury demand since then. And I have concluded regrettably in each of those cases, as I said earlier, that while we may have a minor hobgoblin walking around the courtroom, we do not have a true witch complete with broomstick.

That concludes my comments at this time and my contribution to the Ed, Charlie and Bob Show.

MR. AXINN: Thank you very much, Judge Brieant. If the original Ed and Charlie Show had half the cogency and careful thought given to it that this Ed and Charlie Show has had so far, it would have changed the course of American history for the better long ago. But there is obviously still a raging dispute here, and I am going to invite Judge Sweet now to step into the thicket because I want to get out of it.

THE HONORABLE ROBERT W. SWEET: Thank you, Mr. Chairman. Steve knows me very well, and that is why he has given me this great opportunity. It is quite clear that the show is inviolate, but it may be helpful to have somebody moving some of the props around toward the end. And I figured that basically is my function.

Since 1970 I have recognized that my duty is principally to certify to Steve's wisdom and capacity in the antitrust area, and that that of course is why I was invited here this afternoon. Having done that, obviously it would be appropriate for me to sit down. But I have been assigned this topic as a cover and I am prepared to do the best I can to perform.

On the subject of jury or nonjury, that is really not my bag this afternoon; and you have heard two genuine scholars at the law discuss it. It would not be appropriate to get into it except from the point of view that everybody ought to have a swing at the issue because it is, of course, the gut problem which all of you will have to face. As I see it, in making the decision there are three elements that go into it — rectitude, speed and certitude.

As far as the first is concerned, you may or you may not, depending on your posture in the litigation, desire a correct result. As between any old judge and a jury, I would certainly for myself pick a jury. As between an established, relatively predictable judge and a jury, I would suppose there should be no difference in the result. So one has to remind oneself occasionally of Damon Runyon's view of the law, that nothing between humans is better than three to one. But still, there should not be any difference in the result.

I really lean toward some of the considerations that Judge Becker mentioned — the question of the value to society. And just to state my own view, such as it is and obviously an immature one, but my own view is that this process, the entire process, is based on a desire of mankind and a society like ours to have order and understanding. And if that is indeed the purpose of the entire exercise through which we struggle, then it seems to me there is a value in having the layman involved in determining the values.

Now as far as speed is concerned, here I perhaps may disagree with others. I vote for the jury trial. In the jury trial, there is no "take it for what it's worth." And as Learned Hand was wont to say, I understand, "No district judge is worth his or her salt until they can sleep through eight hours of an attorney's argument and look awake." And I think that there is such a tendency for judges in a nonjury case. I think that there is something quite electrifying to an experienced trial attorney to see a dozing juror. And that may speed things along.

Of course, there is in terms of speed the fact that when it is done, it is done. There are no painful post-mortems, briefs, opinions by judges seeking, as Judge Brieant has indicated, to deal with all of the issues in a rational, coherent manner. It is over.

Finally, the third consideration in the choice it seems to me is that of certitude. I would suggest that there is an added reinforcement of fact-finding by a jury that conceivably might intimidate a court of appeals, perhaps a bit more than a fact-finding by a district judge, no matter how many credibilities he sprinkles through his opinion.

But let us assume then that however and on whatever basis, the decision has been made that the antitrust case, the complicated case, is going to a jury. We are faced then with the problem and sort of the tenet that Holmes expressed which Rehnquist used in his *Parklane* dissent[18] — that is to maximize the layman's common sense, the passional elements in our nature, and keep the administration of law in accord with the wishes and feelings of the community.

My wisdom on this subject is not dark or deep. I was reversed by the Court of Appeals in my first antitrust jury case, not because of an improper instruction I hasten to add, but because neither I nor the jury could have reasonably drawn the inference we did from the evidence presented. Parenthetically I note that very recently precisely the same thing happened to Judge Nickerson who also properly instructed an irrational jury, as it turned out.

I have, however, labored through a few long trials and I have listened carefully to my betters, such as Jim Brosnahan in San Francisco and Bob Hanley of Chicago, when they have discussed how to accomplish the presentation of complicated issues. What you are about to taste then is sort of a turkey hash of leftovers from a number of various sources.

Let me say though that Hanley's techniques, I think, have now stood the test of time to a degree. The *MCI* case has reached the appellate level. And that case took from February to June to try and which presented such problems familiar to you but to no other sensible person about fully distributed cost, and long-range incremental cost, and short-range marginal cost, and et cetera, et cetera; that case resulted in a jury verdict of $900 million, although reversed, not in terms of the techniques or some of the matters which I am going to mention to you. Basically, those things which were employed in that case were successful at least on the appellate level.

I am going to speak briefly, I hope, on four aspects of this problem —

18. Parklane Hosiery Co. v. Shore, 439 U.S. 322, 337 (1979).

out-of-court preparation, pre-trial conference following up much of what Judge Becker said about an in limine hearing, something about the jury selection process, and finally some comments about various trial techniques that might be used.

The first, this out-of-court issue of preparation for a complex jury trial by the use of shadow juries, complex social, society-testing techniques, and so on, I have absolutely no knowledge of, except to say that it is done and there are those who do have that sort of knowledge. And I would suggest to you that the writing in the field indicates that that kind of research, social research if you will, would be very useful in being able to identify the issues which would most directly impact the jury.

As far as pre-trial is concerned, of course, the way in which this happens is sort of luck of the draw, depending obviously on the place where you are and the judge with whom you are confronted. There are those who say that in the Southern District, we have 26 separate duchies and you need a passport to get from one courtroom to another, and you certainly cannot predict a particular judge's attitude with respect to pre-trial and what ought to be covered.

I would suggest to you the things which I would think you could probably get established and covered in a pre-trial setting. Some of them have been mentioned. A glossary. An agreed-upon index of documents and perhaps issues. An agreement obviously with respect to exhibits except as to certain ones where there might be some continued dispute which might be worthwhile at the jury level. But by and large, I would think almost all exhibits could be dealt with before you appear before the jury. Similarly, with respect to charts and any demonstrable physical evidence that you might have. And a thoroughgoing exploration of experts and their testimony. Though obviously you can get into a dispute on that subject, my own view is that that would be an essential part of simplifying the case for jury disposition. Trial books for each juror, including the things that I have mentioned by way of index, glossary, exhibits, et cetera.

Having made such a suggestion, of course, it goes almost without saying that I would think that under these circumstances note-taking by jurors is appropriate. If you are going to give them a trial book, it is pretty stupid not to be able to let them draw doodles in it or make notes or whatever.

A lot has been said on the subject of segmentation of a case, and that is certainly something that should be discussed at the pre-trial level: timing, issues, whether the case can be managed in a way to present certain aspects of it in a given timeframe.

There are successful, large antitrust cases in which electronic evidence has been very useful, the actual making of movies, to demonstrate. And I think one of the things which we are observing in trial courts these days is the really quite dramatic effect of electronic evidence. Whether it is that people would, if they see it on a screen, believe it where they would not otherwise or not, I am not sure. But I do think it is effective and should be considered.

When you get to the jury selection process, you obviously have the problem that has been adverted to — the composition of the jury. Some have suggested that an increased pay allowance for the jurors would be something that would solve this problem. From my point of view I do not think it is a problem so much of the money (although that is obviously a factor) as it is finding people who are willing to take the sufficient amount of time away from their careers to be able to serve on such a jury.

It is at that point, I would suggest, that the judge has his maximum degree of being able to get into the selection process. I would recommend that when you assemble your panel and you start the process, the first order of business should be an individual interview with anyone who is selected to be interviewed, that is potential jurors, in the robing room and discuss in a somewhat informal setting (to encourage a degree of candor) just how complicated it is, how difficult and so on; and that way hope that you will be able to get a suitable jury.

Obviously, there are risks in this. On the one hand the jurors of unemployables; on the other, retirees. And the selection process is difficult.

In this I do not think a big factor in that aspect of it is the method by which the jury is selected. I personally use a struck jury method as opposed to a jury box. I do not know that that really makes a great deal of difference, and would suggest to you that it probably does not. But I do think it is very important that at an early stage the counsel and the court have an opportunity to view the jurors in terms of their capacity to take the time to serve in this process.

Now, the trial itself. I think it really essential that the court deliver some preliminary charges, outline the case, give some indication as to what the law is going to be. It is also absolutely essential that there be no side bars. That would destroy the process. The case will be long and complicated enough so that if there is some issue on which counsel feels particularly aggrieved, there is no reason why it cannot be moved on to another afternoon, to another session outside of the jury's hearing.

I have already indicated what I think on the note-taking subject. If you are going down this road, your presumption is that these laymen are capable or can be made capable to dispose of the issue. Therefore, it seems to me axiomatic that they can participate to the extent of asking any questions that they might wish to ask. However, I also think that that is not an untrammeled suggestion. The questions ought to be formulated, given to the court, reviewed and then asked if necessary.

Friday has got to be off. I mean, there is no question in my view that you could not participate in this exercise and go five days a week. Friday is something that would be necessary for everybody's mental health and also give an opportunity to keep things on a schedule. There is a question of the form in which evidence is to be presented, such as using written narrative statements on direct cross-examination, something that Judge Green considered and rejected. The conflict between Rule 43, the requirement that evidence be taken orally in open court, and 403 of the

Federal Rules of Evidence giving the court power to exclude relevant evidence to determine to what degree, and to cut down the trial just by limiting the testimony that is presented. Such limitations were imposed in the *MCI* case and the practice survived on appeal.[19]

I think weekly openings, perhaps weekly instructions are desirable. I think obviously at the end, whether you have these weekly or you have final instructions, I believe the charge should go to the jury in written form. The jury should be completely familiar with them.

The question of separating out issues, bifurcation, I think is a very difficult one. *MCI*, a complicated case by definition that went to the jury, was sent back by the Seventh Circuit on the question of damages. The court stated, describing a little bit about what the retrial would be: "It seems difficult to determine how much MCI lost from the alleged slow-down of its growth without knowing something about the lawful price environment in which it and its competition could reasonably expect to operate. As we've indicated, MCI might not need to disaggregate its proof of damages among individual unlawful acts which cause loss but must be able to rationally separate. . . ." Well, the minute you get into issues like that, you begin to realize that the ability to bifurcate or to try separate issues is a very complicated and difficult one, and you might end up doing everything twice.

So I think these suggestions may or may not be helpful to you all. I can say only that on a day-in/day-out basis, I would think that many judges are impressed by the collective wisdom of juries and society's common sense and its ability to decide complicated issues even in this framework. Hopefully these suggestions culled mostly from others might sharpen and simplify the operation of that collective wisdom.

Thank you very much.

MR. AXINN: Thank you very much, Judge Sweet. As far as those encomiums of praise are concerned, it is only an acute sense of honesty that allows me to accept them.

Now I think it is time to permit comments from Judge Becker and Judge Brieant on the presentation of one another and of Judge Sweet. And when we have completed that, I hope we shall get some questions from the audience or from the judges to one another.

JUDGE BECKER: Two comments. First of all, the factor most frequently focused on as a reason not to have a jury in a complex case (i.e. how long the case is going to take), in my view has nothing to do with complexity. Now it may well be that empirically it is easier to establish that people get bored or lose interest when there is a long trial than it is to establish that complex, technical issues go over the heads of jurors or, as I have suggested, judges.

But it seems to me that while in practical terms that may be a good reason, unless you increase the pay of jurors or give them parking privi-

19. MCI Communications Corp. v. American Tel. & Tel. Co., 1982-83 Trade Cas. (CCH) ¶ 65,137 (7th Cir. 1983).

leges or something, not to have jurors in long cases, that has nothing to do with the Constitution. It has nothing to do with the jury trial right. It has nothing to do with any complexity exception. And it seems to me there are less restrictive ways of dealing with that problem, which bridges me into my second comment.

The constitutional guarantee of trial by jury has relatively little to do, I would suggest — I do not say nothing to do but less to do than a lot of us think — with what kind of jury you have. In other words, I do not think that the Constitution prohibits some special kinds of juries. For instance, there were blue ribbon juries for years. Blue ribbon juries were abrogated by abrogating the statute or the rule-making authority which called them into existence, not generally by virtue of a constitutional decision.

There is a venerable history. You would be interested to know that among the early uses of specially qualified juries were juries of cooks, and fishmongers — this is way back in England in the 14th century — where one was accused of selling bad food; a jury of merchants to try an issue between two merchants touching merchants' affairs. This goes back into the 14th and 15th centuries, and these are chronicled by Thayer in his famous 1892 Harvard Law Review article.

In the state of New York for years and years you had special jury. The New York state special jury was upheld on two occasions by the United States Supreme Court in the *Moore* case[20] which was in 1948 and in the *Ray* case.[21]

Now ultimately the special jury statute was repealed by the New York legislature. But it seems to me that one less restrictive way of confronting the problem is perhaps experimentation with some blue ribbon kind of juries, some jury of better educated people, and perhaps the other means that I suggested and Steve mentioned earlier of paying the jurors more (Judge Sweet I guess mentioned it), improving their living conditions, as it were, so that it will get people who are a) better equipped and b) more hospitable to sitting for four months, six months, eight months or a year so that we do not have to bite the bullet of this very difficult constitutional question.

I think that judges know as little about organic chemistry as cooks, carpenters, truck drivers and policemen, and maybe less. So I go back to what I said before. I think that a jury is as qualified or more qualified. You at least might get a couple of bright ideas out of three or four jurors than you will get out of one judge in terms of analyzing the credibility of the expert. Charlie's quite right — they are tried on the basis of expert testimony. And I think you will get as good a result as you will get from a judge.

MR. MARK NEVILLE: Do you think it would add some light to the issue to ask the jurors in a case whether they consider themselves competent, perhaps at the outset after the case has been explained to them, and then after the case is over?

20. H.L. Moore Drug Exchange v. Eli Lilly & Co., 662 F.2d 935 (2d Cir. 1981), *cert. denied*, No. 81-225 (Oct. 4, 1982).
21. 581 F.2d 998 (D.C. Cir.), *cert. denied*, 439 U.S. 933 (1978).

MR. AXINN: Of course, in the *ILC Peripherals* case,[22] at least the foreman admitted that he could never be competent on a retrial. You'd never find a competent jury. But, with that, what do you think?

JUDGE BECKER: I do not think that it would help very much in the beginning. And in terms of making the judgment, I think it would be a very poor basis on which to bottom your review.

It might, however, if you got a sufficient body of empirical data by this kind of study. I mean you are not talking about a very good sample. But if you studied this thing for long enough, and I think this is one of the reasons that the Supreme Court denied the petition for certiorari it had in the *U.S. Financial* case,[23] if you studied the thing long enough, you may learn enough about the dynamics of this kind of trial, what juries can do and how judges can manage these cases to make an informed decision.

JUDGE SWEET: I would second that thought. I apologize. I have it in here but not readily printable at the moment. There has been some writing about the *Corona* case, the migrant worker murders in California, where there has been a very careful analysis, at least in terms of time and parties, et cetera. I think perhaps in time, not in the fashion which you suggest but more along the lines that I think Judge Becker was aiming at, maybe with some better analysis and empirical study, one might be able to develop something.

In my own experience in jury selection, it would be useless to try it at the outset and dangerous to do it at the end. But you might be able to do something by way of designing a study if you could put together enough of them and do some analysis and research after the entire thing is over.

JUDGE BECKER: There is an article in the Connecticut Law Review[24] which talks about this. A rudimentary questionnaire was sent out, and we are starting to get some data but I think we do not have nearly enough.

MR. AXINN: I just want to say that I have been doing this for some time. I think this is the most terrific, super program we have had with judges in an awfully long time. I want to thank the three of you very much on behalf of the entire section for coming and sharing your insights with us today.

Thanks very much.

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22. ILC Peripherals Leasing Corp. v. IBM Corp., 367 F. Supp. 258 (N.D. Okla. 1973), *rev'd per curiam*, 510 F.2d 894 (10th Cir.), *cert. dismissed*, 423 U.S. 802 (1975).

23. 648 F.2d 515 (9th Cir. 1980), *cert. denied*, 451 U.S. 970 (1981).

24. Comment, *The Right to an Incompetent Jury: Protracted Commercial Litigation and the Seventh Amendment*, 10 Conn. L. Rev. 775 (1978).

Chapter 5
ANNUAL DINNER AND ADDRESS by STATE ATTORNEY GENERAL ROBERT ABRAMS

CHAIRMAN STEPHEN M. AXINN: Today has been a treat for all of us. This Section today has put on an Antitrust Program of such quality and excellence that I cannot recall an occasion when we have been of greater service to the Bar. This morning, Kimba Wood led a program on Deregulation and Its Implications for Antitrust, starring Fred Kahn, Paul MacAvoy, Gordon Spivack and Miles Kirkpatrick, all of whom did a superb job. This afternoon we had two concurrent workshops, one on Distribution led by Alan Weinschel, and one on Exemptions led by Paul Koepff. Then we were treated to a special demonstration of the qualities of our judiciary by Judge Edward Becker of the Third Circuit Court of Appeals, and Judges Charles Brieant and Robert W. Sweet of the Southern District of New York, on the question of Complexity of Jury Trials.

This evening, before we get to our principal guest of honor and to his remarks, there are a few matters of delightful business that I am privileged to preside over.

First, I would like to introduce to you the people who are seated on the dais. These are the special people who make this Section run and/or who make this government run.

On my far left, the Regional Director of the Federal Trade Commission in New York, Roy Richey.

Immediately to his right, a member of our Executive Committee for many, many years and a stalwart of this Section, is Ed Wolfe.

Immediately to their right, is Professor Harry First of the NYU Law School who was a guest speaker today.

To their right, is Wally Barthold, who was today elected the Vice Chairman Elect of our Section.

Wayne Collins is next to Wally. Wayne is a Special Assistant to Assistant Attorney General Baxter in Washington.

Next to him is Henry King of Davis Polk. Henry is a former Chairman of this Section and is now a member of our Executive Committee.

Next to him is Eleanor Fox. Eleanor is a former Chair of this Section, a member of our Executive Committee and a Professor of Law at NYU.

Next to her is Judge Brieant, whom I am sure you all know.

My successor, come June 1, is on my immediate left, the very delightful Kimba Wood.

I will pass over Attorney General Abrams only for the moment.

To his right, however, is the Assistant Attorney General for Antitrust in New York and I think you all know him, or will, Lloyd Constantine.

To his right is Jim Halverson. Jim is the immediate past Chairman of this Section and a member of our Executive Committee.

And to Jim's right is Irv Scher who preceded Jim as Chairman of our Section and is a member of our Executive Committee as well.

Then, proceeding along the line, is Larry Fox who is the Vice Chairman of the Legislative Committee of our Section. Larry was a speaker today and has been a very, very active participant in our affairs.

Next to him is Bill Lifland whom you all know. Bill is our Section Delegate to the House of Delegates of the New York State Bar Association. I can hardly see any farther but I understand that sitting next to Bill this evening is Scott Bass who was a speaker this afternoon at our Section meeting on Distribution.

And on the far right is the Chief of the New York Regional Office of the Antitrust Division of the Department of Justice, Ralph Giordano.

And now if I can ask you for one round of applause for all these estimable ladies and gentlemen.

(Applause)

You really have done a terrific job all day today and all year.

I now have the pleasure, if I may call upon Jim Halverson to rise and come to this lectern, to present to Jim, on behalf of the Section, a plaque in honor of the magnificent performance that Jim put in as Chairman of this Section during the year just ended. The plaque reads, "Presented to James T. Halverson in recognition of his services as Chairman of the Antitrust Law Section for the years 1981-82" and a very richly deserved plaque. Thank you very much, Jim.

(Applause)

JAMES T. HALVERSON: Thanks, Steve.

And my special thanks to all the Committee Chairmen and everyone who worked so hard during the year that I was Chairman, thank you very much.

CHAIRMAN AXINN: Before proceeding to introduce our guest speaker this evening, I would just like to say that events such as this are hard to produce and take an awful lot of work. I am very grateful that during the course of this past year I have been assisted by my friend and colleague, Doug Adler, in producing events like this for the State Bar Association. I am very grateful to Doug for tonight's dinner and for the whole program today.

And now, if I may, I would like to proceed to the principal business that we have before us. I would like to say that this Section is proud to have as its honored guest and principal speaker tonight the Attorney General of the State of New York, Bob Abrams.

The Antitrust Section of the New York State Bar Association has had a very long and I hope a mutually rewarding affiliation, through its Executive Committee and its Working Committees, with the New York State Attorney General's office. But not until tonight have we had the good fortune to be addressed by the Attorney General himself. I think it is typical of this particular Attorney General, whom the people of New York had the good sense to elect and then to reelect, that he would take time from his responsibilities and duties to come and address this Section and to inform us as to his antitrust views and the antitrust activities of his office and his administration. But Bob is such an extraordinary individual and has had so many other firsts to his record, that this is really not in any way unusual for him. Bob is a product of the Bronx and of the New York City public school system. He is a graduate of Columbia College and New York University School of Law. Bob tells me that he spent seven years in private practice in this city, which means that he knows all the tricks of our trade and we should be careful in attempting to pull any on him.

In 1970 he was elected Bronx Borough President, a position he held until the people of the state had the good sense to elect him Attorney General in 1978. In 1982 he was overwhelmingly reelected.

Now many of us know the marvelous strides that Bob has made in restructuring and reinvigorating the staff of the Attorney General's office, particularly as they concern antitrust. Throughout his career and specifically throughout his history as the Attorney General of the State of New York, Bob has been actively involved in taking a leading role in seeking new directions for antitrust enforcement at the state level. He has a very bright, new effective team of antitrust lawyers at the Attorney General's office. Lloyd Constantine, who is on his right, has already played an active role in this Section's activities and we are grateful to him for doing so.

We are all aware of some of the activities of the Attorney General's offices in areas such as the Milk investigation and prosecution. We know that Bob, in the last few days, announced that he has turned the attentions of his office to at least one other beverage. This is a bill relating to territorial restrictions in the beer industry which I suppose I should refer to as Draft Legislation.

(Laughter)

Ladies and gentlemen, I am very proud, very pleased and honored on behalf of this Section to present to you the Attorney General of the State of New York, Robert Abrams.

HONORABLE ROBERT ABRAMS: Thank you very much, Steve, distinguished members of the judiciary and leaders of the antitrust bar of this great state.

When I came in this evening I panicked because I guess life has been so hectic and busy for me that while I had ample time to prepare my remarks for the evening, I realized when I came in, was greeted by Steve, saw a lot of people here, and went over to the bar to get a drink, that I was not prepared to begin with a joke. How can any guest speaker be a success if he does not begin with a humorous incident or story? I reached into my repertoire and came up with this one which probably all of you have heard, so I am failing right at the outset. It relates to an incident that occurred to St. Peter. He was presiding up there, at those pearly gates, way up in the clouds, in the great heavens, and he greeted this newcomer with a great deal of warmth and indicated how honored he was to greet this man because although he had been around a long time and many members of the newcomer's noble profession, lawyers, had arrived there as well, he was especially honored to meet this individual, not only because of the great distinction that he had in the practice of law over many decades but because he achieved the ripe old age of 155. That is something that is not attained by everybody who has arrived in heaven and who has been greeted by St. Peter. The gentleman said, rather modestly: "Well, St. Peter, I appreciate the warmth of your welcome but I must correct you. I did not come up here after spending 155 years on earth." At which time St. Peter excused himself and left the scene for a while and returned and said, "Sir, there is no mistake, we just recomputed your timesheets and they do add up to 155 years."

(Laughter)

I checked with Lloyd to see if these guys file timesheets and he said they do.

(Laughter)

I have had a great time for the last four years. It has been a real thrill for me to be elected to the post of Attorney General and to be given the opportunity to build on the record and tradition of my 59 predecessors. We have attempted to make a number of changes to try to make the agency overall more streamlined and more efficient. We have tried to breathe some new life into the agency. It is the second largest law office in the nation. We have 15 offices around the state. We have 465 lawyers. And it gave me the chance to try to bring to that agency men and women who share my vision of the potential work of the Attorney General and the commitment to the public interest. Probably the proudest thing that has happened to me in my first term was to be able to try to attract (and I hope in part have been successful at attracting) some very special people. Perhaps the kind of people who have come to the Antitrust Bureau are a reflection of the kind of people who overall have come to our agency. For example, out of the last five or six people whom we have hired in the Antitrust Bureau, one individual spent five years at Dewey Ballentine and Hughes Hubbard doing antitrust work. A second one clerked for a federal judge and spent four years working for Arent, Fox, in Washington and Skadden Arps here in New York. A third one was a Phi Beta Kappa graduate of Bennington College, Harvard Law School, spent three years at Kelly Drye working on antitrust matters, and left the Antitrust Division of the Department of Justice to come to work in the New York State Attorney General's office. Another one we just hired spent three years working for Leroy Richey at the Federal Trade Commission right here in New York. That is the kind of profile and person that we have been able to attract and that has enabled me to undertake some major new initiatives. That could not have been done if I did not have a very special person heading the Antitrust Bureau in the New York State Attorney General's Office. I want to publicly acknowledge and thank him for his special acumen and dedication. I am talking about Lloyd Constantine, who is a brilliant, aggressive and experienced litigator who has given the kind of impetus and drive that I think or I hope that you have found in the people of this state over the last three and a half, four years. I would also like to acknowledge the presence of the Deputy Chief of the Bureau, Bonnie Whitner, who is an able and effective Deputy.

I know that it is customary for this distinguished Annual Meeting to be addressed by the Assistant Attorney General in charge of the Antitrust

Division of the United States Department of Justice. Had that tradition been continued this year, I would not have had this opportunity to talk to you about a subject that troubles me — this national administration's abdication of its antitrust enforcement responsibilities and its abandonment of carefully evolved legal standards. . . .

(Applause)

. . . which were once beyond the realm of partisan whim.

(Applause)

There is more.

(Laughter)

I am only just warming up.

(Laughter)

Kimba is giving me an extra dimension of inspiration.

I am therefore most appreciative of the invitation that you have extended to me tonight to convey some strongly held views.

The enforcement void created by federal inaction and federal hostility to the law has placed an unprecedented burden on the Office of the Attorney General in New York and on state attorneys general throughout the nation. It has therefore also created an unprecedented opportunity for these offices to exercise ancient but recently dormant powers in these areas of vital concern to the public. Along with you I intend to see that the antitrust laws are not relegated to the status of antiquarian relics. As a personal note, let me add that while your offices and mine will not always be on the same side of cases and issues, you will always find us to be fair, as well as firm, and responsive while yet responsible. You are the leading practitioners of antitrust law in New York where commerce far exceeds that of any other in these United States. The antitrust laws, variously characterized as the Bill of Rights and Magna Carta of the American system of free enterprise, have come under a withering assault unlike any other since they were codified in the Sherman Act of 1890. That the attack should be spearheaded by the Justice Department and the Federal Trade Commission, the traditional champions for fostering and protecting competition, is in my view truly shocking.

Of course, I recognize that in the past each change in federal administration has brought a measured shift in antitrust enforcement priorities. This is healthy and it is to be expected. It has kept competition and advocacy from becoming stagnant. However, the course that has been chartered by the Antitrust Division and the Federal Trade Commission during the last two years is not merely a shift in emphasis. Rather, it is an all-out assault on the basic tenet of a non-partisan enforcement policy. It has amounted to a reckless discarding of firm legal precedent and has opened defiance of the Supreme Court.

To some of us it raises a grave question as to whether the executive branch is discharging its constitutional obligation to, and I now quote from the United States Constitution, "to take care that the laws be faithfully executed."

The Antitrust Division's most blatant acts of contempt for the law have been in its repeatedly expressed intention to disregard established principles with respect to certain boycotts as well as tying arrangements and retail price fixing conspiracies. The pernicious practice of retail price fixing has been consistently opposed by the federal government, which has treated it as a per se violation of the Sherman Act since 1911. Just last summer, the Supreme Court, in a decision characterized as "stupid" (and that was the word used by William Baxter), reaffirmed the vitality of this rule. Fair trade laws, the last vestiges of legal resale price maintenance, were eradicated during the Ford administration. The Congress which did so relied on the Justice Department's finding that the practice was costing American consumers over $2 billion yearly in over-charges, causing prices to average 18% to 27% above a free market level. Only a few months before President Reagan took office, the Antitrust Division indicted and convicted the Cuisanart Company for retail price fixing.

It is against this backdrop that Mr. Baxter, upon taking office, declared that retail price maintenance should rarely be prosecuted and should not be treated as a per se antitrust violation. The Antitrust Division has even threatened to appear on the side of the retail price fixer. It would indeed be ironic and perversely fitting for the Division to make good on this threat in one of the parens patriae suits filed by a state attorney general in the wake of the Antitrust Division's own successful criminal prosecution of the Cuisanart Company. To my mind it is indefensible for the Antitrust Division to give the business community the go-ahead on retail price fixing because it may well lead to criminal indictment in a state such as New York. That we in New York are willing to use our criminal antitrust enforcement powers can be seen from the fact that the Attorney General's office recently secured 43 convictions for acts of retail price fixing in New York's milk industry.

Less dramatic but no less harmful is the Antitrust Division's position on vertical restraints which should be examined under at least a searching rule of reason inquiry. The Antitrust Division has in effect adopted a rule of per se legality. It has stamped its imprimatur on vertical restraints which substantially eliminate actual intrabrand competition. . . . intrabrand competition in highly successful and concentrated industries. This has been justified as fostering interbrand competition which is all but illusory in many industries, especially those where consumers have strong brand loyalty as a result of mass advertising.

For example, while Congress has hotly debated whether or not to grant the beer industry partial immunity from the antitrust laws, the Antitrust Division has not so much as engaged in a sidelong glance, let alone a reasonable look, at the recent creation of territorial monopolies for the distribution of beer by the nation's dominant firm. This is, of course, the very practice which is sought to be legalized by the proposed Malt Beverage Act. The Division has decided to grant immunity in advance of this legislation.

It is timely to look back at the legislative history of the antitrust laws in this nation and the social and economic context in which those laws arose.

These laws embodied a healthy distrust of the virtues of bigness obtained by the elimination of competition. This principle was already deeply rooted in the antitrust common law of the various states before passage of the Sherman Act, which Senator Sherman viewed as a supplement to state enforcement. Now, with the substantial withdrawal of the federal government from enforcement of the laws, as we had come to know them, we are back where we started, relying again on state enforcement.

I intend to maximize the modest antitrust resources at my disposal to the fullest possible extent under the criminal and civil provisions of the state's Donnelly Act and the substantial powers that are granted to the Attorney General's office under the various federal antitrust laws. This task is monumental. Many of you are in firms which have far more lawyers than all of the antitrust attorneys in the 50 State Attorneys General's offices put together. Plainly this means that the enforcement gaps, created by the Department of Justice through its open hostility to the rule of law, cannot be completely filled by state government. The role of private attorneys general in this area is, therefore, vitally critical.

I would like to take this opportunity as well to tell you a few things that our office is doing to address meaningfully this enforcement problem in New York and around the nation.

First, I have directed my Antitrust Bureau to concentrate on cases with the broadest possible impact, especially those where there is evidence of criminality. Our emphasis will continue to be on fostering competion in basic industries involving central commodities and services, such as construction materials and health care.

Where appropriate, our Antitrust Bureau will coordinate with the State's Organized Crime Task Force, which is headed by one of my deputies as well.

Second, I have instituted, without the use of state funds, a statewide computer-assisted project to monitor and ferret out collusive bidding patterns in public contracts for goods and services throughout the state. With more than 2500 public entities in New York State awarding contracts after competitive bid, this method of investigation is one rational way of honestly confronting an otherwise unmanageable problem of detection and establishing a realistic deterrent. We have been closely scrutinizing areas as diverse as paving contracts and ambulance services.

Third, I am proposing to the State Legislature this year two generic bills which will greatly strengthen state antitrust enforcement and enhance the state's competitive climate. One bill will empower a grand jury sitting in any county in the state to indict for criminal antitrust activity that is committed in any other county of the state. In the milk prosecutions, my office conducted investigative grand juries in three counties where one grand jury might have sufficed, with a substantial saving, of course, going to the State Treasury, a substantial saving of state funds and witness and attorney time. The statewide grand jury procedure has already been adopted with great success in eight different states, including some of our neighboring states, in Pennsylvania as well as New Jersey.

The other generic bill would replace the now archaic Donnelly Act with a completely new antitrust law for the state of New York. My office will be actively seeking your own views, institutionally and individually, on this major piece of antitrust law reform. The most important feature of this bill is its strict conformity with the language and interpretation of the Sherman Act. This is of special significance given my promise of increased state enforcement activity. I feel that our business community must no longer be asked to live with the uncertainties of two divergent sets of antitrust standards.

Fourth, I will continue to propose legislation which addresses the Antitrust Division's failures in enforcing the law, such as its refusal to act on the market divisions in the beer industry, which I alluded to before and which Steve mentioned. The House Judiciary Committee has received documented testimony demonstrating that the establishment of exclusive malt beverage distributorships will extinguish intrabrand competition and cause beer retail prices to rise as much as 20% as they did for soft drinks after the passage of the 1980 Soft Drink Interbrand Competition Act, an act which I think will go down in infamy for abuse of the plain meaning of language. Two days ago I proposed state legislation that would seek to ban exclusive territorial allocations in the beer industry.

Let me observe finally that the great void in antitrust enforcement is a national problem. I will accordingly propose to my colleagues in the National Association of Attorneys General that each state designate at least one antitrust attorney to coordinate multi-state enforcement activity. The pooling of investigative staff and subpoena powers, and the creative use of cross-deputization, can establish a nationwide public antitrust firm which will begin to address the problems which arise from the enforcement policies of this current national administration. State attorneys general are firmly committed to strong enforcement of antitrust laws. The legislative narrowing overruling of the *Illinois Brick* decision has been the most important item on the legislative agenda of the National Association of Attorneys General for the last four years. A renaissance of state enforcement is underway here in New York and indeed around the nation. I regret that on my first opportunity to address you this evening I must report that vigorous state antitrust enforcement was not an additional force to protect competition in this country. Rather, it was on its way to becoming the replacement for the leadership expected from our national government.

In 1907 the Attorney General of Texas filed an antitrust case against the Waters, Pierce Oil Company. A jury returned a verdict for the then astounding sum of $1.6 million. So that the significance of that case would not be lost on the general populous, the attorney general had the money placed in a wheelbarrow and rolled up the main street of the state capital to be deposited in the state treasury.

(Laughter)

Now, I do not really approve of such wheelbarrow stunts . . . .

(Laughter)

CHAPTER 6
FEDERAL ANTITRUST ILLEGALITY AS A DEFENSE ON A CONTRACT: *KELLY V. KOSUGA* REVISITED

Robert S. Walker†

I. Introduction

There is presently a divergence of opinion regarding the use of federal antitrust illegality as a defense in action on a contract.[1] The problem commonly arises in situations where a contract is entered into by two parties, and subsequently one of the parties wishes to avoid this contractual liability; the first party brings an action on the contract, and the breaching party interposes the defense that the contract is in violation of federal antitrust law.[2] At that point, the trial courts must decide whether to allow the defense or not.

Unfortunately, this decision is not as easy as it sounds. The Supreme Court grappled with the problem of whether to allow such a defense from the early 1900's until approximately 1959,[3] concentrating its analysis on the "interface between contract rights and common law principles of the Sherman Act and state antitrust laws."[4] The Court viewed the common law as rejecting antitrust illegality defenses where the contract and underlying economic transaction were collateral to the alleged restraint of trade under the antitrust laws, and did not consider the Sherman Act as a legislative abolition of this collateral/direct common law principle.[5] The Court subsequently allowed the defense in a situation where unlawful price-fixing provisions of a contract were "essential parts of an illegal scheme."[6] Finally, the Court attempted to resolve its tortuous antitrust illegality defense doctrine in the case of *Kelly v. Kosuga*.[7]

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†Jones, Day, Reavis & Pogue, Cleveland, Ohio; J.D., Cleveland-Marshall College of Law, 1982.

1. *Compare, e.g.*, Mullins v. Kaiser Steel Corp., 642 F.2d 1302 (D.C. Cir. 1980), *rev'd*, 102 S. Ct. 851 (1982) *with* Nat'l Elec. Contractors Ass'n, Inc. v. Howard P. Foley Co., 498 F. Supp. 552 (D. Md. 1980). These two cases provide an excellent example of the problem because they both involve disputes over money owed to pension funds pursuant to collective bargaining agreements entered into between the respective employers and labor unions.
2. The scope of this article is confined to treating the question of the validity of the defense vis-à-vis the federal antitrust laws; in actions brought under state antitrust statutes the issue is resolved under the various state doctrines; the defense is usually allowed. *See, e.g.*, Cummings v. Union Blue Stone Co., 164 N.Y. 401, 58 N.E. 515 (1900); Lufkin Rule Co. v. Frengeli, 57 Ohio St. 596, 49 N.E. 1030 (1898). *See also, e.g., Ohio Rev. Code Ann.* §1331.05 (Page 1979) (violation of Ohio's antitrust laws precludes enforcement of the contract). *See generally* 54 Am. Jur. 2d *Monopolies, Restraints of Trade, and Unfair Labor Practices* §§641-44 (1971).
3. *See* Comment, *The Defense of Antitrust Illegality in Contract Actions,* 27 U. Chi L. Rev. 758, 759 (1960) [hereinafter cited as *Antitrust Illegality*].
4. II E. Kintner, Federal Antitrust Law §15.4, at 449 (1980). *See* Connolly v. Union Sewer Pipe Co., 184 U.S. 540 (1902).
5. E. Kintner, *supra* note 4, §15.4, at 449-50.
6. Continental Wall Paper Co. v. Louis Voight and Sons Co., 212 U.S. 227, 261 (1909). *See* E. Kintner, *supra* note 4, §15.4, at 450-51.
7. 358 U.S. 516 (1959). *See* notes 15-33 *infra* and accompanying text.

In *Kelly* the Court attempted to accommodate the competing interests of contract and antitrust law by enunciating a less-than-clear test to follow when the defense is interposed:[8]

> [W]here . . . a lawful sale for a fair consideration constitutes an intelligible economic transaction in itself, we do not think it . . . violative of the intent of the parties to give it effect even though it furnished the occasion for a restrictive agreement. . . .

The Court also acknowledged, however, that situations may arise where "the judgment of the Court would itself be enforcing the precise conduct made unlawful by the [Antitrust] Act,"[9] and stated that federal courts should *not* enforce contracts in such instances.[10] The "overriding policy" remained of preventing people from "getting other people's property for nothing when they purport to be buying it."[11]

The tests set forth in *Kelly v. Kosuga* did little to clarify this conflict between principles of contract law (where one should receive the benefits and also bear the burdens of his contract)[12] and antitrust law (where economic restraints of trade under, among others, the Sherman Act and Clayton Act embody a distinct Congressional policy against unreasonable restraints of trade were not analyzed or weighed to reach a rational result accommodating each set of interests). Not surprisingly, the results of later adjudications on this issue in the federal courts reflect this uncertainty.[13]

This Article will discuss the *Kelly* doctrine and its underlying precedents and rationale; cases subsequent to *Kelly* will then be analyzed in light of *Kelly* to ascertain whether the tests are followed and, if so, whether the results reflect a proper balance of the equities; the recent Supreme Court decision of *Kaiser Steel Corp. v. Mullins* will be discussed; finally, proposals will be proffered regarding when an antitrust illegality defense should be allowed.

II. The Kelly Doctrine

Kelly v. Kosuga began as a simple diversity action by a seller of onions to recover the price of onions sold and delivered to the buyer.[14] The petitioner had purchased fifty cars of onions from the respondent at an agreed price of $960 per carload, but petitioner only withdrew thirteen of

8. 358 U.S. at 521.
9. *Id.* at 520.
10. *Id.*
11. *Id.* at 520-21, *quoting* Continental Wall Paper Co. v. Louis Voight and Sons Co., 212 U.S. 227, 271 (1909) (Holmes, J., dissenting). *See generally Antitrust Illegality, supra* note 3, at 761.
12. *Antitrust Illegality, supra* note 3, at 768-73.
13. *See* note 1 *supra* and accompanying text. *See also* Antitrust Advisor §11.72 (Shepard's 1978) (antitrust violation as an affirmative defense in contract and patent infringement actions). *See generally* Annot., 3 L.Ed.2d 1798 (1959). This uncertainty is underscored by the general rule that courts generally will not enforce an illegal contract. A. Corbin, Contracts §§1373-74 (one vol. ed. 1952). The three major exceptions to this rule are contracts only collaterally illegal, severable contracts and contracts where the plaintiff is not in pari delicto with the defendant. *Id. See also Antitrust Illegality, supra* note 3, at 758 n.3.
14. 358 U.S. 516, 518 (1959).

the cars from the storage area after the sale.[15] Petitioner defaulted on some of the payments, and the respondent sold the remainder of the onions because of deterioration of the same in storage.[16] The respondent sued for the price of all onions sold and delivered plus storage charges, less the amounts received by the respondent when he sold the remaining uncollected onions.[17]

The buyer asserted an antitrust violation as a defense, alleging that the agreement was "made pursuant to and as an indivisible part of an agreement which violated §1 of the Sherman Antitrust Act,"[18] that is, the contract was made for the express purpose of creating a false market condition to fix the price of onions sold in Illinois.[19] The district court struck the defense as a matter of law, and the Seventh Circuit Court of Appeals affirmed this decision.[20]

The Supreme Court first noted that "the plea of illegality based on violation of the Sherman Act has not met with much favor in this Court."[21] The petitioner argued, however, that the Court's previous cases denying the use of the defense involved situations where a person *not* a party to the original illegal contract sought to invoke the defense, and in the instant case petitioner *was* a party to the original contract.[22] In the latter situation, petitioner argued, public policy concerns would bar the judicial enforcement of the contract, notwithstanding contract law principles.[23] The Court rejected this argument summarily, stating that if the defense was so allowed as a collateral method of enforcement of federal antitrust laws, the theory would create "a very strange class of private attorneys general."[24]

The Court then discussed the facts of the case under the teachings of

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15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.* at 516. The petitioner alleged that respondent and one Sam Siegel met with petitioner and other onion growers in November and December 1955, and represented that

> unless the growers purchased a large quantity of [the] onions, the defendant and Siegel would deliver them on the futures exchange for the purpose of depressing the future price and the cash market price of onions. The petitioner and the other growers . . . were fearful that this would cause them considerable loss. It was finally agreed that they would purchase 287 of the 600 cars of onions stored in the Chicago area, and the respondent Siegel agreed not to deliver any onions on the future market for the remainder of the current trading season.

Id. at 517.
19. *Id.*
20. *Id.* at 516.
21. *Id.* at 518. The Court cited for this proposition Connolly v. Union Sewer Pipe Co., 184 U.S. 540 (1902) (one who purchased products from a company allegedly involved in a combination in restraint of trade not allowed to set up such illegality as a defense), and D.R. Wilder Mfg. Co. v. Corn Products Ref. Co., 236 U.S. 165 (1915) (sale of merchandise with concomitant standing offer of a rebate if purchaser bought exclusively from seller).
22. 358 U.S. at 519.
23. *Id.*
24. *Id.* at 520. Petitioner relied on a case dealing with illegality in the contract fraud context. *See* McMullen v. Hoffman, 174 U.S. 639 (1899). *Cf.* Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc., 340 U.S. 211 (1951) (unclean hands of plaintiff in related antitrust violation no defense to antitrust action). *See also* Antitrust Advisor §11.69, at 818-820 (Shepard's 1978).

Continental Wall Paper Co. v. Louis Voight and Sons Co.,[25] wherein an antitrust defense *was* allowed, and concluded that *Continental* was no broader than its facts; the Court reasoned that the character of the parties is not determinative and the Court would entertain the defense *only* in situations where it would be enforcing the "precise conduct" made unlawful by the legislature by enforcing the contract.[26] The Court would not assist parties to evade their contractual obligations unless narrow exceptional circumstances were present;[27] in any event, the contract under scrutiny in *Kelly* was found to be an "intelligible economic transaction" in itself, wholly divisible (in the Court's collective mind) from the proscribed illegal acts.[28]

The effect of *Kelly* was "to eliminate the collateral-inherent illegality distinction"[29] and to substitute in its place a test which focuses on an extremely narrow issue: whether the contract before the Court involves judicial enforcement or sanction of the precise conduct which constitutes a violation of the antitrust laws.[30] Other sub-issues the Court considered in regard to this inquiry included whether the contract constitutes a separate economic transaction itself apart from any antitrust violations, and if so, the Court would then give effect to the contract if goods or services were rendered for a "fair consideration."[31] And, in the Court's own words, the overriding policy is to prevent unjust enrichment which may accompany the successful interposition of an antitrust defense.[32]

The *Kelly* doctrine has been argued in federal courts since 1959 to the present date with varying degrees of success.[33] An important aspect of the doctrine's application, however, is that the reasoning of the lower federal courts differs widely. In many instances the analysis appears to be only a facade which disguises policy decisions made with little or no reference to the Supreme Court's *Kelly* holding. The next section of this Article will discuss major cases applying the doctrine, analyze their reasoning and results, and put forth reasons why the *Kelly* doctrine should be either further explained or modified by the Supreme Court.

III. Subsequent Cases Applying the Kelly Doctrine

A. Lower Court Decisions

Major post-*Kelly* cases which allow the antitrust illegality defense will be discussed to ascertain what elements are necessarily present before the defense is entertained by a federal court. These decisions will be contrasted with cases which do not allow the defense, and distinguishing characteristics of the cases will be identified.

25. 212 U.S. 227 (1909).
26. 358 U.S. at 520.
27. *Id.* at 520-21.
28. *Id.* at 521.
29. E. Kintner, *supra* note 4, §15.6, at 459.
30. *Id.*
31. 358 U.S. at 521.
32. *Id.* at 520-21.
33. See note 1 *supra* and accompanying text.

In *National Electrical Contractors Ass'n v. Howard P. Foley Co.*,[34] collection agents for the National Electrical Industry Fund (NEIF) brought contract actions to recover monies allegedly owed by electrical contractors to the International Brotherhood of Electrical Workers (IBEW) under certain labor agreements entered into between the parties.[35] The NEIF was a defendant in an antitrust action also before the court, wherein it was alleged that amounts due to the NEIF were payable under a price-fixing conspiracy and constituted a per se violation of section 1 of the Sherman Act.[36] The context in which this case arose was upon a motion to stay the contract case proceedings pending resolution of the antitrust suit; the stay was granted to the petitioners.[37]

The controversy regarding the propriety of a stay centered upon the issue of whether the defendants could assert an antitrust defense in the actions on the contracts.[38] The Court bluntly noted that "*Kelly* stands for the proposition that a defendant in a contract action may not raise an antitrust claim to avoid the contract," but instead must rely on remedies afforded litigants in the Sherman Act.[39] *Kelly*'s narrow exception relating to enforcement of the precise conduct made unlawful by the Sherman Act was found, however, to be appropriate in the instant situation:[40]

> [T]he policies and considerations that have led other courts to bar an antitrust defense are either absent from or less weighty in the cases here. . . . [T]he contracts the present plaintiffs seek to enforce are not readily divisible from the alleged contract violations; each contract can be viewed as "an intelligible economic transaction in itself" *only* if viewed without the NEIF [price fixing] provision. . . . *The very provision sought to be enforced is the essence of the illegal agreement between NECA and the IBEW.*

The court impliedly found that the contract could not be served, and therefore to enforce the contract would have been to sanction conduct made illegal by the Sherman Act. The court also stated that the stay would not unjustly enrich any party, i.e., it would not enable one party to get another's property without paying for it.[41] The court wanted to avoid the "anomalous position of declaring the NEIF illegal, and at the same time permitting its enforcement."[42]

The court carefully followed the *Kelly* doctrine and appurtenant tests, finding that the contract under dispute was itself an embodiment of the illegal price fixing scheme. No unjust enrichment would occur by

34. 498 F. Supp. 552 (D. Md. 1980).
35. *Id.* at 553.
36. *Id.* "The NEIF was created through an agreement between the National Electrical Contractors Association (NECA) and the IBEW, entered into on December 8, 1976." *Id.*
37. *Id.*
38. *Id.* at 553-54.
39. *Id.* at 554.
40. *Id.* (emphasis added).
41. *Id.*
42. *Id.* at 555.

granting a stay, the court noted, because the payments were not considered the normal quid pro quo of a labor contract, and the delay in passing judgment was found to not unduly prejudice the parties.[43] However, this case must be distinguished from the cases discussed below because an antitrust suit regarding the very contracts in issue was proceeding concurrently, and the antitrust issues were therefore being separately litigated.

The *Electrical Contractors* case contrasts with the District of Columbia Circuit Court of Appeals decision in *Mullins v. Kaiser Steel Corp.*[44] in which similar labor agreement provisions were litigated. In *Mullins* trustees of the United Mine Workers of America (UMW) Health and Retirement Funds sued Kaiser Steel Corporation under a collective bargaining agreement which required the employer to make periodic payments to the funds.[45] Under Article XX(D) of the agreement, there were three ways to measure the employer's obligation to contribute to the funds: the amount of coal produced by an employer for sale or use; the number of hours worked by employees; and the amount of coal "procured or acquired" for sale or use for which no contribution had been made.[46]

The employer attempted to defend on the ground that the "procured or acquired" clause was illegal under the Sherman Act because it constituted an anticompetitive penalty.[47] The district court ignored the defense and granted a motion for summary judgment in favor of the trustees.

The District of Columbia Circuit Court of Appeals agreed with the district court, holding that the antitrust defense could not be entertained by the district court.[48] The Court recounted the long history which the defense had before *Kelly v. Kosuga*,[49] and phrased the core question as follows: "[H]ow can the Court be a party to an anticompetitive scheme simply by enforcing a contract which requires employees to make payments into a union's health and retirement funds?"[50] The answer given was that it would not, and the purchase-of-coal clause was found to be " 'an intelligible economic transaction in itself.' "[51] The contract was fully

43. *Id.*
44. 642 F.2d 1302 (D.C. Cir. 1980) *rev'd*, 102 S. Ct. 851 (1982).
45. 642 F.2d at 1305. The employer was contractually liable for the payments under the National Bituminous Coal Wage Agreement of 1974. *Id.*
46. *Id.*
47. *Id.* at 1307. The employer also defended on the ground that the contract violated the "hot cargo" provisions of the National Labor Relations Act, 29 U.S.C. §158(e) (1976). *See* 642 F.2d at 1313-18 for a discussion of this defense.
48. *Id.* at 1308.
49. The court stated that

> [v]arious "tests" were articulated to achieve the reconciliation needed to square antitrust law with basic contract principles. Contracts "collateral" to the unlawful combinations should be enforced but "inherently illegal" agreements could not. . . . The test was as useless as it sounds.

Id. at 1309.
50. *Id.* at 1310.
51. *Id.*

performed by the members of the bargaining unit, and they were entitled to the "full measure of their bargained-for consideration."[52]

The dissent by Judge Wilkey vehemently disagreed with the majority's characterization of the issues in the case at bar, as well as the majority's construction of the *Kelly* doctrine.[53] He reasoned that enforcement of the purchase-of-coal clause violated the antitrust law because the clause *itself* was restrictive; *Kelly* was distinguished because there "the parties made an *additional* agreement not to deliver onions to the futures market. . . ."[54] The dissent reasoned further that enforcement of the penalty payments was enforcement of the precise conduct proscribed by the Sherman Act, and to force Kaiser to sue the UMW in a separate antitrust action for damages under the antitrust laws would be more than circuitous: "It would be unseemly for this court to compel Kaiser to make the very payments giving rise to pecuniary injury redressable under the antitrust laws."[55]

Several comparative points between *Electrical Contractors* and *Mullins* are worthy of note. First, in both cases enforcement of the contract would have been enforcing a violation of the Sherman Act. In *Mullins* it would have been a simple matter to sever the illegal clause from the contract and thus enforce the balance of the agreed-upon payments to the union funds.[56] Although, as the *Mullins* court correctly noted, the parties had bargained for the payments, and such a severance would have constituted a partial derogation of the agreed-upon consideration, that analysis is not included in the teachings of *Kelly v. Kosuga*.[57] The *Mullins* court thus participated in and facilitated an illegal contractual agreement.

Second, the *Mullins* court's concern with alternative remedies also does not comport with the *Kelly* doctrine. Although in *Electrical Contractors* the antitrust issues were being litigated in a separate suit, the *Mullins* court's concern that a separate antitrust action would vitiate any inequities simply begs the question. If the issues could be litigated in one suit based on the same alleged embodiment of antitrust violations, then concerns relating to judicial economy would dictate that the defense should be entertained in a suit on the contract.[58]

Finally, the *Mullins* court was concerned that the parties should benefit from the mutual promises incorporated into the collective bargaining agreement. The court correctly construed *Kelly* as allowing recoveries on contracts which are separate intelligible economic transactions, so one

52. *Id.* The court noted, in regard to *Kelly*, that "[i]f onions must be paid for, so too must past services." *Id. But see* notes 93-103 *infra* and accompanying text.

53. 642 F.2d at 1320-35 (Wilkey, J., dissenting).

54. *Id.* at 1322 (emphasis in original).

55. *Id.* at 1325.

56. *See* Sealy Mattress Co. of So. Cal. v. Sealy, Inc., 346 F. Supp. 353, 358-59 (N.D. Ill. 1972); *see also* Milsen Co. v. Southland Corp., 454 F.2d 363, 365-69 (7th Cir. 1971).

57. 358 U.S. at 518-21.

58. *But see* Huge v. Long's Hauling Co., 590 F.2d 457, 459-60 (3d Cir.), *cert. denied*, 442 U.S. 918 (1978) (defendant's reserved right to counterclaim on alleged Sherman Act violations was determinative policy militating against allowing antitrust defense); *accord*, Medusa Corp. v. Gordon, 496 F.2d 249 (6th Cir. 1974).

party would *not* be released from contractual liability when an illegality defense is put forth. But even accepting the above as true, *Kelly* recognized that the narrow exception allowing such defenses originating in *Continental Wall Paper* was still viable; if the *Continental* test was met, an exception to the general rule not allowing antitrust defenses in a contract suit must be acknowledged in the situation where a court is asked to implement and sanction an illegal contract.[59] Consideration and other traditional contract principles are thus displaced by the *Kelly* doctrine and should therefore not play a part in any judicial determination of whether to let the defense be asserted in a contract action.

The case of *Viacom International Inc. v. Tandem Products, Inc.*[60] provides a good example of a court focusing on one aspect of the *Kelly* doctrine's formula and relegating the remainder of the test to a minor role in order to facilitate a basic policy judgment.[61] In *Viacom* Tandem and CBS negotiated the rights to exhibit the "All in the Family" television series. CBS was granted all syndication and distribution rights under an oral agreement between Tandem and CBS.[62] The district court found that the FCC "financial interest" rule applied to the written contract later consummated by the parties.[63] This rule prohibited television networks "from acquiring the type of interest in a television program that CBS possessed by virtue of its exclusive license to distribute and syndicate 'All in the Family.' "[64] Thereafter CBS assigned its distribution and syndication rights to the program to Viacom International.[65]

Viacom brought suit against Tandem for a judgment declaring its rights under the contract between its assignor CBS and Tandem Productions.[66] The district court rejected Tandem's attempt to avoid the distribution and syndication agreement on the ground that it was in violation of the antitrust laws. Tandem alleged that the "tie-in of distribution and syndication rights to broadcast rights coerced it into relinquishing what it would

59. 358 U.S. at 520-21. *See* Vendo Co. v. Lektro-Vend Corp., 433 U.S. 623, 646 n.3 (1976) (Stevens, J., dissenting), where Justice Stevens cited, among others, *Kelly v. Kosuga* and stated:

> It is well settled, and the District Court so held, that when the precise conduct proscribed by the antitrust laws is sought to be furthered by litigation, the antitrust laws forbid a court from giving judgment if to do so "would be to make the courts a party to the carrying out of one of the very restraints forbidden by the Sherman Act."

Id. At least one Justice believes this exception is still viable. This notation is critical as the Court had not addressed the *Kelly* problem for the past twenty years (besides the above-quoted footnote). *See also* notes 93-97 *infra* and accompanying text.

60. 526 F.2d 593 (2d Cir. 1975).

61. *See, e.g.*, Huge v. Long's Hauling Co., Inc., 590 F.2d 457 (3d Cir.), *cert. denied*, 442 U.S. 918 (1978) (emphasis on counterclaim remedy as alternate recovery route); Medusa Corp. v. Gordon, 496 F.2d 249 (6th Cir. 1974) (same misplaced emphasis).

62. 526 F.2d at 595. At this point Tandem began production of the series and it went "on the air" for the first time approximately one year later. *Id.*

63. *Id.* at 595-96.

64. *Id.* at 595.

65. *Id.*

66. *Id.* at 594.

have preferred to retain,"[67] and was therefore violative of section 1 of the Sherman Act because it would "appreciably restrain competition."[68]

The circuit court noted that *Kelly* expounded an extremely narrow exception to the general rule prohibiting use of an antitrust illegality defense to a contract.[69] Viacom agreed that any tying arrangement was not indirectly illegal, and the contract involved was a separate intelligible transaction within the meaning of the words as used in *Kelly*;[70] conversely, Tandem argued that enforcement of the contract would sanction the precise conduct made illegal by the Sherman Act.[71] The court focused on the supposed "overriding consideration"[72] which influenced the *Kelly* Court, namely the "concern that the successful interposition of antitrust defenses is too likely to enrich parties who reap the benefits of a contract and then seek to avoid corresponding burdens."[73] The court also announced a second reason for affirming the district court's denial of use of the defense: the defense would prolong, complicate and confuse a simple action on a contract.[74] The lower court decision was affirmed.[75]

The problems with the court's analysis are underscored by the result of the case. First, once again a court has clouded the issues (as well as the Supreme Court's pronouncements in this area of law) to reach a policy result.[76] The court's concern that Tandem would be unjustly enriched is proper,[77] but *Kelly v. Kosuga* noted a narrow exception to the general rule which was based on *Continental Wall Paper*, and the focus of the case should concern whether the court's enforcing a contract furthers actions made illegal by the Sherman Act; other circumstances relating to contract law and unjust enrichment are *supplemental* to the main test.[78] In this situation the court erroneously avoided the main thrust of the *Kelly* doctrine to concentrate on the contract aspects of the case.

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67. *Id.* at 597.
68. *Id.*
69. *Id.* at 598, *citing* Continental Wall Paper Co. v. Louis Voight and Sons Co., 212 U.S. 227 (1909).
70. 526 F.2d at 598.
71. *Id.*
72. *Id.* at 599.
73. *Id.* Tandem answered this argument by the proposition that no distribution or syndication of "All in the Family" had yet occurred; therefore no unjust enrichment argument could successfully lie because no payments had been made up to the time of trial. *Id.* However, the court disposed of this argument by noting that "the level of payments for *broadcast* reflected the fact that CBS was receiving distribution and syndication rights." *Id.* (emphasis added).
74. *Id.* The court discussed the scope of additional matters which would have to be explored if litigation of the antitrust defense were allowed. The court noted the following areas of proof needed to allege an illegal tying arrangement successfully: two separate distinct products; actual exercise of economic power; anticompetitive effects experienced in the tied market; and some degree of interstate commerce involved in the tied market. *Id.* at 599-600.
75. *Id.* at 600.
76. See note 59 *supra* and accompanying text.
77. Although it may be proper, it may *still* be ill-reasoned. See note 73 *supra*.
78. *See* National Elec. Contractors Ass'n, Inc. v. Howard P. Foley Co., 498 F. Supp. 552 (D. Md. 1980). *See also* Petroleum for Contractors, Inc. v. Mobil Oil Corp., 493 F. Supp. 320 (S.D.N.Y. 1980). *See generally* Vendo Co. v. Lektro-Vend Corp., 433 U.S. 623, 646 n.3 (1976) (Stevens, J., dissenting).

Second, the court's reasoning regarding alternative available remedies is also misplaced because it is *irrelevant* to the Supreme Court test whether an antitrust illegality defense may be interposed.[79] The complication of the case which would result is an *effect* of the decision, and should not provide a major rationale for allowing or not allowing the defense.

Finally, in conjunction with the "alternate remedy" argument, the court had taken the "anomalous position"[80] that the contract is valid under one analysis (contract) but possibly invalid under another (antitrust). The consolidation of these aspects of the case would facilitate judicial economy and relieve the financial burdens on the parties which would accompany two lawsuits instead of one.

An excellent example of how the *Kelly* doctrine should be applied to a contract situation is provided by *Tampa Electric Co. v. Nashville Oil Co.*,[81] where Tampa brought a declaratory judgment action to determine whether its contract with Nashville was valid and enforceable.[82] Tampa was an electric public utility serving the City of Tampa (Florida) and its surrounding communities; Nashville was engaged in the business of selling and mining coal.[83] In 1955 a contract for the purchase of coal was entered into,[84] whereby the seller made available to the buyer large quantities of coal from Nashville's Western Kentucky field.[85] The contract generally provided that Nashville would supply Tampa with "the total requirements of fuel of the Buyer for the operation of its . . . Gannon station [units]"[86] for a 20-year period. Two years after the contract was signed, Nashville advised Tampa that it would not perform under the contract.[87]

Nashville defended in the contract action on the ground that the contract violated section 3 of the Clayton Act because Tampa Electric was required to purchase exclusively from Nashville to the exclusion of competitors, with the corresponding result of substantially lessening competition in the Tampa area coal line of commerce.[88] The court discussed *Kelly v. Kosuga* and concluded that the "*determining factor* is whether the result of the contract had the proscribed effect [under the

79. Kelly v. Kosuga, 358 U.S. 516 (1959). *But see* note 58 *supra* and accompanying text.
80. National Elec. Contractors Ass'n, Inc. v. Howard P. Foley Co., 498 F. Supp. 552, 555 (D. Md. 1980).
81. 276 F.2d 766 (6th Cir. 1960), *rev'd on other grounds*, 365 U.S. 320 (1961).
82. 276 F.2d at 768.
83. *Id.*
84. *Id.* Nashville was an assignee of the contract rights from Potter Towing Company, David K. Wilson and Justin Potter, the original seller/signatories to the contract. *Id.* at 769.
85. *Id.*
86. *Id.*
87. *Id.* "To supply the appellant [Tampa] under this contract [would have] required a capital expenditure in excess of $7,500,000.00 by the appellees [Nashville]", which Nashville was not inclined to undertake. *Id.*
88. *Id.* at 770. The court found that a "single contract of sale of sufficient magnitude, with performance extending over a period of time, can cause this result" which is proscribed by the Clayton Act. *Id. See* Clayton Act, 15 U.S.C. §14 (1976). *See also* Tampa Elec., 276 F.2d at 770-73.

antitrust laws] . . ., *even though the result is a harsh one for one of the parties.*"[89]

The court recognized that contractual hardships to the parties were *not* factors to be considered in making a substantive decision on whether or not to allow the interposition of defense of antitrust illegality in a contract action, and thereby properly interpreted the *Kelly* doctrine as enunciated by the Supreme Court. The court made careful reference to *Continental Wall Paper* to distinguish which public policy should be examined and furthered in such situations, and noted that antitrust "public policy demands that the [aid of the court] should be denied without regard to the interests of individual parties."[90] The court concluded that the contract was an executory one and not divisible, so parts of the contract could not be severed to salvage the remainder; the judgment of the district court was affirmed.[91]

The court in *Tampa Electric* did not ignore policy issues — it merely applied the *Kelly* doctrine in light of *which* policies were to weigh more heavily pursuant to the doctrine. Ignoring other irrelevant factors which heavily influenced other courts (such as alternate remedies, hardships to the parties and unjust enrichment/contract principles), the court found the policies weighed more heavily in favor of the antitrust laws.[92] Traditional contract principles were therefore not ignored, but given a lesser standing in the totality of the analysis.

The above cases demonstrate the wide array of court attitudes toward the *Kelly* doctrine regarding how it is to be applied, what the test really means, what factors mean more than others and what policy judgments underlie the decision.

B. The Kaiser Steel Case

The Supreme Court has recently acted to dissipate the confusion experienced by the federal courts in construing the *Kelly* doctrine in *Kaiser Steel Corporation v. Mullins*, where the circuit court denied the use of the antitrust illegality defense.[93] The Supreme Court disagreed with the district and circuit courts and ruled that "*Kosuga* . . . contemplated that the defense of illegality would be entertained in a case like this."[94]

89. 276 F.2d at 773 (emphasis added). The court stated it would not allow the defense to be asserted unless to enforce the contract the "Court would be a party to carrying out of one of the very restraints forbidden by the Act." *Id.*

90. *Id.* at 773-74.

91. *Id. See* Sealy Mattress Co. of So. Cal. v. Sealy, Inc., 346 F. Supp. 353 (N.D. Ill. 1972); *but see* Denton v. Mr. Swiss of Missouri, Inc., 564 F.2d 236 (8th Cir. 1977) (invalid portion of contract inextricably woven into its remainder, and therefore no severability). *See also* dissenting opinion of Judge Weick in *Tampa Electric*, who stressed the harsh result to the parties and the availability of other remedies under the antitrust laws. 276 F.2d at 774-84.

92. Note that the court decided the defense issue in this case under the Clayton Act; the *Continental Wall Paper* exception was framed in terms of the Sherman Act only. If the *Kelly* exception is so "narrow," as virtually all courts agree, then perhaps this issue should have been examined further in *Tampa Electric*. In any event, at least to this court, *Continental Wall Paper* is not completely restricted to its facts.

93. See notes 44-55 *supra* and accompanying text.

94. 102 S. Ct. 851, 858 (1982).

Justice Rehnquist, writing for the majority, stated that if Kaiser's agreement was illegal under the Sherman Act or the Labor-Management Relations Act, enforcement of its promise to contribute money to the pension fund on the basis of amounts of coal purchased from operators other than operators covered under the National Bituminous Coal Wage Agreement of 1974 would involve a court "commanding unlawful conduct."[95] The Court discussed the holdings of *Continental* and *Kelly* and concluded that the pension fund payments under the purchased coal clause, linked to non-union operators' coal purchases, constituted a "penalty for dealing with producers not under contract with the UMW."[96] The fact that the alternate remedies were available was deemed irrelevant in a footnote: "*Kosuga* conforms to a common law exception to the rule that courts will not enforce illegal contracts."[97] The case, however, does little to alleviate concern over whether the *Kelly* doctrine is applicable in closer situations. It merely restates *Kelly* and *Continental* in general terms, concluding on the clear facts of the case that the defense should be allowed.

C. Recapitulation

The vaguences of the *Kelly* doctrine contributes to its divergent interpretations by the federal courts. Moreover, the equities inherent in various situations virtually compel the courts to vary and bend the doctrine to avoid unjust and clearly unfair results which would accompany a rigid application of the *Kelly* tests.[98] Thus, before *Kaiser Steel*, the Supreme Court was content not to rediscuss the problem of the antitrust illegality defense.[99] This did not obviate an examination of basic unfairness in light of the post-*Kelly* decisions discussing the defense, however. Even if the result is what the *Kelly* court desired, various other factors come into play which possibly *should not* be relegated to a minor role in the analysis.

First, the hardships of the parties should be considered in the analysis. The Supreme Court should redefine the limits of the *Kelly* exception to allow a court to ascertain whether a contract is executory or partially fulfilled, whether a party's reliance on a contractual arrangement will cause it to incur substantial damages in the event a defense is successfully inserted into the proceedings, or whether the other party will be unjustly enriched by the disallowance of his contractual obligations.[100] Although some commentators may view the present doctrine as being a flexible

95. *Id.* at 857.
96. *Id.* at 858.
97. *Id.* at 858 n.7.
98. *See, e.g.*, Mullins v. Kaiser Steel Co., 642 F.2d 1302 (D.C. Cir. 1980), *rev'd*, _____ U.S. _____, 102 S. Ct. 851 (1982); May Dep't Stores Co. v. First Hartford Corp., 435 F. Supp. 849 (D. Conn. 1977).
99. The only Supreme Court case before *Mullins* to mention *Kelly* had been Vendo Co. v. Lektro-Vend Corp., 433 U.S. 623 (1976) where Justice Stevens in dissent stated that *Kelly's exception* to the general rule not allowing antitrust illegality defenses was still valid law. *Id.* at 646 n.3 (Stevens, J., dissenting).
100. *See Antitrust Illegality, supra* note 3, at 768-73, 776.

one,[101] most courts treat the tests as an all-or-nothing proposition by either excluding considerations of hardships to parties, thus relying on *Continental Wall Paper*, or taking *Kelly* out of context and asserting that its major teaching is that parties should not be able to get something without paying for it.[102] A further clarification of the doctrine is necessary to provide additional guidance to courts and to define the parameters of their discretion under the law. This clarification could include allowing the court to consider whether any consideration has passed between the parties, and if not,[103] perhaps the defense should be allowed if all other facets of the *Kelly* doctrine are present.

Second, questions relating to whether an alternative remedy exists under the antitrust laws should be given little (if any) weight in the analysis.[104] Whether the defense is interposed as a defense to a contract action or whether illegality is alleged in a direct suit, the same degree of proof is required: for the antitrust illegality defense to hold, illegality must be, in fact, proven.[105] The fact that the defense may delay or unduly complicate proceedings is important only if delay of the inevitable is a relevant consideration to the application of the tests.[106] As the doctrine stands now, considerations of this sort are irrelevant and misleading, and such judicial misgivings should not become part of the analysis for the foregoing reasons.

Finally, the doctrine should be explained more fully in regard to what constitutes an "intelligible economic transaction in itself. . . ."[107] This would aid courts in determining whether the contract itself is the antitrust violation in issue, or whether the contract could stand on its own as a product of free bargaining which does not result in an unlawful substantial lessening of competition. This would free the courts from invalidating contracts which do not contain severability clauses (but do contain restrictive arrangements),[108] and would concurrently aid courts in deciding what parts of a contract may still be enforced.[109]

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101. *See, e.g.*, E. Kintner, *supra* note 4, §15.6, at 459-60; *Antitrust Illegality*, *supra* note 3, at 776.
102. *Compare* Tampa Elec. Co. v. Nashville Oil Co., 276 F.2d 766 (6th Cir. 1960), *rev'd on other grounds*, 365 U.S. 320 (1960) *with* Viacom Int'l Inc. v. Tandem Productions, Inc., 526 F.2d 593 (2d Cir. 1975).
103. In addition, inquiry could be allowed into whether any party relied to his detriment on the contract.
104. See note 92 *supra* and accompanying text.
105. *See* Tampa Elec. Co. v. Nashville Oil Co., 276 F.2d 766 (6th Cir. 1960), *rev'd on other grounds*, 365 U.S. 320 (1961).
106. Not allowing the defense on this ground would actually work a hardship to the party defending on a contract, since he may not want to continue after the contract suit in a separate antitrust action because of time, expense or publicity. *Compare* Viacom Int'l Inc. v. Tandem Productions, Inc., 526 F.2d 593 (2d Cir. 1975) *with* Milsen Co. v. Southland Corp., 454 F.2d 363 (7th Cir. 1971). *See also* note 58 *supra* and accompanying text.
107. Kelly v. Kosuga, 358 U.S. 516, 521 (1959).
108. *Compare* National Elec. Contractors Ass'n, Inc. v. Howard P. Foley Co., 498 F. Supp. 552 (D. Md. 1980) *with* Mullins v. Kaiser Steel Corp., 642 F.2d 1302 (D.C. Cir. 1980), *rev'd*, 102 S. Ct. 851 (1982).
109. *See* Sealy Mattress Co. of So. Cal. v. Sealy, Inc., 346 F. Supp. 353 (N.D. Ill. 1972).

In summary, the proposed changes to the *Kelly* doctrine will enable courts to make more equitable judgments without doing an injustice to antitrust policy, the expectations of parties to a contract, or the principles construed in *Kelly v. Kosuga*. Presently the courts use the doctrine to serve policy interests in individual cases which may not comport with a national standard embodied in federal statutes or Supreme Court interpretations thereof. In addition, parties submerged in such a controversy have little chance accurately to predict the outcome of a court dispute on contracts allegedly in restraint of trade. The Supreme Court should meet this challenge to both further balance the equities in similar circumstances and announce a standard workable approach to antitrust illegality defense disputes.

IV. Conclusion

The Supreme Court attempted to streamline an ambiguous area of federal contract and antitrust law litigation in its decision in *Kelly v. Kosuga*. In *Kelly* the Court asserted that the defense of antitrust illegality would be entertained if enforcement of a contract would "itself be enforcing the precise conduct made unlawful by the [Sherman] Act."[110] The Court also stated that other factors to be considered were whether the contract constituted an "intelligible economic transaction in itself"[111] and whether the defense would allow one party to reap the benefits of a contract while avoiding its concomitant burdens.[112] It is apparent that in certain circumstances the *Kelly* doctrine may be invoked to reach a rational result.[113] However, in other cases, inconsistent readings of *Kelly* have led to widely varying results.[114] The difficulty in this area lies not exclusively with inconsistent applications of the *Kelly* doctrine — the doctrine *itself* should be either explained or delimited to provide federal courts with guidance in its application.

A factor which the Court continued to find *not pertinent* to the analysis is whether alternative remedies exist under antitrust law. Since the context in which the defense arises is a contract action, the defense should be allowed to ascertain with finality whether the contract is itself violative of federal antitrust law. This could be coupled possibly with a counterclaim in the same suit by the defending party on the contract, but

110. 358 U.S. 516, 520, relying on Continental Wall Paper Co. v. Louis Voight and Sons Co., 212 U.S. 227 (1909), for this proposition.
111. 358 U.S. at 521.
112. *Id.* at 520-21.
113. *See, e.g.*, Denton v. Mr. Swiss of Missouri, Inc., 564 F.2d 236, 243 (8th Cir. 1977) (illegal tying arrangement "inextricably woven" into contract providing for royalties and gross rate charges included in licensing agreement); Electroglas, Inc. v. Dynatex Corp., 473 F. Supp. 1167, 1170-71 (N.D. Cal. 1979) (illegal tying arrangement distinguished from separate prototype "wafer saw" purchase contract to deny application of the *Kelly* exception); May Dep't Stores Co. v. First Hartford Corp., 435 F. Supp. 849 (D. Conn. 1977) (FTC consent order found not to prohibit the sale of substantially all of the assets of additional department store by May Co., but only required FTC *permission* before such acquisition — enforcement of the contract, therefore, found *not* to be enforcement of precise conduct prohibited by order).
114. See notes 34-92 *supra* and accompanying text.

in both instances the degree of proof relating to contract illegality would remain the same.

Factors which the Court should incorporate into the doctrine include whether any party relied on the contract to its detriment, whether consideration has passed and whether a party would be unjustly enriched if the defense should prevail. This approach would balance the harsh result of a determination that the contract is inherently illegal on a party who has, for example, sold goods but not yet received payment. It would also give more weight to the "unjust enrichment" part of the *Kelly* doctrine, achieving a better balance of equities and relieving the harsh results attendant to a rigid application of the "enforcement of the precisely proscribed conduct" determinative test in *Kelly*.

It is submitted that the proposed changes to the doctrine would help both to relieve parties from the harsher applications of the *Kelly* doctrine and to achieve uniformity in the federal system with respect to federal antitrust illegality defenses to contracts. *Kelly* has indeed cleared up some ambiguity in this area[115] and it is hoped that the Court will take up the challenge and complete the task.

115. See note 49 *supra* and accompanying text.