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# The Market Power Model of Contract Formation: How Outmoded Economic Theory Still Distorts Antitrust Doctrine

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# THE MARKET POWER MODEL OF CONTRACT FORMATION: HOW OUTMODED ECONOMIC THEORY STILL DISTORTS ANTITRUST DOCTRINE

Alan J. Meese\*

*Transaction cost economics ("TCE") has radically altered industrial organization's explanation for so-called "non-standard contracts," including "exclusionary" agreements that exclude rivals from access to inputs or customers. According to TCE, such integration usually reduces transaction costs without producing anticompetitive harm. TCE has accordingly exercised growing influence over antitrust doctrine, with courts invoking TCE's teachings to justify revision of some doctrines once hostile to such contracts. Still, old habits die hard, even for courts of increasing economic sophistication. This Article critiques one such habit, namely, courts' continuing claim that firms use market or monopoly power to impose exclusionary contracts on unwilling trading partners. In so doing, the Article takes issue with both the Harvard and Chicago Schools of Antitrust, normally seen as antagonists, each of which has erroneously embraced the "market power" model of contract formation.*

*For the last several decades, courts have premised particular rules of antitrust liability upon the assumption that firms used preexisting market power to "coerce" or "force" trading partners to enter exclusionary agreements. Most notably, courts have held that a monopolist's use of such power to obtain an exclusionary agreement violates § 2 of the Sherman Act, without any additional showing that the agreement produced economic harm. Following similar logic, courts enforcing § 1 of the Act have banned tying agreements obtained by firms with market power, reasoning that sellers used their power to "force" buyers to enter such contracts. Finally, courts have invoked the market power model when holding that dealers or consumers can challenge unlawful agreements they have themselves entered and enforced,*

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contrary to the common law doctrine of *in pari delicto* ("in equal fault"). Courts have reasoned that plaintiffs' participation in such contracts is involuntary, because defendants use market power to impose them. While modern courts sometimes consider evidence that such agreements produce benefits, they nonetheless assume that sellers employ market power to impose them and treat such coercive imposition as a harm coexisting with any efficiencies.

These doctrines survive to this day, along with the market power model of contract formation, despite courts' increasing economic sophistication. This Article locates the origin of these doctrines and the market power model in price theory's workable competition model, often associated with the "Harvard School" of Antitrust. Assumptions informing the workable competition model excluded the possibility that exclusionary agreements produced benefits, giving rise to the natural inference that firms with market power imposed such contracts against the will of trading partners. Courts embraced this account of these agreements and announced hostile doctrines resting upon the assumption that such contracts were expressions of market power "used" to impose them. While Chicago School scholars questioned these doctrines, their critique ironically rested upon a more precise price-theoretic account of how firms purportedly used market power to impose these agreements.

In the past few decades, TCE has emerged as a competing paradigm for evaluating non-standard contracts. Building on the work of Ronald Coase, practitioners of TCE argued that many such contracts, including those that "exclude" rivals, can reduce the cost of transacting, particularly anticipated costs of opportunism made possible by relationship-specific investments. While most practitioners of TCE have ignored the means by which such contracts are formed, Coase himself once indicated that such integration was "voluntary," albeit without elaboration. This Article elaborates on prior work by the author and others showing that firms can induce voluntary acceptance of these provisions by offering cost-justified discounts to trading partners who agree to them, thereby using the institution of contract to redefine background rights and obligations so as to minimize transaction costs. While courts have sometimes invoked TCE's beneficial characterization of such agreements, they have not recognized the implication, examined here, that such contracts are purely voluntary, clinging instead to the decades-old conclusion that firms use preexisting market power to impose them.

TCE does not teach that all non-standard agreements reduce transaction costs. Moreover, parallel developments suggest that some such agreements may reduce economic welfare by raising rivals' costs and conferring market power. Here again, however, there is no reason to believe that proponents of such agreements use market power to impose them. Instead, proponents can induce input suppliers to enter such contracts voluntarily, simply by sharing with them expected monopoly profits the arrangements will help create. Thus, such agreements are no more "coercive" than ordinary cartel arrangements.

*The Article ends by exploring implications of these insights for antitrust doctrine. First, courts should discard substantive antitrust doctrines that depend upon the “market power” model of contract formation in favor of more direct analysis of the economic impact of challenged practices. This admonition cuts both ways. On the one hand, plaintiffs should not prevail or establish a prima facie case in monopolization or tying litigation simply by showing that a firm with power has “imposed” an exclusionary agreement. At the same time, recognition that voluntary exclusionary rights agreements can produce anticompetitive harm undermines the Chicago School claim that failure to establish preexisting market power should doom challenges to ties and other agreements scrutinized under § 1 of the Sherman Act. Second, and in the same vein, courts should reject any effort to infer the existence of such power from the presence of non-standard agreements, because the presence of such agreements is at least equally consistent with a conclusion that they are the result of harmless voluntary integration. Third, courts should discard exceptions to the in pari delicto doctrine based on the “market power” model of contract formation and reconsider current law allowing dealers and consumers to challenge agreements they have voluntarily entered.*

## INTRODUCTION

More than a generation ago industrial organization witnessed a scientific revolution in the form of transaction cost economics (TCE). The transaction cost approach offered a radically different interpretation of various forms of contractual integration that economists and judges had previously condemned as anticompetitive. In particular, proponents of this new approach provided explanations for non-standard agreements, which constrained dealers or customers after a sale. These scholars contended that, while apparently anticompetitive, such agreements in fact often minimized the costs of relying upon an otherwise atomistic market to conduct economic activity and thereby enhanced economic welfare.

Not surprisingly, TCE has exerted a growing influence on antitrust doctrine over the past few decades, with courts invoking its beneficial account of various non-standard agreements to justify revision of doctrines once hostile to such contracts. Still, old habits die hard, even when courts of increasing economic sophistication articulate antitrust doctrine. This Article identifies and critiques one such habit, namely, the propensity of courts to characterize certain agreements as expressions of market or monopoly power “used” to impose contracts on unwilling trading partners. This habit, it will be shown, originated in neoclassical price theory, which two schools of antitrust thought ordinarily viewed as antagonists—Harvard and Chicago—embraced as a methodology for understanding how such agreements are formed.

For the last several decades, beginning in antitrust law's "inhospitality era," courts have premised particular rules of liability upon the assumption that firms with market power used that power to "coerce" or "force" trading partners to enter certain contracts, particularly contracts excluding rivals from portions of the market. Most notably, courts have held that a monopolist that "used" its power to obtain an exclusionary agreement thereby violated § 2 of the Sherman Act, without any additional showing that the agreement produced economic harm. Following similar logic, courts enforcing § 1 of the Act banned all tying agreements obtained by firms with the slightest market power, reasoning that sellers used their power to "force" buyers to enter such contracts. Like the "use" of monopoly power to impose exclusionary agreements, such "forcing" was unlawful per se, without any additional proof of harm.

The market power model of contract formation did more than influence substantive antitrust doctrine. The model also helped courts decide who can challenge unlawful conduct. In particular, courts have held that dealers or consumers can challenge unlawful agreements they have themselves entered and enforced. Although the common law doctrine of *in pari delicto* ("in equal fault") ordinarily prevented parties from challenging agreements they had helped negotiate, courts declined to invoke this bar, reasoning that participation by consumers and dealers in such contracts was involuntary, because manufacturers had used market power to impose such agreements against plaintiffs' will. Courts even applied this logic to non-exclusionary agreements such as resale price maintenance, which raised the prices dealers could charge consumers.

Applying the teachings of TCE, courts have modified or abandoned many doctrines announced during the inhospitality era. Nonetheless, doctrines based upon the market power model of contract formation survive to this day. For instance, the Supreme Court's most recent treatment of exclusionary contracts reiterates both the "abuse of power" test under § 2 and § 1's per se rule against ties supposedly "forced" on purchasers. Lower courts have followed suit, with some even suggesting that conduct excluding rivals from the marketplace itself implies the existence of market power. At the same time, courts have reiterated their conclusion that dealers or consumers may challenge exclusionary agreements in which they have participated if they were "forced" or "coerced" to enter such contracts, a showing made whenever the defendant possesses sufficient power to establish the underlying offense.

This Article critiques the "market power" account of contract formation and the various doctrines the account informs. This account,

it is shown, rests on neoclassical price theory's workable competition model. Scholars applying the workable competition model, particularly those in the so-called Harvard School of antitrust policy, drew a distinction between unilateral "competition on the merits," on the one hand, which could result in monopoly, and the purported use of such market power to exclude rivals, on the other. These scholars argued that antitrust law should not interdict the use of monopoly or market power achieved via legitimate competition to impose high prices, but should instead ban the use of such power to exclude rivals, and antitrust doctrine reflected this distinction.

The same scholars also viewed non-standard contracts as unjustified departures from the sort of "perfect competition" that presumptively produces a welfare-maximizing allocation of resources. Because such contracts produced no apparent benefits, there was no reason to conclude that dealers or consumers entered them voluntarily. Most real world firms possess some market power, no matter how slight, and members of the workable competition school naturally concluded that firms used that power to coerce acceptance of such agreements. Thus, these scholars concluded that such agreements were not "competition on the merits" but instead reflected the use of power to exclude rivals, and antitrust doctrine predictably condemned such agreements along with other non-standard provisions during antitrust's inhospitality era. While some scholars, particularly from the "Chicago School," questioned these doctrinal results, their critique ironically rested upon a more precise account, also drawn from price theory, of the market power model than scholars invoking the workable competition model had offered. Price theory, and not other influences such as Legal Realism, accounted for legal doctrines resting upon the market power model of contract formation.

Price theory is not the only economic framework that purports to explain the origin and formation of non-standard contracts. During the last few decades of the twentieth century, so-called Transaction Cost Economics (TCE) emerged as a competing paradigm for evaluating non-standard agreements in the form of complete or partial integration. Ronald Coase initiated the transaction cost revolution by arguing that complete vertical integration could reduce the cost of transacting, that is, relying upon atomistic markets to conduct economic activity. Building on Coase's work, other practitioners of TCE argued that many non-standard contracts, including those that "exclude" rivals, can also reduce the cost of transacting, particularly anticipated costs of opportunism made possible by relationship-specific investments. In particular, such agreements could create the economic equivalent of property rights and thereby prevent some actors

from free riding on the productive activities of others. While most practitioners of TCE had ignored the means by which such contracts were formed, Coase himself had argued that such integration was “voluntary,” albeit without explaining just how, exactly, proponents of such contracts induced trading partners to enter them. As this Article shows, firms can induce voluntary acceptance of these provisions by offering cost-justified discounts to trading partners who agree to them, thereby using the institution of contract to redefine background rights and obligations so as to minimize the cost of conducting economic activity.

TCE does not teach that all non-standard agreements reduce transaction costs. Moreover, parallel developments suggest that some such agreements may, under certain restrictive conditions, reduce economic welfare by raising the costs of a firm’s rivals, thereby allowing the proponent of the agreement to exercise market power. Here again, however, there is no reason to believe that proponents of such agreements use market power to impose them. Instead, proponents can induce input suppliers to enter such contracts voluntarily, simply by sharing with them expected monopoly profits the arrangements will help create. Thus, such agreements no more result from “coercion” than ordinary cartel arrangements.

Part I of this Article outlines how the “market power” model of contract formation has influenced and still influences various aspects of antitrust doctrine. Examples of doctrine reflecting such influence include the “use of power” test applied to claims of monopolization under § 2 of the Sherman Act, the *per se* rule against certain tying contracts derived from § 1 of the Sherman Act, and judicial hostility to the supposed use of power, including discriminatory pricing, to “impose” agreements analogous to ties. Finally, the model also informs and limits the scope of the *in pari delicto* defense recognized at common law, empowering dealers to challenge various agreements, whether or not “exclusionary,” they knowingly entered, on the ground that any such agreement was not voluntary.

Part II concludes that the “market power” model is a manifestation of neoclassical price theory and its workable competition model, economic frameworks that dominated industrial organization for much of the twentieth century. While Chicago School scholars (as usual) took issue with the doctrinal conclusions reached by courts and the Harvard School, they agreed with Harvard scholars that firms employed market power to impose such agreements and in fact offered a more precise account of what such imposition entailed. This Part ends by explaining that price theory, and not Legal Realism,

accounts for the market power model of contract formation and derivative antitrust doctrines.

Part III reviews TCE's critique of workable competition's account of non-standard contracts. According to TCE, such agreements usually have nothing to do with monopoly power, but are instead methods of reducing the "transaction costs" that atomistic rivalry would entail. While TCE's insights have significantly influenced antitrust law and policy, doctrines based on the market power model of contract formation remain firmly intact. This Part then offers a model of contract formation different from that embraced by the Harvard and Chicago Schools, derived from TCE and Ronald Coase's work on the voluntary reallocation of property rights. This "Coasean bargain" model, it is shown, suggests that contracts that reduce transaction costs by preventing opportunism are voluntary redefinitions of property rights and not imposed via market power. This part extends this "Coasean bargain" model to explain agreements that "raise rivals' costs" and thus confer market power on the proponent of the agreement. Like agreements that reduce transaction costs, such contracts are best understood as purely voluntary reallocations of property rights ordinarily allocated by law to input suppliers.

Part IV explores some implications of this Article's insights for antitrust doctrine. First, this Part argues that substantive antitrust doctrines of monopolization and tying that depend upon the "market power" model of contract formation rest upon outmoded economic theory and should be discarded in favor of more direct analysis of the economic impact of challenged practices. This admonition cuts both ways. On the one hand, plaintiffs should not prevail or even establish a *prima facie* case in a monopolization or tying case simply by showing that a firm with power has "imposed" an exclusionary agreement. At the same time, recognition that voluntary exclusionary rights agreements can produce anticompetitive harm undermines those opinions—endorsed by members of the Chicago School—holding that the possession of preexisting market power is a necessary condition for antitrust liability under § 1 of the Sherman Act. Second, and in the same vein, courts should reject any effort to infer the existence of such power from the presence of non-standard agreements, since the presence of such agreements is at least equally consistent with a conclusion that they are the result of harmless voluntary integration. Third, courts considering assertions of the *in pari delicto* defense should abandon the assumption that manufacturers "force" dealers and consumers to accept provisions that reduce transaction costs or raise rivals' costs, given the Coasean paradigm's conclusion that manufacturers will share the fruits of such agreements with input owners.

Thus, courts should discard exceptions to the *in pari delicto* doctrine based on the “market power” model of contract formation and reconsider current doctrines allowing dealers and consumers to challenge agreements they have entered.

## I. MARKET POWER AND CONTRACT FORMATION IN THE COURTS

Various antitrust doctrines rest upon the assumption that firms with market power “use” that power to impose “exclusionary agreements” upon unwilling dealers or consumers. This Part examines these doctrines in greater detail, beginning with a careful examination of the role of the “market power” account in the law of monopolization, where this model has had particular influence.

### A. Monopolization

Section 2 of the Sherman Act forbids “monopolizing” “any part of the trade or commerce among the several States[.]”<sup>1</sup> From the beginning, courts have held that § 2 does not forbid the mere possession of monopoly, *viz.*, “monopoly in the concrete.”<sup>2</sup> Instead, the Act only forbids the acquisition or maintenance of monopoly by conduct not deemed “normal” or “ordinary.”<sup>3</sup>

Courts have adhered to this fundamental construction of the Act, consistently holding that plaintiffs invoking § 2 must establish some undesirable conduct *in addition to* possession of a monopoly.<sup>4</sup> While courts have expressed and implemented this overarching standard in a variety of ways, one formulation has been surprisingly persistent, serving as a template for evaluating monopolization claims for over sixty years. Under this “abuse of power” test, the offense of monopoli-

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1 15 U.S.C. § 2 (2006).

2 *Standard Oil Co. v. United States*, 221 U.S. 1, 62 (1911) (holding that the Sherman Act forbids only unreasonable restraints of trade and does not forbid “monopoly in the concrete”); *see also* *United States v. United Shoe Mach. Co.*, 247 U.S. 32 (1918) (holding that § 2 only forbids “unusual” or “wrongful” acts that result in or protect monopoly); *Am. Tobacco Co. v. United States*, 221 U.S. 106, 178–81 (1911) (holding that § 2 only forbids acts which “unduly” create or protect monopoly).

3 *See Am. Tobacco Co.*, 221 U.S. at 178–79; *Standard Oil Co.*, 221 U.S. at 178–81; *see also United Shoe Mach. Co.*, 247 U.S. at 63–65 (rejecting attack on contracts that disadvantaged rivals because the agreements were normal and served legitimate purposes).

4 *See Eastman Kodak v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992); *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585 (1985); *United States v. Grinnell Corp.*, 384 U.S. 563 (1966); *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001); *United States v. United Shoe Mach. Corp.*, 110 F. Supp. 295 (D. Mass. 1953), *aff’d*, 347 U.S. 521 (1954) (*per curiam*).

zation consists of two elements: (1) the possession of monopoly power and (2) the “use or exercise of that power” to exclude or destroy competition.<sup>5</sup> Moreover, in a seemingly circular approach, courts that invoke this formulation define “monopoly power”—at least rhetorically—as the power “to control prices or exclude competition.”<sup>6</sup>

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5 See, e.g., *Eastman Kodak*, 504 U.S. at 481 (noting that the first element of the test is “possession of monopoly power”); *id.* at 482–483 (“The second element of a § 2 claim is the use of monopoly power ‘to foreclose competition, to gain a competitive advantage, or to destroy a competitor.’” (quoting *United States v. Griffith*, 334 U.S. 100, 107 (1948))); *Lorain Journal Co. v. United States*, 342 U.S. 143 (1951)); *Griffith*, 334 U.S. at 107; *LiveUniverse, Inc. v. MySpace, Inc.*, 304 F. App’x 554 (9th Cir. 2008); *Smith Wholesale Co. v. Philip Morris USA, Inc.*, 219 F. App’x 398 (6th Cir. 2007); *Spirit Airlines, Inc. v. Nw. Airlines, Inc.*, 431 F.3d 917, 931 (6th Cir. 2005); *United States v. Dentsply Int’l, Inc.*, 399 F.3d 181, 186–91 (3d Cir. 2005); *Borden, Inc. v. Fed. Trade Comm’n*, 674 F.2d 498 (6th Cir. 1982); *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 271–74 (2d Cir. 1979); see also *Novell, Inc. v. Microsoft Corp.*, 505 F.3d 302, 316–17 (4th Cir. 2007) (holding that allegation that “Microsoft’s use of its monopoly power in the operating-system market to foreclose the distribution channels for [plaintiff’s] applications” established antitrust standing); *id.* at 316 (recounting allegation that “Microsoft exploited its monopoly power to require or encourage OEMs to refrain from installing [plaintiff’s] products on their computers”); *id.* at 309 (recounting allegation that Microsoft used “leverage” to “impose restrictive and exclusionary agreements”); *United States v. Microsoft Corp.*, 253 F.3d 34, 64 (D.C. Cir. 2001) (finding that contractual restrictions on original equipment manufacturers were a “use[ ] of Microsoft’s market power to protect its monopoly”); Brief for the United States of America and Federal Trade Commission as Amici Curiae Supporting Petitioner at 13–14, *Verizon Commc’ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004) (No. 02-682), 2003 WL 21269559, at \*13–\*14 (invoking this test); *E.I. DuPont de Nemours & Co.*, 96 F.T.C. 653, 730, 736–38 (1980).

As noted in the text, courts sometimes apply a different test, banning “the willful acquisition or maintenance of [monopoly] power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.” *Compare Aspen Skiing*, 472 U.S. at 595–96 & n.19 (quoting *Grinnell Corp.*, 384 U.S. at 570–71), with *id.* at 595 (quoting with approval jury instruction that also banned the “use” of monopoly power), and *id.* at 597–98 (same). For another example, see *Conwood Co. v. U.S. Tobacco Co.*, 290 F.3d 768, 782 (6th Cir. 2002) (condemning “willful acquisition, maintenance or use of [monopoly] power by anti-competitive or exclusionary means”). As explained below, even courts employing this formulation sometimes rely upon a “market power” account of exclusionary contracts when condemning a monopolist for, say, “willful maintenance” of its power. See, e.g., *Grinnell Corp.*, 384 U.S. at 578 (describing five year leases as imbued with “coercive power . . . towards restraining trade and creating a monopoly” and thus conduct that violated § 2); see also *Aspen Skiing*, 472 U.S. at 597–98 (quoting with approval lower court instructions stating that “taking advantage of scale economies by constructing a large and efficient factory . . . [constitutes] a consequences of size and not an exercise of monopoly power” and thus does not violate § 2).

6 *Eastman Kodak*, 504 U.S. at 481 (internal quotation marks omitted) (holding that plaintiffs had adduced sufficient evidence to support a finding that the defen-

Thus, by the terms of the test, at least, “exclusion of competition” can establish *both* the presence of monopoly power *and* the second, conduct element as well. Moreover, even some courts that do not expressly invoke the abuse of power standard for liability purposes nonetheless define monopoly power in this manner.<sup>7</sup> Indeed, the most recent § 2 complaint filed by the Antitrust Division of the Department of Justice alleges that a defendant “abused its monopoly power . . . through its exclusionary contracts” and that “[e]ach exclusionary contract” entailed willful exploitation of that power.<sup>8</sup>

If taken literally, the abuse of power test would sweep very broadly. After all, all sorts of conduct harms rivals and “excludes” competitors from the marketplace, thus “excluding competition” within the plain meaning of the test. A firm that makes the proverbial “better mousetrap” excludes firms making mediocre ones.<sup>9</sup> Similarly, a firm that realizes economies of scale and underprices rivals “excludes” less efficient firms.<sup>10</sup>

Nonetheless, the abuse of power test has never condemned this sort of normal business conduct. To be sure, there is *dicta* in some recent opinions treating these forms of exclusion as evidence the “excluding” firm possess monopoly power.<sup>11</sup> However, courts gener-

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dant could “control prices or exclude competition” and thus possessed monopoly power in the relevant market); *see Aspen Skiing*, 472 U.S. at 596 n.20 (invoking jury’s finding that the defendant possessed monopoly power, defined as the power to control prices in the relevant market or to exclude competitors); *Grinnell Corp.*, 384 U.S. at 571 (“[M]onopoly power [is] ‘the power to control prices or exclude competition.’” (quoting *United States v. E. I. du Pont de Nemours & Co.*, 351 U.S. 377, 391 (1954))); *Dentsply*, 399 F.3d at 187; *PepsiCo, Inc. v. Coca-Cola Co.*, 315 F.3d 101 (2d Cir. 2002); *Conwood Co.*, 290 F.3d at 782; *Covad Commc’ns Co. v. BellSouth Corp.*, 299 F.3d 1272, 1283 (11th Cir. 2002); *United States v. Microsoft Corp.*, 253 F.3d 34, 51 (D.C. Cir. 2001); *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000); *Berkey Photo*, 603 F.2d at 272.

7 *See Aspen Skiing*, 472 U.S. at 596; *Grinnell Corp.*, 384 U.S. at 571; *Conwood Co.*, 290 F.3d at 782.

8 Complaint at 26, ¶¶ 83–84, *United States v. United Reg’l Health Care Sys.*, No. 7:11-cv-00030 (N.D. Tex. Feb. 25, 2011).

9 *See* Einer Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L. REV. 253, 264 (2003) (invoking this example).

10 *See* HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY* 553 (2d ed. 1999) (“Nothing is a more effective barrier to entry than a firm’s capacity to produce a high quality product at a low price, or to provide improved service to its consumers.”); Thomas A. Piraino, Jr., *Identifying Monopolists’ Illegal Conduct Under the Sherman Act*, 75 N.Y.U. L. REV. 809, 818 (2000) (collecting scholar commentary and evidence suggesting that firms achieve monopoly power by offering superior products and/or realizing efficiencies).

11 *See Dentsply*, 399 F.3d at 187 (“[M]onopoly power . . . has been defined as the ability to control prices or exclude competition . . . . However, because such evidence

ally ascertain the presence or absence of monopoly power by defining the relevant market and calculating the defendant's market share.<sup>12</sup> Moreover, a high market share does not itself establish monopoly power if other firms would readily enter the relevant market if the defendant charged supracompetitive prices.<sup>13</sup> In short, under the "abuse of power" test, the monopoly power element "stands on its own two feet" and involves an independent assessment of the defendant's power based upon the structure of the relevant market.

In addition, mere proof that a monopolist's conduct literally "excludes" rivals from some portion of the market, or even the entire market, has never satisfied the second element of any § 2 test. Instead, courts have repeatedly held that the creation of a new product, realization of economies of scale and resulting low, above-cost prices and similar conduct all constitute "competition on the merits."<sup>14</sup> Such merits-based rivalry, it is said, does not constitute an "exer-

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is only rarely available, courts more typically examine market structure in search of circumstantial evidence of monopoly power." (internal quotation marks omitted)); *United States v. Microsoft Corp.*, 253 F.3d 34, 51 (D.C. Cir. 2001) (suggesting in dicta that direct proof of anticompetitive impact could suffice to establish monopoly power under § 2). The implication of these dicta seems to be that mere proof of anticompetitive impact, including perhaps the exclusion of rivals, would itself suffice to establish monopoly power.

12 See *Eastman Kodak v. Image Technical Servs., Inc.* 504 U.S. 451, 481 (1992); *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377 (1956); *Dentsply*, 399 F.3d at 187.

13 See *United States v. Syufy Enters.*, 903 F.2d 659, 664 (9th Cir. 1990) (holding, absent barriers to entry, high market share does not establish market power); see also *Microsoft*, 253 F.3d at 51 (holding presence of entry barriers necessary to a finding that defendant possesses monopoly power).

14 See *Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 223 (1993) (holding above-cost pricing is "competition on the merits" even if it drives inefficient rivals out of business); *Atl. Richfield v. USA Petroleum*, 495 U.S. 328, 331 (1990) (holding above-cost pricing cannot cause "antitrust injury"); *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 595–96 (1985) (approving jury instruction stating that monopolists may enjoy economies of scale without incurring antitrust liability); *Conwood Co. v. U.S. Tobacco Co.*, 290 F.3d 768, 783 (6th Cir. 2002) (citing *Aspen Skiing* for the same proposition); *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 274–75, 281–82 (2d Cir. 1979) (holding economies of scale or technological innovations cannot violate § 2); *id.* at 276–85 (rejecting claim that Kodak's invention of new camera and failure to disclose invention to rivals contravened § 2); see also *United States v. Nat'l Lead Co.*, 332 U.S. 319, 359 (1947) (rejecting decree requiring defendants to share technical know-how with competitors); *United States v. United Shoe Mach. Co.*, 110 F. Supp. 295, 344–45 (D. Mass. 1953) (distinguishing between "competition based on pure merit," on the one hand, and unlawful exclusion on the other); *id.* at 343–45 (concluding that internal conduct conforming to "inevitable economic laws" is not "exclusionary" under § 2); *E.I. DuPont de Nemours & Co.*, 96 F.T.C. 653, 746–51 (1980) (holding that failure to license propri-

cise” of monopoly power, even if derived from gigantic scale that creates monopoly power in the first place.<sup>15</sup> Moreover, courts have recognized that any safe harbor for “competition on the merits” entails a concomitant right to refuse to sell one’s high quality or inexpensive product to rivals.<sup>16</sup>

The paradigm case of “using” power to exclude rivals involves the supposed imposition of an exclusionary agreement on unwilling dealers or consumers. Indeed, the Supreme Court invoked the “abuse of power” test in its most recent decision examining alleged contractual exclusion by a monopolist,<sup>17</sup> as have various lower courts.<sup>18</sup> Examples include tying agreements,<sup>19</sup> exclusive dealing contracts,<sup>20</sup> and other agreements by dealers or consumers not to deal with rivals.<sup>21</sup> Moreover, even courts that do not expressly invoke the “abuse of power” test nonetheless sometimes rely upon the assertion that a monopolist

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etary technology was not unlawful exclusion, although it prevented entry of competitors); Alan J. Meese, *Monopolization, Exclusion and the Theory of the Firm*, 89 MINN. L. REV. 743, 797–808 (2005) [hereinafter Meese, *Monopolization*] (describing the origin of judicial preference for “competition on the merits”).

15 See *Berkey Photo*, 603 F.2d at 274–75 (distinguishing between economies of scale, which are a “consequence of size,” on the one hand, and exercises of market power, on the other); *id.* at 272–76 (explaining with great precision the distinction between possession and exercise of monopoly power).

16 See *Verizon Commc’ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004) (“The opportunity to charge monopoly prices—at least for a short period—is what attracts ‘business acumen’ in the first place; it induces risk taking that produces innovation and economic growth. To safeguard the incentive to innovate, the possession of monopoly power will not be found unlawful unless it is accompanied by an element of anticompetitive conduct.”); *Nat’l Lead*, 332 U.S. at 359; *Berkey Photo*, 603 F.2d at 281; *E.I. DuPont de Nemours & Co.*, 96 F.T.C. at 746–51.

17 See *Eastman Kodak*, 504 U.S. at 482–86.

18 See *infra* note 57.

19 See *Eastman Kodak*, 504 U.S. at 482–86; *United States v. Microsoft Corp.*, 253 F.3d 34, 60–64 (D.C. Cir. 2001); see also *Novell, Inc. v. Microsoft Corp.*, 505 F.3d 302, 316 (4th Cir. 2007) (characterizing such agreements as “exploit[ation] [of Microsoft’s] monopoly power to require or encourage OEMs to refrain from installing Novell’s products”); *id.* at 309 (referring to use of “leverage . . . to impose restrictive and exclusionary agreements”); *DSM Desotech, Inc. v. 3d Sys. Corp.*, No. 08-CV-1531, 2009 WL 174989, at \*4 (N.D. Ill. Jan. 26, 2009) (invoking “use of power” test when evaluating alleged attempted monopolization via tying).

20 See *United States v. Dentsply Int’l, Inc.*, 399 F.3d 181, 196 (3d Cir. 2005) (holding that monopolist “exert[ed]” its power to foreclose competition via exclusive dealing contracts imposed on dealers).

21 See *Lorain Journal Co. v. United States*, 342 U.S. 143 (1951); *United States v. Griffith*, 334 U.S. 100, 103–108 (1948) (holding that theaters “employ[ ]” their monopoly power as a “trade weapon” to induce film distributors to agree not to supply films to rival theaters).

“used” monopoly power to impose such a contract when concluding that the firm violates § 2.<sup>22</sup>

Because courts only purport to ban exercises of power that “exclude competition,” the “abuse of power” test leaves the most obvious exercises of monopoly power unscathed.<sup>23</sup> That is to say, under this test (and current law), monopolists may exercise the full extent of their power the “old-fashioned way” by charging above-cost prices.<sup>24</sup> While such monopoly prices arguably injure consumers, they do not “exclude competition.” If anything, such high prices and the reduced output that causes them will enhance competition, by leaving room in the marketplace for new entrants and protecting less efficient, smaller incumbents.<sup>25</sup>

The “abuse of power” test thus divides a monopolist’s behavior into three categories: (1) “normal” conduct, which does not involve an “exercise” of monopoly power, but which may create or help maintain such power; (2) “legitimate” exercises of monopoly power, i.e., output reductions and price increases, and (3) unlawful, illegitimate exercises of such power, that is, exclusionary contracts and other exercises of power that disadvantage rivals.<sup>26</sup> Conduct in the first category—competition on the merits—does not offend § 2, even if it creates or maintains monopoly. Moreover, firms may employ legitimately-gained power by charging whatever the market will bear, and the prospect of such profits creates incentives to engage in “competition on the merits.”<sup>27</sup> At the same time, firms may not employ power, however gained, to impose agreements that disadvantage rivals.<sup>28</sup>

22 See *United States v. Grinnell Corp.*, 384 U.S. 563, 578 (1966) (holding that monopolist’s lease-only policy was “coercive” exclusionary conduct); *United States v. Microsoft Corp.*, 253 F.3d 34, 63 (D.C. Cir. 2001) (finding that contractual conditions applied to PC manufacturers were a “use” of monopoly power). See generally Meese, *Monopolization*, *supra* note 14, at 755–771 (discussing the evolution of monopoly jurisprudence under § 2).

23 See *supra* notes 5–10 and accompanying text.

24 See *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 274 (2d Cir. 1979).

25 See *id.* at 274 n.12 (“Nor is a lawful monopolist ordinarily precluded from charging as high a price for its product as the market will accept. True, this is a use of economic power; indeed, the differential between price and marginal cost is used as an indication of the degree of monopoly power . . . . But high prices, far from damaging competition, invite new competitors into the monopolized market.” (citations omitted)).

26 See *supra* notes 5–7.

27 See *Verizon Commc’ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004); *Berkey Photo*, 603 F.2d at 281.

28 See Meese, *Monopolization*, *supra* note 14, at 755–62; William Page, *Legal Realism and the Shaping of Modern Antitrust*, 44 EMORY L.J. 1, 27–29 (1995) [hereinafter Page, *Legal Realism*] (describing role played by concept of “coercion” in various antitrust

Thus, antitrust doctrine tolerates one exercise of monopoly power, but bans the purported expression of such power to impose exclusionary agreements.

The taxonomy outlined above once functioned as a *per se* rule against exclusionary contracts entered by monopolists, as courts dismissed arguments that such agreements produced benefits justifying their exclusionary impact.<sup>29</sup> More recently, however, courts have rejected this *per se* approach, further narrowing the category of conduct that § 2 prohibits. Thus even if a plaintiff demonstrates that a monopolist's exclusionary agreements disadvantage rivals, courts will allow defendants to show that such agreements produce significant benefits and thereby avoid condemnation.<sup>30</sup> Even if the defendant adduces evidence that the restriction produces significant benefits, however, the plaintiff can still prevail by showing that the defendant could achieve these same benefits via a less restrictive alternative.<sup>31</sup> When a monopolist cannot justify its agreement, courts conclude that

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doctrines during the 1940s, 1950s and 1960s). While Professor Page very ably describes how concerns over supposed "coercion" influenced antitrust doctrine during the Warren Court era and before, he does not articulate any model of contract formation consistent with this view or ascertain the role that price theory played in informing that model. Nor does he recognize the role the Chicago School played in actually buttressing and elaborating the market power model of contract formation. See *infra* notes 72, 169, 172, 178, 181–182 and accompanying text.

29 See *United States v. Grinnell Corp.*, 384 U.S. 563, 578 (1966); see also *United States v. United Shoe Mach. Co.*, 110 F. Supp. 295, 343–45 (D. Mass. 1953) (banning conditional leases and tying agreements entered by a monopolist without considering possible benefits of such arrangements).

30 See *Eastman Kodak Co. v. Image Technical Servs., Inc.* 504 U.S. 451, 483 (1992) (holding that once plaintiff shows that agreements foreclose rivals from a portion of the market, "[l]iability turns, then, on whether 'valid business reasons' can explain [defendant]'s actions" (quoting *Apsen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 605 (1985))); *United States v. Dentsply Int'l, Inc.*, 399 F.3d 181, 196–97 (3d Cir. 2005) (holding that defendant's proffered business justification was pretextual); *United States v. Microsoft Corp.*, 253 F.3d 34, 58–59 (D.C. Cir. 2001) (reciting business justification defense to *prima facie* case); see also *Berkey Photo*, 603 F.2d at 284 (holding that otherwise anticompetitive refusal to share technology can be justified by "valid business policy"); *id.* at 283 (finding that particular tactic disadvantaging rivals was "solely a benefit of integration and not, without more, a use of Kodak's power in the film market").

31 See, e.g., *Eastman Kodak*, 504 U.S. at 484–86 (rejecting defendant's summary judgment motion where plaintiff adduced evidence that the defendant could have achieved legitimate objectives without restrictive agreements); *Microsoft*, 253 F.3d at 58–59 (articulating this test).

it has employed preexisting monopoly power to exclude competition and maintain its monopoly.<sup>32</sup>

While this modified test is more generous to defendants than it once was, it still rests upon an assumption that even beneficial agreements produce harms that co-exist with any benefits. After all, the search for a “less restrictive” means of achieving a monopolist’s objective depends upon an assumption that the restraint is “restrictive” in some meaningful sense.<sup>33</sup> Since the abuse of power test does not require a showing that the restraint produces actual harm, the test must rest upon an assumption that, despite any benefits, the restraint is nonetheless the result of market power used to impose it. Courts that recognize that such restraints may produce benefits have not offered any alternative account of how such contracts are formed.

### B. Tying

Courts have relied upon a similar test when analyzing so-called “tying contracts,” under § 1 of the Sherman Act. Such agreements require buyers to purchase a second, tied product as a condition of receiving the first, tying product.<sup>34</sup> The quintessential example involves a franchise contract granting a franchise—a tying product—in return for an agreement by the franchisee also to purchase inputs such as spices or sauces from the franchisor.<sup>35</sup>

For decades now, many ties have been unlawful per se.<sup>36</sup> In particular, such agreements are unlawful without more if the seller possesses “economic power” in the market for the tying product and requires buyers to purchase the tied product as a condition of

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32 See *Eastman Kodak*, 504 U.S. at 483–86; *Dentsply*, 399 F.3d at 196–99; *Microsoft*, 253 F.3d at 63.

33 See Meese, *Monopolization*, *supra* note 14, at 761.

34 See *IBM v. United States*, 298 U.S. 131 (1936) (evaluating requirement that purchasers of adding machines also purchase IBM punch cards).

35 See, e.g., *Queen City Pizza, Inc. v. Dominos Pizza, Inc.* 124 F.3d 430 (3d Cir. 1997) (evaluating requirement that franchisees purchase pizza dough and sauce from the franchisor); *Mozart Co. v. Mercedes-Benz of N. Am., Inc.*, 833 F.2d 1342 (9th Cir. 1987) (evaluating requirement that franchisees purchase repair parts from franchisor).

36 See *Eastman Kodak*, 504 U.S. at 486–87 (explaining per se rule in context of tying); *N. Pac. Ry. Co. v. United States*, 356 U.S. 1, 8 (1958) (holding defendant’s tying agreements per se unreasonable); *IBM*, 298 U.S. at 139–40 (holding defendant’s tying of punch cards to tabulating machines unreasonable, although not mentioning per se rule). But see *Microsoft*, 253 F.3d at 89–94 (holding that per se rule does not apply to tie of platform software to operating system).

purchasing the tying product.<sup>37</sup> While lower courts have recognized justifications for ties deemed "unlawful per se," the Supreme Court has refused to endorse the availability of such defenses.<sup>38</sup>

The per se rule against tying contracts does not reflect a determination that all or most agreements satisfying this test result in lower output or higher prices.<sup>39</sup> Instead, the per se rule rests upon the assumption that such agreements are the result of "anticompetitive forcing."<sup>40</sup> Courts have for decades defined such "forcing" as the use of market power to compel a purchaser to do something it would not do in a competitive market, such as purchase an unwanted product.<sup>41</sup> Such "forcing," it is said, prevents rivals from offering purchasers similar products and therefore interferes with "competition on the merits" analogous to perfect competition.<sup>42</sup> If the seller's version of the tied

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37 See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2 (1985); *Northern Pacific*, 356 U.S. at 5-7.

38 See *Eastman Kodak*, 504 U.S. at 461-65 (articulating per se rule without mentioning possibility of justification); *Jefferson Parish*, 466 U.S. at 25 n.42 (approving repeated earlier conclusions that less restrictive means would achieve beneficial purposes of tying contracts); *Northern Pacific*, 356 U.S. at 6 n.5 (concluding that benign functions of such contracts can be achieved by "other means much less inimical to competition"); cf. *Mozart*, 833 F.2d at 1350-51 (entertaining and sustaining an affirmative defense).

39 *Jefferson Parish*, 466 U.S. at 32-42 (O'Connor, J., concurring) (criticizing per se rule on this basis).

40 *Id.* at 13-16 (majority opinion) (holding that per se rule rests upon conclusion that satisfaction of per se test establishes existence of "forcing"); see also *Northern Pacific*, 356 U.S. at 6-7 (same).

41 See *Eastman Kodak*, 504 U.S. at 464 (defining market power for purposes of the per se rule as "the power 'to force a purchaser to do something that he would not do in a competitive market'" (quoting *Jefferson Parish*, 466 U.S. at 14)); *Jefferson Parish*, 466 U.S. at 12 ("[T]he essential characteristic of an invalid tying arrangement lies in the seller's exploitation of its control over the tying product to force the buyer into the purchase of a tied product . . ."); *U.S. Steel Corp. v. Fortner Enters., Inc.*, 429 U.S. 610, 620 (1977) (holding market power inquiry examines whether seller has power "to require purchasers to accept burdensome terms that could not be exacted in a completely competitive market"); *Northern Pacific*, 356 U.S. at 5-6 (asserting tying contracts "force[ ] [buyers] to forgo their free choice between competing products"); see also Alan J. Meese, *Tying Meets the New Institutional Economics: Farewell to the Chimera of Forcing*, 146 U. PA. L. REV. 1, 18-21 (1997) [hereinafter Meese, *Tying*] (summarizing development of law on "forcing").

42 See *Jefferson Parish*, 466 U.S. at 12 ("When such 'forcing' is present, competition on the merits in the market for the tied item is restrained and the Sherman Act is violated."); *Northern Pacific*, 356 U.S. at 6 (holding tying contracts imposed by firms with market power restrain "competition on the merits"); *Times-Picayune Publ'g Co. v. United States*, 345 U.S. 594, 605 (1953) (noting that by imposing a tying contract, "a seller coerces the abdication of buyers' independent judgment as to the 'tied' product's merits and insulates it from the competitive stresses of the open market").

product really was superior, courts claim, “freely choosing” buyers would choose it anyway in a market undistorted by market power.<sup>43</sup> Such forcing itself suffices to establish antitrust harm under § 1.

Courts and agencies have applied similar logic when condemning practices analogous to ties. For instance, the Federal Trade Commission condemned, via consent decree, a monopolist’s favorable pricing treatment of retailers that agreed to devote ninety percent of their shelf space to the defendant’s products, thereby disadvantaging smaller, competing manufacturers as well as those retailers who declined such discounts.<sup>44</sup> Relying upon the work of one of the nation’s leading antitrust scholars, the Commission claimed that such differential pricing reflected the exercise of market power to induce acceptance of the shelf space provisions and violated the Robinson-Patman Act.<sup>45</sup>

Indeed, more than three decades earlier the Commission had invoked similar logic, convincing the Supreme Court to condemn an oil refiner that strongly encouraged its dealers to stock a supplier’s tires, batteries and accessories.<sup>46</sup> Although recognizing that the agreement was not a tying contract, the Court nonetheless agreed with the Commission that it was an “unfair method of competition.”<sup>47</sup> The Court emphasized that the defendant and its dealers “do not bargain as equals,” but that the defendant exerted “power” over dealers.<sup>48</sup> Indeed, the Court said, defendant’s treatment of its dealers mimicked the “central competitive characteristic” of a tying arrangement, namely, “the utilization of economic power in one market to curtail competition in another.”<sup>49</sup> The Court even approved the Commission’s refusal to consider evidence of the arrangement’s benefits, because any benefits flowed from “the use of oil company power, to effectively sew up large markets.”<sup>50</sup>

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43 See *Times-Picayune*, 345 U.S. at 605 (“[A]ny intrinsic superiority of the ‘tied’ product would convince freely choosing buyers to select it over others, anyway.”); *Standard Oil Co. of Cal. v. United States*, 337 U.S. 293, 306 (1949) (“If the manufacturer’s brand of the tied product is in fact superior to that of competitors, the buyer will presumably choose it anyway.”).

44 See *McCormick & Co.*, No. 961-0050, 2000 WL 264190, at \*3 (F.T.C. Mar. 8, 2000).

45 See *id.* at \*12 & n.3 (citing Herbert Hovenkamp, *Market Power and Secondary-Line Differential Pricing*, 71 GEO. L.J. 1157, 1170 (1983)).

46 See *Atl. Ref. Co. v. FTC* 381 U.S. 367 (1965).

47 *Id.* at 369–71.

48 *Id.* at 368.

49 *Id.* at 369.

50 *Id.* at 371.

Some have recommended a more fact-intensive “Rule of Reason” approach to tying agreements, under which power over the tying product would be a necessary, but not sufficient, condition for liability.<sup>51</sup> These advocates echo the more general argument—associated with the “Chicago School” of antitrust—that proof of market power should be a necessary condition for liability under the Rule of Reason, because firms without such power cannot cause anticompetitive harm.<sup>52</sup> Still, the per se rule against tying and its rationale have remained unchanged for over fifty years.<sup>53</sup>

At the same time, § 1 does not prevent the exercise of such power to “force” consumers to pay a monopoly price for the tying product.<sup>54</sup> Instead, as in the § 2 context, courts distinguish between the (legal) “use” of power to charge whatever the market will bear and the use of

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51 See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 37–38 (1985) (O'Connor, J., concurring) (applying this fact-intensive approach); *Digital Equip. Corp. v. Uniq Digital Techs., Inc.*, 73 F.3d 756 (7th Cir. 1996) (applying the same fact-intensive approach). But see *Town Sound and Custom Tops, Inc. v. Chrysler Motors Corp.*, 959 F.2d 468 (3d Cir. 1992) (holding proof of market power not necessary to establish liability in Rule of Reason tying case).

52 See *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210, 217–21 (D.C. Cir. 1986) (invoking similar logic to justify requirement that plaintiff establish market power to establish prima facie case under the Rule of Reason); *Polk Bros. v. Forest City Enters.*, 776 F.2d 185, 191 (7th Cir. 1986); RICHARD A. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE*, 165–66 (1976) (arguing that horizontal ancillary restraints should be lawful absent proof that the defendants possess market power); Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 19–23 (1984) [hereinafter Easterbrook, *Limits of Antitrust*] (proposing that plaintiff's failure to establish market power should doom a Rule of Reason case).

53 At one time, courts equated “economic power” with any departure from perfect competition that conferred the slightest power. See *United States v. Loew's Inc.*, 371 U.S. 38, 45–48 (1962) (holding that copyright possession creates presumption of economic power); *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 49–50 (9th Cir. 1971) (holding that trademark ownership confers economic power sufficient to invoke per se rule). Some courts even suggested that the existence of such contracts implied the “power” to impose them. See *Fortner Enters., Inc. v. U.S. Steel Corp.*, 394 U.S. 495, 504 (1969); *Loew's, Inc.*, 371 U.S. at 49 (holding that the existence of market foreclosure confirmed the presumption that copyright conferred economic power); *N. Pac. Ry. Co. v. United States*, 356 U.S. 1, 7–8 (1958) (“The very existence of this host of tying arrangements is itself compelling evidence of the defendant's great power . . .”). However, courts have more recently equated such power with the sort of “market power” necessary to establish other antitrust violations. See *Jefferson Parish*, 466 U.S. at 26–29 (holding that thirty percent share of a relevant product market did not suffice to establish the sort of economic power necessary to establish a per se tying violation).

54 See *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752 (1984) (holding that Sherman Act § 1 does not apply to single firm conduct).

that same power to impose contractual provisions.<sup>55</sup> The former, one might say, constitutes a just reward for merits-based competition, while the latter entails the use of power to thwart competition and gain more power.<sup>56</sup> Indeed, when initially justifying the per se rule against ties, the Supreme Court expressly invoked § 2 doctrine's ban on the "use" of power to disadvantage rivals.<sup>57</sup>

As noted above, some lower courts have allowed defendants to justify tying contracts that are otherwise unlawful per se. Nonetheless, these courts still rely upon a market power model of contract formation. Thus, even if a defendant proves that the agreement creates benefits, plaintiffs nonetheless prevail if they show that the defendant can realize the same benefits by means of a less restrictive alternative.<sup>58</sup> As in the monopolization context, this "less restrictive alternative test" depends upon an assumption that the restraint's benefits coexist with harms, namely, "coercive forcing."<sup>59</sup> Thus, even courts that have recognized the propensity of such contracts to produce benefits nonetheless assume that sellers employ market power to impose them and treat such coercive imposition as a harm coexisting with any benefits.

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55 See *Jefferson Parish*, 466 U.S. at 14 ("[T]he law draws a distinction between the exploitation of market power by merely enhancing the price of the tying product, on the one hand, and by attempting to impose restraints on competition in the market for the tied product, on the other. When the seller's power is just used to maximize its return in the tying product market, where presumably its product enjoys some justifiable advantage over its competitors, the competitive ideal of the Sherman Act is not necessarily compromised. But if that power is used to impair competition on the merits in another market, a potentially inferior product may be insulated from competitive pressures.").

56 See *id.*

57 See *Times-Picayune Publ'g Co. v. United States*, 345 U.S. 594, 608–09 (1953) (invoking *Griffith* holding that a monopolist may not "use" power to enter contracts that disadvantage rivals as support for the per se rule against tying contracts); see also *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 275–76 (2d Cir. 1979) (analogizing § 2's abuse of power test to the per se rule against tying).

58 See *Metrix Warehouse, Inc. v. Daimler-Benz Aktiengesellschaft*, 828 F.2d 1033, 1039–42 (4th Cir. 1987) (finding a tie unlawful where "less restrictive alternative" was purportedly available); *Chicken Delight*, 448 F.2d at 50 (same); see also *Eastman Kodak v. Image Technical Servs., Inc.* 504 U.S. 451, 484–86 (1992) (rejecting proffered justification for tie under § 2 where plaintiff offered proof that less restrictive alternatives could produce same benefits).

59 Alan J. Meese, *Antitrust Balancing in a (Near) Coasean World: The Case of Franchise Tying Contracts*, 95 MICH. L. REV. 111, 141–42 (1996) [hereinafter Meese, *Antitrust Balancing*].

### C. In Pari Delicto

The “market power” account of contract formation also figures prominently in the law governing who may challenge unlawful agreements, even agreements with no exclusionary impact. Assume that a franchisee launches a § 1 challenge to a franchise contract containing exclusionary agreements such as tying and exclusive dealing provisions as well as non-exclusionary contracts such as minimum resale price maintenance and exclusive territories. This challenge seems odd at first because the franchisee is challenging provisions to which it agreed. Indeed, at common law, the doctrine of *in pari delicto* (“in equal fault”) would have barred such challenges, preventing plaintiffs from profiting from their unlawful acts.<sup>60</sup> Still, antitrust courts often allow such challenges to proceed, even if the plaintiff entered the agreement with full knowledge of its exclusionary potential. Indeed, over four decades ago, the Supreme Court held that *in pari delicto* did not bar a suit by dealers challenging tying and exclusive dealing agreements as well as agreements setting minimum resale prices and granting exclusive territories.<sup>61</sup> This was so, the Court said, despite the lower court’s finding that plaintiffs were fully aware of the agreements’ provisions, reaped “enormous profits” from the franchise opportunities, and sought out additional franchise agreements subject to the same provisions.<sup>62</sup> Such restrictions could only benefit the manufacturer, the Court said, with the result that dealers’ “participation was not voluntary in any meaningful sense”<sup>63</sup> because they were “forced to accept [the] more onerous terms as a condition of doing business.”<sup>64</sup>

Although the dealers may have actively sought the franchise opportunities, they did not, the Court said, seek “each and every clause of the agreement.”<sup>65</sup> Instead, petitioners “apparently” accepted these restrictive provisions to obtain the more attractive franchise

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60 See *Crest Auto Supplies, Inc. v. Ero Mfg. Co.*, 360 F.2d 896, 900 (7th Cir. 1966) (collecting authorities); see also *Eastman Kodak Co. of N.Y. v. S. Photo Materials Co.*, 273 U.S. 359, 377 (1927) (opining that the defense would apply if plaintiff had entered contract voluntarily); *Victor Talking Mach. Co. v. Kemeny*, 271 F. 810, 819 (3d Cir. 1921) (holding plaintiff may not recover prospective profits from illegal scheme).

61 See *Perma Life Mufflers, Inc. v. Int’l Parts Corp.*, 392 U.S. 134, 137 (1968).

62 *Id.* at 138.

63 *Id.* at 139.

64 *Id.* at 140.

65 *Id.* at 139.

opportunity.<sup>66</sup> While the restrictive provisions may have conferred some minor benefits on the dealers, they did not, according to the Court, “mitigate . . . the losses that a dealer would suffer when forced to buy higher-priced [defendant’s] products . . . .”<sup>67</sup> Instead the restrictions were involuntary, the result of the manufacturer’s exercise of market power.<sup>68</sup> Even though the opinion announcing the judgment suggested a blanket abolition of the defense, controlling concurring opinions opined that the defense should be available when parties to the restraint had bargained on equal terms.<sup>69</sup> One concurring Justice even suggested that the defense would be available if plaintiff-dealers had agreed to exclusionary agreements benefitting the manufacturer in return for anticompetitive contracts benefitting dealers.<sup>70</sup> Though announced at the height of antitrust’s inhospitality era, this holding still stands, regardless whether the challenged agreement is “exclusionary.”<sup>71</sup>

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66 *Id.* The Court offered no citation of the record for this assertion. This conclusion, then, seems to have been based purely on a theoretical appraisal of the purported nature and impact of such agreements.

67 *Id.* at 141 n.5. The Court also remarked that “[n]either of these provisions [requirements of exclusive dealing and carrying a full line of parts] could be in the dealer’s self-interest since they obligate him to buy from Midas regardless of whether more favorable prices can be obtained from other sources of supply and regardless of whether he needs certain parts at all.” *Id.* at 140–41.

68 *Id.* at 141–42; *id.* at 145 (White, J., concurring); accord *Simpson v. Union Oil Co.*, 377 U.S. 13 (1964); *Gen. Leaseways, Inc. v. Nat’l Truck Leasing Ass’n*, 830 F.2d 716, 720 (7th Cir. 1987) (reading *Perma Life* as resting on finding that restraints before it resulted from economic coercion).

69 See *Perma Life*, 392 U.S. at 138–41 (majority opinion); *id.* at 145 (White, J., concurring) (“When those with market power and leverage persuade, coerce, or influence others to cooperate in an illegal combination to their damage, allowing recovery to the latter [dealer] is wholly consistent with the purpose of § 4, since it will deter those most likely to be responsible for organizing forbidden schemes.”); *id.* at 149–51 (Marshall, J., concurring) (arguing that the doctrine should not bar dealer challenge of exclusive dealing and tying contracts that can only benefit the manufacturer).

70 *Id.* at 149–50 (Marshall, J., concurring).

71 See *Bateman Eichler, Hill Richards, Inc., v. Berner*, 472 U.S. 299 (1985) (holding that defense still stands); *Howard Hess Dental Labs. Inc. v. Dentsply Int’l, Inc.*, 424 F.3d 363, 381–84 (3d Cir. 2005) (reading *Perma Life* as barring suit by antitrust plaintiffs who are involved at the “requisite level” in the challenged conspiracy); *id.* at 381–82 (invoking doctrine in support of conclusion that indirect purchasers could not treat dealers as “co-conspirators” with manufacturer that had imposed exclusive dealing contracts); *id.* at 383 (relying in part upon district court’s conclusion that dealer participation in exclusive dealing contract was not “voluntary in any meaningful sense”); *Blackburn v. Sweeney*, 53 F.3d 825 (7th Cir. 1995) (holding doctrine barred suit when both sides were in fact equally responsible for the restraint); *Gen. Leaseways*, 830 F.2d at 720–31 (sustaining jury’s finding of zero damages based on findings that the plaintiff had participated equally in the creation and enforcement of

In short, several antitrust doctrines rest upon the assumption that firms with market power employ that power to “impose” exclusionary contracts on dealers or consumers. Absent such power, it is said, firms could not obtain agreement to such contracts, which necessarily make dealers or consumers “worse off” than they otherwise would be. Moreover courts presume, sometimes conclusively, that the use of market power to impose such agreements constitutes antitrust harm justifying Sherman Act condemnation. While courts allow firms to obtain or maintain monopoly power and thereby charge high prices, by engaging in “competition on the merits,” they condemn the use of that power to impose agreements that supposedly extend or protect such power.<sup>72</sup> Finally, the “market power” model of contract formation informs doctrines governing which parties may challenge otherwise unlawful agreements.

## II. PRICE THEORY, WORKABLE COMPETITION, AND THE “MARKET POWER” MODEL OF CONTRACT FORMATION

The Sherman Act does not mention any taxonomy between coercive agreements and “competition on the merits.” Instead, the distinction is a judicial gloss on the phrases “restraint of trade” and “monopolize”—in §§ 1 and 2 of the Act, respectively, glosses that only began to appear more than three decades after the Act’s passage.<sup>73</sup> This Part finds the source of this gloss in economic theory, namely, neoclassical price theory: the economic model that informed industrial organization when courts first generated these doctrines.

### A. *The Rule of Reason, Price Theory, and Workable Competition*

The Sherman Act’s “Rule of Reason” impels courts to determine whether a contract produces “monopoly or its consequences,” defined as the use of power to increase prices, reduce output, or reduce quality.<sup>74</sup> From the beginning, courts turned to economic theory to deter-

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the challenged scheme); *Burlington Indus., Inc. v. Milliken & Co.*, 690 F.2d 380, 387 (4th Cir. 1982) (reading *Perma Life* to allow assertion of *in pari delicto* defense when both parties participate in the formation and execution of the challenged agreement); *Javelin Corp. v. Uniroyal, Inc.*, 546 F.2d 276 (9th Cir. 1976) (same); *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3, 15–16 (4th Cir. 1971) (same).

<sup>72</sup> See Page, *Legal Realism*, *supra* note 28, at 27–28.

<sup>73</sup> See *United States v. Int’l Harvester Co.*, 274 U.S. 693, 708–09 (1927) (noting that antitrust law does not ban unexercised power but instead only regulates “unlawful conduct in the exercise of [that] power”).

<sup>74</sup> See *Standard Oil Co. v. United States*, 221 U.S. 1, 60–62 (1911); *id.* at 52 (listing increased prices, reduced output and reduced quality as three evils of monopoly); *Am. Tobacco Co. v. United States*, 221 U.S. 106 (1911); see also Alan J. Meese, *Price*

mine the causes and consequences of challenged conduct.<sup>75</sup> In particular, courts have relied upon industrial organization, that subset of economic theory that seeks to identify the welfare consequences of various business activities.<sup>76</sup> Indeed, five decades ago, one leading industrial organization theorist summarized the discipline as directed toward determining the impact of market structure *and* market conduct on market performance.<sup>77</sup> “[M]arket conduct,” he said, “embrac[ed] the practices, policies, and devices which [enterprises] employ in arriving at adjustments to the markets in which they participate . . . .”<sup>78</sup>

For most of the twentieth century, however, industrial organization was not so much an independent discipline as it was applied price theory.<sup>79</sup> Writing in the early 1970s, Nobel Laureate Ronald Coase reviewed two leading textbooks on industrial organization produced by Joe Bain and George Stigler, scholars representing the Harvard and Chicago schools—supposedly at odds with one another—respec-

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*Theory, Competition and the Rule of Reason*, 2003 ILL. L. REV. 77, 84–88 (2003) [hereinafter Meese, *Rule of Reason*] (detailing content of *Standard Oil's Rule of Reason*).

75 See Robert H. Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, 74 YALE L.J. 775, 805 (1965) [hereinafter Bork, *Rule of Reason*] (explaining how the logic of the Rule of Reason requires courts to employ up to date economic theory to determine the consequences of challenged restraints); Meese, *Rule of Reason*, *supra* note 74, at 89–92 (same); see also HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 268 (1991) [hereinafter HOVENKAMP, ENTERPRISE] (“One of the great myths about American antitrust policy is that courts began to adopt an ‘economic approach’ to antitrust problems only in the 1970’s. At most, this ‘revolution’ in antitrust policy represented a change in economic models. Antitrust policy has been forged by economic ideology since its inception.”); Michael S. Jacobs, *An Essay on the Normative Foundations of Antitrust Economics*, 74 N.C. L. REV. 219, 226 (1995) (“In almost every era of antitrust history, policymakers have employed economic models to explain or modify the state of the law and the rationale for its enforcement.”).

76 See JOE S. BAIN, *INDUSTRIAL ORGANIZATION* 2 (1959) [hereinafter BAIN, *INDUSTRIAL ORGANIZATION*] (defining subject to be studied as “the performance of business enterprises—their performance, that is, in aspects or dimensions which appear to affect importantly the general public welfare”).

77 See *id.* at 3.

78 *Id.* (emphasis omitted); see also *id.* at 266–68 (defining “market conduct” to include collusive agreements and exclusionary tactics); *id.* at 330–31 (defining exclusionary conduct to include tying agreements, requirements contracts and similar conduct).

79 See R. H. Coase, *Industrial Organization: A Proposal for Research*, in *POLICY ISSUES AND RESEARCH OPPORTUNITIES IN INDUSTRIAL ORGANIZATION* 59, 61–64 (Victor R. Fuchs ed., 1972) [hereinafter Coase, *Industrial Organization*] (arguing that, as of 1972, Industrial Organization consisted simply of applied price theory); Oliver E. Williamson, *Delimiting Antitrust*, 76 GEO. L.J. 271, 295 (1987) [hereinafter Williamson, *Delimiting Antitrust*] (discussing “applied price theory tradition” of antitrust).

tively.<sup>80</sup> Coase concluded that “[e]ssentially, both [authors] consider the subject of industrial organization as applied price-theory,” what Coase would also call “blackboard economics,”<sup>81</sup> an assessment that Stigler and others shared.<sup>82</sup>

Price theory, in turn, was the subset of microeconomics that sought to predict the allocational results of a price system based upon private property and free exchange.<sup>83</sup> The foundation for analysis was “perfect competition,” a state of affairs that rested upon numerous assumptions, most quite unrealistic.<sup>84</sup> The model assumed a baseline of well-defined property rights and the absence of fraud or other impediments to bargaining.<sup>85</sup> Exogenous technological considerations determined possible methods of production and thus each

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80 See Coase, *Industrial Organization*, *supra* note 79, at 61–64. Bain received his PhD from Harvard, where he participated in the working group on workable competition founded by Edward Mason. Bain’s industrial organization text identified his “primary obligation” to Mason. See BAIN, *INDUSTRIAL ORGANIZATION*, *supra* note 76; Richard A. Posner, *The Chicago School of Antitrust Analysis*, 127 U. PA. L. REV. 925, 925–26 (1979) [hereinafter Posner, *Chicago School*] (distinguishing Chicago from the Harvard School); *id.* at 928 n.8 (stating that the Harvard School’s position was “well conveyed in the writings of Edward S. Mason”).

81 Coase, *Industrial Organization*, *supra* note 79, at 62; *see id.* at 61–64 (arguing that, as of 1972, industrial organization consisted simply of applied price theory).

82 See JOE BAIN, *INDUSTRIAL ORGANIZATION*, 25–27 (1968); RICHARD CAVES, *AMERICAN INDUSTRY: STRUCTURE, CONDUCT, PERFORMANCE* 15 (3d ed. 1972) (“[I]ndustrial organization’ applies the economist’s models of price theory to the industries in the world around us.”); GEORGE J. STIGLER, *THE ORGANIZATION OF INDUSTRY* 1 (1968) (stating “there is no such subject as industrial organization” because courses taught on the subject simply replicated “the content of economic theory—price or resource allocation theory”).

83 See JOE S. BAIN, *PRICE THEORY* 1–15 (1952) [hereinafter BAIN, *PRICE THEORY*].

84 See FRANK H. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* 76–81 (1921) [hereinafter KNIGHT, *RISK, UNCERTAINTY, AND PROFIT*] (detailing various assumptions of perfect competition model); *see also* George J. Stigler, *Perfect Competition: Historically Contemplated*, 65 J. POL. ECON. 1, 11 (1957) [hereinafter Stigler, *Perfect Competition*] (asserting that Knight provided first complete articulation of perfect competition model).

85 See YORAM BARZEL, *ECONOMIC ANALYSIS OF PROPERTY RIGHTS* 11–13 (1997) (arguing perfect competition depends upon well-enforced property rights); CARL KAYSER & DONALD F. TURNER, *ANTITRUST POLICY* 13 n.12 (1959) (arguing efficient market competition requires well-defined property rights); KNIGHT, *RISK, UNCERTAINTY, AND PROFIT*, *supra* note 84, at 56 (“The foundation of the process [studied] is the private *ownership* of productive resources—a synonym for individual freedom.”); *id.* at 78–79 (arguing perfect competition’s no fraud assumption is a redundant implication of perfect knowledge); GEORGE J. STIGLER, *THE THEORY OF COMPETITIVE PRICE* 22 (1942) [hereinafter STIGLER, *COMPETITIVE PRICE*] (arguing perfect competition requires enforcement of contracts and protection of private property); Friedrich A. Hayek, “Free” *Enterprise and Competitive Order*, in *INDIVIDUALISM AND ECONOMIC ORDER* 107, 110–16 (1948) (contending that well-functioning competitive order depends

firm's "production function," namely, a mathematical representation of the relationship between the costs of various inputs and the firm's output.<sup>86</sup> Firms took this function as a given and selected the most efficient, i.e., cost-minimizing, method of production in light of the costs of relevant inputs.<sup>87</sup> Such purely technological considerations also explained the boundaries of the firm, namely, what a firm chooses to make itself and what it purchases from others.<sup>88</sup> In this imaginary world, the market boasted innumerable firms, each too small to influence market price.<sup>89</sup> Firms acted independently, information costs were nonexistent, and there were no obstacles to the movement of resources such as labor and capital.<sup>90</sup> These latter assumptions ensured that economic activity and exchange occurred instantaneously and produced an equilibrium of price and output, excluding the operation of time from the model.<sup>91</sup>

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upon properly-designed "legal framework" of contract, property, tort and business law).

86 See KELVIN LANCASTER, *INTRODUCTION TO MODERN MICROECONOMICS* 73 (1969) ("A general statement of all outputs that can be obtained from all efficient input combinations is called the *production function*."); TIBOR SCITOVSKY, *WELFARE AND COMPETITION* 113–21 (1951) (explaining concept of production function); STIGLER, *COMPETITIVE PRICE*, *supra* note 85, at 109–10 ("Production functions are descriptive of techniques or systems of organization of productive services, and they are therefore taken from disciplines such as engineering and industrial chemistry: to the economic theorist they are data of analysis."); Frank H. Knight, *Immutable Law in Economics: Its Reality and Limitations*, 36 *AM. ECON. REV.* 93, 96 (1946) [hereinafter Knight, *Immutable Law*] ("Economic theory . . . leav[es] technology to its various special disciplines, from shop practice and agronomy to cookery and artistic technique. This separation . . . assum[es] that technology is 'given,' that in using any means available to achieve a physically defined end that process will be chosen, among those known in the arts and science of the culture in question, which yields the largest ratio of output to input.").

87 See SCITOVSKY, *supra* note 86, at 113–21.

88 See *infra* note 105 and accompanying text.

89 See KNIGHT, *RISK, UNCERTAINTY, AND PROFIT*, *supra* note 84, at 55, 174.

90 See *id.*, at 77 (explaining that perfect competition depends upon assumption that individuals "'own themselves[,] [that] there is no exercise of constraint over any individual by another"); *id.* (arguing that perfect competition requires "'perfect mobility' in all economic adjustments, no cost involved in movements or changes"); MILTON FRIEDMAN, *PRICE THEORY* 10 (1962) (arguing the price system "assume[s] . . . [t]here is freedom to compete but not freedom to combine"); Stigler, *Perfect Competition*, *supra* note 84, at 14 ("[I]t seems essential to assume the absence of collusion as a supplement to the presence of large numbers . . .").

91 See KNIGHT, *RISK, UNCERTAINTY, AND PROFIT*, *supra* note 84, at 81 (noting that the perfect competition model assumes that production occurs in "a brief interval of time," after which all market participants "meet[ ] in a central market to exchange their wares"); FRANK M. MACHOVEC, *PERFECT COMPETITION AND THE TRANSFORMATION OF ECONOMICS* 178–79 (1995) (describing perfect competition's instantaneous process of market clearing); Hayek, *The Meaning of Competition*, *supra* note 85, at 92, 96

In this world each firm was a "price taker," observing price in the relevant product market and setting output that maximized its profit in light of production cost, determined by the firm's production function.<sup>92</sup> Given these conditions, no firm exercised market power, i.e., priced above cost.<sup>93</sup> A firm that priced above this market price would instantly lose all sales.<sup>94</sup> In this hypothetical world, individual self-interested transactions would ensure an allocation of resources maximizing output from society's given endowment of resources.<sup>95</sup>

Price theorists did not believe that the perfect competition model accurately described the real world. For instance, many markets violated the assumption of innumerable firms, and products were rarely homogenous. Both departures could confer market power—the ability to price above costs. This exercise of power, in turn, would distort the allocation of resources as firms reduced their output, diverting resources to less valuable uses.

Still, these scholars believed that certain departures from perfect competition could be beneficial. For instance, technology might require firms to achieve significant scale to minimize production cost.<sup>96</sup> Achievement of such scale could reduce the number of independent firms in the market, contravening perfect competition's numerosity assumption.<sup>97</sup> Still, this departure was generally justified, because the benefits of cost reductions outweighed the welfare loss from increased concentration and resulting misallocation.<sup>98</sup> In the

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(noting that perfect competition instantaneously produces optimal resource allocation); see also LÉON WALRAS, *ELEMENTS OF PURE ECONOMICS* 242 (William Jaffé trans., Richard D. Irwin, Inc. 1954) (1926) ("Once the equilibrium has been established in principle, exchange can take place immediately. Production, however, requires a certain lapse of time. We shall resolve the second difficulty purely and simply by ignoring the time element at this point.").

92 See *supra* note 86 and accompanying text (explaining role of production function in determining firm's costs in perfect competition).

93 See STIGLER, *COMPETITIVE PRICE*, *supra* note 85, at 21–22, 149.

94 See *id.* at 156 (arguing that in perfect competition "no firm can sell any amount above the ruling price").

95 See KNIGHT, *RISK, UNCERTAINTY, AND PROFIT*, *supra* note 84, at 85–86.

96 See BAIN, *INDUSTRIAL ORGANIZATION*, *supra* note 76, at 146–52; *id.* at 146 ("[T]here are available to firms in almost any industry certain economies of large scale production, such that, by becoming larger up to a certain point, . . . the firm attains lower costs per unit of output produced."); SCITOVSKY, *supra* note 86, at 331–33 (detailing concept of economies of scale).

97 See George J. Stigler, *The Extent and Bases of Monopoly*, 32 AM. ECON. REV. 1 (1942) [hereinafter Stigler, *Extent and Bases*].

98 See KAYSEN & TURNER, *supra* note 85, at 5–8; JOHN PERRY MILLER, *UNFAIR COMPETITION* 411 (1941) (arguing that "it would not be feasible to pulverize industry sufficiently to approximate pure competition" because doing so would "interfere[ ] with

same way, product differentiation would confer modest market power on firms, power generally justified by the benefits of product variety.<sup>99</sup>

The prospect of beneficial departures from perfect competition had obvious implications for public policy. Despite the theoretical utility of the model, scholars generally rejected perfect competition as a desideratum of public policy, including antitrust policy. Instead, these scholars argued that policy should pursue “workable competition,” tolerating departures from perfect competition and resulting market power whenever necessary to achieve offsetting efficiencies.<sup>100</sup>

### B. *Workable Competition and Non-Standard Contracts*

While the “workable competition” model tolerated certain departures from perfect competition, the model still embraced numerous other assumptions as normatively desirable goals.<sup>101</sup> Non-standard

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the attainment of the optimum scale of plant and rate of operation”); GEORGE W. STOCKING & MYRON W. WATKINS, *MONOPOLY AND FREE ENTERPRISE* 53–61, 108 (1951); *id.* at 13 (“Pure competition can scarcely be realized in a machine age.”); *see also* Meese, *Monopolization*, *supra* note 14 (collecting additional sources). Professor Williamson formalized this insight, showing that a merger to monopoly producing a slight reduction in production costs would usually result in a net improvement in economic welfare. *See* Oliver E. Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 AM. ECON. REV. 18 (1968) [hereinafter Williamson, *Welfare Tradeoffs*].

99 Edward S. Mason, *Monopoly in Law and Economics*, 47 YALE L.J. 34, 36–37 (1937) (concluding that economists should not automatically oppose product differentiation despite resulting market power); Edward S. Mason, *The Current Status of the Monopoly Problem in the United States*, 62 HARV. L. REV. 1265, 1266–67 (1949) [hereinafter Mason, *Current Status*] (stating that perfect competition is only desirable when it maximizes economic welfare); Meese, *Monopolization*, *supra* note 14, at 780 n.156 (collecting additional authorities to this effect).

100 *See* KAYSER & TURNER, *supra* note 85, at 44–45 (“[T]he primary goal of antitrust policy [should] be the limitation of undue market power to the extent consistent with maintaining desirable levels of economic performance.”); *id.* at 78 (“Market power resting on certain bases we consider ‘reasonable,’ because we think it either undesirable or impossible to eliminate them.”); *id.* (noting market power resulting from economies of scale is “reasonable” because “[i]t could be reduced only at the cost of producing at higher costs in inefficiently small units; this price we do not desire to pay”); EDWARD S. MASON, *Workable Competition Versus Workable Monopoly*, in *ECONOMIC CONCENTRATION AND THE MONOPOLY PROBLEM* 382, 387 (1957) (recognizing that society must tolerate some market power so that firms may realize scale economies); *see also* J.M. Clark, *Toward a Concept of Workable Competition*, 30 AM. ECON. REV. 241 (1940) (outlining a concept of workable competition).

101 *See* KAYSER & TURNER, *supra* note 85, at 7 (“[T]he rigorous model of the perfectly competitive market is the appropriate starting point of any definition [of competition relevant to antitrust policy] . . . .” (footnote omitted)); *id.* at 8 (“[T]hough the model of [perfectly] competitive market structure is not usable as such in our definition of competition, other concepts of the model are.”); Friedrich A. Hayek,

contracts contravened several of these remaining assumptions. For one thing, many such agreements limited market rivalry, offending the model's requirement that market participants make independent decisions.<sup>102</sup> Perhaps most importantly, many non-standard agreements constrained one party's future autonomy. For instance, a dealer that signed an exclusive dealing arrangement would forfeit its preexisting right—assumed by perfect competition—to use its labor and property as it wished, that is, to purchase and resell the goods of other manufacturers.<sup>103</sup> This constraint, as noted above, seems to render the relevant market less rather than more competitive. Moreover, dealers realized no apparent benefit from this constraint on their freedom of action.<sup>104</sup>

The mere fact that such contracts resulted in departures from perfect competition did not require their condemnation. Still, unlike economies of scale and product differentiation, non-standard contracts produced no apparent benefits. According to price theory, technological efficiencies gave rise to firms and determined their boundaries, and increased efficiency manifested itself in altered pro-

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*supra* note 85, at 92, 94 (noting that most assumptions of perfect competition “are equally assumed in the discussion of the various ‘imperfect’ or ‘monopolistic’ markets, which throughout assume certain unrealistic ‘perfections’”); Richard N. Langlois, *Transaction Costs, Production Costs, and the Passage of Time*, in COASEAN ECONOMICS: LAW AND ECONOMICS AND THE NEW INSTITUTIONAL ECONOMICS 1, 2 (Steven G. Medema ed., 1998) (noting that Joan Robinson and Edward Chamberlin, pioneers of oligopoly theory, relied upon other assumptions of the perfect competition model).

102 See *United States v. Sealy, Inc.*, 388 U.S. 350 (1967) (evaluating and condemning intrabrand price restraints ancillary to valid joint venture).

103 See KNIGHT, RISK, UNCERTAINTY, AND PROFIT, *supra* note 84, at 77 (explaining that perfect competition depends upon assumption that individuals “own themselves” and that there is “no exercise of constraint over any individual by another individual or by ‘society’”); Alan J. Meese, *Market Failure and Non-Standard Contracting: How the Ghost of Perfect Competition Still Haunts Antitrust*, 1 J. COMP. L. & ECON. 21, 75 (2005) [hereinafter Meese, *Market Failure*] (explaining how exclusive dealing contracts offend assumption of free mobility of factors of production); see also *supra* note 85 and accompanying text (explaining how perfect competition assumed well-defined and unrestrained property rights).

104 Indeed, some scholars argued that if dealers did benefit from exclusivity, they would choose such exclusivity voluntarily, so there was no need for manufacturers to impose contractual exclusivity. See JOEL DIRLAM & ALFRED KAHN, *FAIR COMPETITION: THE LAW AND ECONOMICS OF ANTITRUST POLICY* 181–87 (1954) (contending that dealers will deal exclusively with manufacturers without contractual restraint if exclusivity creates benefits); Derek C. Bok, *The Tampa Electric Case and the Problem of Exclusive Arrangements Under the Clayton Act*, 1961 SUP. CT. REV. 267, 307–08 (1961) (same).

duction functions and lower production costs.<sup>105</sup> Firms realized such efficiencies “internally,” in the course of manufacturing a product, before sale to others.<sup>106</sup> While the realization of efficiencies could lower prices, exclude less efficient rivals and perhaps confer market power, such realization was an ordinary commercial tactic that did not itself entail exercise such power.

Once the firm produced and sold its product “on the market,” there were no technological benefits from restraining purchasers’ discretion via tying or exclusive dealing provisions, for instance.<sup>107</sup> Such agreements did not alter a firm’s production function and could not produce technological efficiencies analogous to, say, economies of scale.<sup>108</sup> Nor did they alter (“differentiate”) the product sold by the

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105 See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 7–8, 86–87, 371 (1985) [hereinafter WILLIAMSON, *ECONOMIC INSTITUTIONS*] (describing price theory’s technological account of the firm and scope of vertical integration). Textbooks of the era stressed that efficiencies were technological in origin, and that technological considerations explained the existence and boundaries of firms. See, e.g., WILLIAM G. SHEPHERD, *MARKET POWER AND ECONOMIC WELFARE* 37 (1970) (“The cost advantages in a firm may be of two types: technical and pecuniary. Only technical economies represent a genuine improvement in social efficiency.” (emphasis omitted)). The chief example, which economists repeatedly invoked, entailed integration of iron making with steel production to achieve cost savings. See F.M. SCHERER, *INDUSTRIAL STRUCTURE AND ECONOMIC PERFORMANCE* 70 (1970); Meese, *Monopolization*, *supra* note 14, at 778 n.146 (collecting examples); Stigler, *Extent and Bases*, *supra* note 97, at 22 (“Of course[,] when vertical integration rests on technological economies—the stock example is the hot strip mill—the question of monopoly is usually irrelevant.”).

106 See R. H. COASE, *THE FIRM THE MARKET AND THE LAW* 3 (1990) [hereinafter COASE, *THE FIRM*] (“The firm to an economist . . . is effectively defined as a cost curve and a demand curve, and the theory [of the firm] is simply the logic of optimal pricing and input combination.” (internal quotation marks omitted)); WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 371 (“[T]rue economies take a technological form, [and] hence are fully realized within firms. [Hence, according to the price-theoretic paradigm, there was] nothing to be gained by introducing nonstandard terms into market-mediated exchange . . . .”); see also SCITOVSKY, *supra* note 86, at 159–71 (describing “efficiency of the firm” as involving use of available technology to combine inputs into outputs at lowest possible cost).

107 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 371–72; see also Donald F. Turner, *The Validity of Tying Arrangements Under the Antitrust Laws*, 72 HARV. L. REV. 50, 63–64 (1958) [hereinafter Turner, *Tying Arrangements*] (arguing that ties do not contribute to cost savings).

108 Professor Donald Turner, a member of the Harvard School of antitrust analysis, responded to the possibility that tying contracts might result in cost savings as follows:

But it is difficult to see how the [interest in reducing costs] could be [served by a tie]. If the products are completely different, the likelihood of joint production costs seems very small. As well, the time differential between the

firm enforcing the agreement. Moreover, the proponents of such agreements expended resources negotiating, enforcing and even defending them in court, and presumably expected some benefit from them. Absent any efficiency benefits, it seemed logical to assume that the proponent expected to derive benefits by obtaining or protecting market power.<sup>109</sup> Given these assumptions, it is no surprise that scholars uniformly interpreted such contracts as departures from perfect competition that, like other departures, produced market power and distorted the allocation of resources, but without offsetting benefits.<sup>110</sup> This, of course, is the modern rationale for treating certain contracts as “unlawful per se.”<sup>111</sup>

The mere fact that agreements are harmful because they create or protect market power does not mean a firm used monopoly power to impose them. Cartel agreements, for instance, are purely voluntary contracts that can do great harm.<sup>112</sup> Moreover, if agreements produce harm, the method of contract formation would seem irrelevant. Nonetheless, during this era, scholars repeatedly asserted that firms used preexisting “market power” or monopoly power to impose such agreements on unwilling dealers and consumers, as a means of extending or protecting that power. A classic example of this reasoning is found in an article by Donald Turner, a Harvard Law School economist, on tying contracts.<sup>113</sup> Turner argued that purchasers preferred not to enter such agreements, since the resulting obligation might prevent buyers from purchasing more attractive substitutes for the tied product in the future.<sup>114</sup> Thus, Turner said, such contracts

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sale of the tying product and the sale of the tied seems to limit severely the possibilities of joint-cost savings.

Turner, *Tying Arrangements*, *supra* note 107, at 63–64. This argument plainly rests upon the assumption that the only source of efficiencies is technological.

109 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 366 (according to price theory “efforts to reconfigure firm and market structures that violated . . . ‘natural’ boundaries were believed to have market power origins.”); Meese, *Rule of Reason*, *supra* note 74, at 98 (explaining how inhospitality era scholars drew this inference).

110 See *supra* note 105 and accompanying text (explaining price theory’s assumption that departures from perfect competition such as product differentiation and economies of scale produced market power).

111 See Bork, *Rule of Reason*, *supra* note 75, at 385–87.

112 John Shepard Wiley, Jr., *Reciprocal Altruism as a Felony: Antitrust and the Prisoner’s Dilemma*, 86 MICH. L. REV. 1906 (1988) [hereinafter Wiley, *Prisoner’s Dilemma*].

113 See Turner, *Tying Arrangements*, *supra* note 107, at 60.

114 See *id.* at 60–62. Turner seemed to concede that a small number of ties might be “efficient” because they helped the manufacturer protect the tying product’s goodwill. See *id.* at 64. Nonetheless, he concluded that such instances were sufficiently rare that courts could conclusively presume that tying contracts reflected an “illegal

were imposed via market power, no matter how slight, in an effort to protect such power or obtain more.<sup>115</sup>

This conclusion, which many scholars shared, is not surprising in light of the intellectual milieu of the time.<sup>116</sup> As noted above, such agreements limited moment-to-moment rivalry and reduced the discretion of parties to them, thereby interfering with the “normal” allocation of resources.<sup>117</sup> Moreover, these restraints made parties bound to them worse off, at least in the period when they were enforced, by preventing them from purchasing from whomever they pleased.<sup>118</sup> Finally, unlike internal expansion or product differentiation, these agreements produced no apparent benefits that could explain purchasers’ consent. Thus, it seemed logical to conclude that the manufacturer who obtained such an agreement had employed some influence—call it “power”—to overcome purchasers’ will, impose such restraints, prevent the free movement of resources, and prevent the operation of perfect competition.<sup>119</sup> Indeed, Turner and his co-author, fellow economist Carl Kaysen, expressly opined that any departure from the results implied by perfect competition was a manifestation of market power.<sup>120</sup>

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purpose” and “some power over the tying product.” *Id.* He did not explain how sellers obtained agreement to one of these rare efficient ties.

115 See *id.* at 64; see also KAYSEN & TURNER, *supra* note 85, at 157–59 (arguing that tying contracts necessarily reflect an exercise of market power).

116 See, e.g., MILLER, *supra* note 98, at 199 (noting that tying contracts were necessarily the result of market power); *id.* at 210 (noting that exclusive dealing contracts were necessarily the result of market power); ALFRED R. OXENFELDT, *INDUSTRIAL PRICING AND MARKET PRACTICES* 210–14 (1951) (describing non-standard contracts, including tying, as necessarily resulting from unequal “bargaining power”); MYRON WATKINS, *PUBLIC REGULATION OF COMPETITION PRACTICES* 220–22 (1940) (arguing that tying contracts are necessarily the result of market power); Alfred E. Kahn, *A Legal and Economic Appraisal of the “New” Sherman and Clayton Acts*, 63 *YALE L.J.* 293, 324 n.160 (1954) [hereinafter Kahn, *Appraisal*] (arguing that tying contracts are necessarily the result of market power); George J. Stigler, *Mergers and Preventative Antitrust Policy*, 104 *U. PA. L. REV.* 176, 176 (1955) [hereinafter Stigler, *Preventative Antitrust Policy*] (“[I]t is evident that [tying and exclusive dealing] can arise only when monopoly power is already possessed.”).

117 See *supra* notes 105, 110 and accompanying text.

118 Cf. *Perma Life Mufflers, Inc. v. Int’l Parts Corp.*, 384 U.S. 134, 140–41 & n.5 (1968) (explaining that dealers could not benefit from an agreement not to purchase from a lower-price or higher quality supplier).

119 See Meese, *Market Failure*, *supra* note 103, at 80–82.

120 See KAYSEN & TURNER, *supra* note 85, at 8 (“Where firms can persistently behave over substantial periods of time in a manner which differs from the behavior that the competitive market would impose on competitive firms facing similar cost and demand conditions, they can be identified as possessing market power.”); *id.* at 75 (reiterating this assertion).

Some such contracts arose in unconcentrated markets, thus suggesting a method of formation unrelated to market power. Still, Kaysen and Turner, for instance, portrayed ties entered by small firms as "random small transactions of no consequence."<sup>121</sup> The dominant economic paradigm simply had no alternative explanation for such agreements.<sup>122</sup>

Far less prevalent, however, was any precise description of just how, exactly, this process of contract formation actually played out. Nor is the process of such contract formation immediately apparent. Market power, after all, consists of the power profitably to reduce output below the competitive level and thus raise price *above* cost.<sup>123</sup> It is not obvious how reducing output and raising price can induce a purchaser to accept an onerous contractual provision.

### C. *Workable Competition and Antitrust Doctrine*

From about 1940–1978, courts, scholars, and the enforcement agencies bought into price theory's workable competition model "hook, line and sinker," and this reliance gave rise to the so-called "inhospitality tradition" of antitrust.<sup>124</sup> Workable competition and the inhospitality tradition it bred induced courts to condemn all sorts of non-standard contracts, including tying agreements, minimum and maximum resale price maintenance, exclusive territories, and exclu-

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121 *Id.* at 159.

122 See *id.* at 157–59 (discussing tying contracts without offering alternative account of how such agreements are formed); cf. THOMAS S. KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* 52–65 (1962) (noting that scientists treat phenomena inexplicable under current models as "anomalies").

123 See *supra* notes 92–99 and accompanying text.

124 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 19 (describing inhospitality tradition of antitrust); *id.* at 370–73 (describing influence of inhospitality tradition on antitrust treatment of non-standard contracts); Frank H. Easterbrook, *Is There A Ratchet in Antitrust Law?*, 60 TEX. L. REV. 705, 715 (1982) [hereinafter Easterbrook, *Ratchet*] ("[The] 'inhospitality tradition of antitrust' . . . called for courts to strike down business practices that were not clearly procompetitive. In this tradition an inference of monopolization followed from the courts' inability to grasp how a practice might be consistent with substantial competition. The tradition took hold when many practices were genuine mysteries to economists, and monopolistic explanations of mysteries were congenial. The same tradition emphasized competition in the spot market."). The phrase "inhospitality tradition" apparently was coined by Professor Donald Turner, an economist who headed the Antitrust Division of the Department of Justice in the 1960s. According to Turner, "I approach territorial and customer restrictions not hospitably in the common law tradition, but inhospitably in the tradition of antitrust law." Donald F. Turner, *Some Reflections on Antitrust*, 1966 N.Y. ST. B. ASS'N. ANTITRUST L. SYMP. 1, 1–2.

sive dealing agreements.<sup>125</sup> Such agreements, courts said, limited “competition” between otherwise independent firms without producing any offsetting benefits not available via less restrictive means.<sup>126</sup> More recently, courts have backed away from some of the more extreme manifestations of the inhospitality tradition, holding that many restrictions once deemed unlawful per se should now be analyzed under the Rule of Reason.<sup>127</sup> At the same time, courts still retain certain per se rules, and the methodology for conducting Rule of Reason analysis reflects various—and outmoded—price-theoretic postulates.<sup>128</sup>

Workable competition and its account of non-standard contracts plainly informed the various antitrust doctrines that depend upon a “market power” account of contract formation. Consider the definition of monopoly power, the first element of the monopolization offense. As noted above, courts define “monopoly power” as the power to “control prices or exclude competition.”<sup>129</sup> Market definition and calculation of market shares is a necessary condition for a

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125 See Meese, *Rule of Reason*, *supra* note 74, at 124–34 (explaining how neoclassical price theory informed Supreme Court’s § 1 jurisprudence during the so-called “inhospitality era” of antitrust). Scholars have offered various accounts of how price theory gave rise to economists’ hostility toward non-standard contracts. Compare WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105 (emphasizing price theory’s technological conception of the firm that purportedly precluded recognition that non-standard contracts overcame market failure), with Meese, *Market Failure*, *supra* note 103 (arguing that price theory’s paradigm for analyzing market failure questions blocked the recognition that non-standard agreements could overcome market failure).

126 See *United States v. Topco Assocs., Inc.*, 405 U.S. 596 (1972) (banning exclusive territories ancillary to legitimate venture because agreements interfered with the “freedom of traders” to sell where they wished); *Albrecht v. Herald Co.*, 390 U.S. 145, 152 (1968) (banning maximum resale price maintenance because agreements would “cripple the freedom of traders” to set prices); *FTC v. Brown Shoe Co.*, 384 U.S. 316, 316, 320, 321 (1966) (finding that a primary dealing agreement involving one percent of the nation’s shoe retailers offended the “central policy of . . . the Sherman Act . . . against contracts which take away freedom of purchasers to buy in an open market” and thus constituted an “unfair trade practice,” violating § 5 of the FTC Act); see also *Times-Picayune Publ’g Co. v. United States*, 345 U.S. 594, 603 (1953) (stating that proponents of tying contracts can achieve legitimate objectives by relying upon consumers to choose whether to purchase tied product); *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 48 (9th Cir. 1971) (holding that less restrictive alternatives could achieve the same benefits as tying contracts).

127 See Meese, *Rule of Reason*, *supra* note 74, at 141–44 (describing judicial retreat from more extreme manifestations of the inhospitality tradition).

128 See *id.* at 144–70.

129 *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391 (1956) (“Monopoly power is the power to control prices or exclude competition.”); *id.* at 389

finding of monopoly power, and the sort of power flowing from mere product differentiation does not suffice.<sup>130</sup> To define a market, plaintiffs must prove the absence of significant “cross-elasticity of demand” between the putative product, on the one hand, and various potential substitutes, on the other.<sup>131</sup> Each of these categories—competition, monopoly, monopolistic competition, product differentiation, cross-elasticity, etc.—was drawn from concepts found and applied in price-theoretic industrial organization texts.<sup>132</sup> Moreover, the policy conclusions, e.g., that mere product differentiation does not constitute “monopoly power” for § 2 purposes, reflected the views of price-theoretic economists and the workable competition model they articulated.<sup>133</sup> Ditto for the view that mere possession of monopoly power should not itself offend the antitrust laws.<sup>134</sup>

Workable competition also influenced and continues to influence the definition of conduct that should give rise to liability under § 2. Recall the distinction between: (1) “competition on the merits” and resulting monopoly prices, and (2) the use of power to exclude rivals.<sup>135</sup> Monopoly pricing, of course, was a price-theoretic concept, again drawn from textbooks. While “competition on the merits” did not itself hail from price theory, the paradigmatic example of such competition, the realization of economies of scale, was a concept

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(defining monopoly power as “a power of controlling prices or unreasonably restricting competition”); *Am. Tobacco Co. v. United States*, 328 U.S. 781, 809–11 (1946).

130 See *E.I. du Pont*, 351 U.S. at 391–93 (“[O]ne can theorize that we have monopolistic competition in every nonstandard commodity . . . . [T]his power that, let us say, automobile or soft-drink manufacturers have over their trademarked products is not the power that makes an illegal monopoly.”).

131 *Id.* at 394–96; see also *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 274 n.12 (2d. Cir. 1979) (“[T]he differen[ce] between price and marginal cost is used as an indication of the degree of monopoly power.”).

132 See BAIN, PRICE THEORY, *supra* note 83, at 126–51 (articulating theory of competitive pricing); *id.* at 190–210 (articulating theory of monopoly pricing); *id.* at 202–05 (explaining that monopolists set price above average total cost); *id.* at 350–76 (discussing monopolistic competition and resulting product differentiation); OXENFELDT, *supra* note 116, at 88–90 (endorsing “workable competition” as a more useful benchmark for public policy than perfect competition); SCITOVSKY, *supra* note 86, at 229–46; STIGLER, COMPETITIVE PRICE, *supra* note 85, at 21–22 (describing “competitive price” as one that equaled marginal cost); Edward Mason, *Monopoly in Law and Economics*, 47 Yale L.J. 34, 35–36 (1937) (discussing implications of product differentiation for antitrust policy).

133 See *supra* note 132 and accompanying text (collecting authorities concluding that market power from product differentiation should not give rise to antitrust concern).

134 See *infra* note 158 and accompanying text.

135 See *supra* notes 14, 42, and 55 and accompanying text.

drawn from neoclassical price theory, and the workable competition model endorsed such competition.<sup>136</sup> Finally, the monopoly power “used” to impose certain contracts on dealers or consumers and thereby disadvantage rivals was also a price-theoretic concept, and price theorists often asserted that monopolists used their power to impose such agreements.<sup>137</sup>

Similar logic drove the test that courts applied to tying contracts.<sup>138</sup> The economic power necessary to establish coercive forcing and thus a violation was initially defined as the power to induce a purchaser to pay prices or accept other terms that it would not accept in a “completely competitive” market.<sup>139</sup> Such power included the sometimes modest power that flowed from mere product differentiation that accompanied an attractive trademark, for instance.<sup>140</sup> Both the “competitive market” and the departure from it in the form of power over price, including the power conferred by product differentiation, were price-theoretic concepts.<sup>141</sup> Moreover, courts’ conclusion that tying contracts were harmful, and that defendants used monopoly power, no matter how slight, to impose them, were straightforward applications of workable competition. Early decisions invoked the work of economists and economically-sophisticated lawyers for the proposition that “[t]ying [contracts] serve hardly any purpose beyond the suppression of competition.”<sup>142</sup> Courts cited these scholars for

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136 See George J. Stigler, *The Economies of Scale*, 1 J.L. & ECON. 54 (1958) [hereinafter Stigler, *Economies of Scale*].

137 See *supra* notes 23–25 and accompanying text (collecting authorities).

138 See *supra* notes 10–16 and accompanying text; see also *Times-Picayune Publ’g Co. v. United States*, 345 U.S. 594, 605 (1953) (“By conditioning his sale of one commodity on the purchase of another, a seller coerces the abdication of buyers’ independent judgment as to the ‘tied’ product’s merits and insulates it from the competitive stresses of the open market.”).

139 See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 27 n.46 (1984); *U.S. Steel Corp. v. Fortner Enters., Inc.*, 429 U.S. 610, 620 (1977) (holding economic power for tying purposes entails power to “raise prices or to require purchasers to accept burdensome terms that could not be exacted in a completely competitive market”); *Fortner Enters., Inc. v. U.S. Steel Corp.*, 394 U.S. 495, 503–04 (1969); see also *supra* note 116 (collecting authorities governing definition of economic power relevant to analysis of tying contracts).

140 See *supra* note 130 and accompanying text.

141 See *supra* notes 98–101 (collecting sources).

142 *Times-Picayune*, 345 U.S. at 605 (internal quotation marks omitted) (citing MILLER, *supra* note 98, at 199–203); see William B. Lockhart & Howard R. Sacks, *The Relevance of Economic Factors in Determining Whether Exclusive Arrangements Violate Section 3 of the Clayton Act*, 65 HARV. L. REV. 913, 942–54 (1952); Note, *Section 3 of the Clayton Act—Coexisting Standards of Legality?*, 49 COL. L. REV. 241, 246 (1949); see also *supra* note 139 (collecting decisions holding that presence of tie creates presumption of

the conclusion that sellers had to employ market power to "coerce" acceptance of such agreements, since no buyer would voluntarily accept such limits on its discretion.<sup>143</sup> While courts now require plaintiffs to make a meaningful showing of market power to invoke the *per se* rule, they still presume conclusively that ties obtained by firms with such power are the result of coercion.<sup>144</sup> Finally, similar considerations apparently impelled courts to conclude that contracts between manufacturers and dealers were involuntary, thereby allowing dealers challenging such agreements to avoid the *in pari delicto* defense.<sup>145</sup>

It is unremarkable that price theory—the then-current economic art—helped courts explain the economic origins and consequences of various commercial practices, including non-standard contracts. As noted earlier, economic theory has been performing this function for at least a century.<sup>146</sup> Where these various doctrines were concerned, however, price theory seems to have done a little bit more. That is to say, price theory's account of these contracts also defined an element of the offense of monopolization, namely, the "use of monopoly power to foreclose competition"<sup>147</sup> as well as the offense of tying, that is, the use of "economic power" to "force" a purchaser to do something it would not do in a competitive market.<sup>148</sup> Courts treated these purported economic phenomena as harms cognizable under the antitrust laws. Thus, price theory and its workable competition model did more than simply tell antitrust courts whether various contracts had particular effects: it also informed courts' determination of what effects courts should treat as legally relevant. In other words, price theory not only supplied the "is" for antitrust: it helped supply the "ought" as well.<sup>149</sup>

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economic power); *see also supra* notes 53 and 142 (collecting decisions holding that the presence of a tie creates a presumption of economic power); *cf. Standard Oil Co. of Cal. v. United States*, 337 U.S. 293, 306 (1949) (citing MILLER, *supra* note 98, at 199–203; Note, *supra* at 246); CORWIN EDWARDS, MAINTAINING COMPETITION 175–78 (1949); MYRON W. WATKINS, PUBLIC REGULATION OF COMPETITIVE PRACTICES IN BUSINESS ENTERPRISE, 220–28 (3d ed. 1940).

143 See sources cited *supra* in note 139.

144 See *Jefferson Parish*, 466 U.S. at 13–15.

145 See *supra* notes 60–72 and accompanying text (describing judicial rejection of *in pari delicto* defense because of purported disparity of bargaining power between manufacturers and dealers).

146 See *supra* note 79 and accompanying text.

147 See *supra* note 5 and accompanying text.

148 See *supra* notes 37, 49, and 139 and accompanying text.

149 See generally Milton Friedman, *The Methodology of Positive Economics*, in *ESSAYS IN POSITIVE ECONOMICS* 3, 3–7 (1966) (explaining that economic theory cannot itself provide the normative content of legal rules); John J. Flynn, *The "Is" and the "Ought" of*

#### D. *Chicago's Elaboration and Internal Critique*

A conclusion that so many antitrust doctrines rest upon price-theoretic logic would seem to commend that doctrine to some potential critics. After all, the "Rule of Reason" requires courts to employ economic theory to determine the origins and consequences of trade practices, including contracts.<sup>150</sup> Price theory seems the best place to start, given that it still forms the basis for much economic inquiry.

Indeed, Robert Bork, pioneer of the Chicago School of antitrust, argued strenuously that price theory was the only legitimate basis for developing antitrust doctrine.<sup>151</sup> Judge Richard Posner reached a similar conclusion, arguing that many doctrines associated with the inhospitality era, including the ban on tying, were the result of unscientific analysis by economically unsophisticated scholars and judges.<sup>152</sup>

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*Vertical Restraints After Monsanto Co. v. Spray-Rite Service Corp.*, 71 CORNELL L. REV. 1095 (1986) (articulating distinction between descriptive and normative uses of economic theory in the antitrust context). For some, the conclusion that price theory supplied the "ought" of antitrust may seem unremarkable. After all, scholars have been arguing for some time that antitrust regulation should maximize "consumer want satisfaction," a concept expressly drawn from neoclassical price theory. See e.g., KAYSER & TURNER, *supra* note 85, at 11–12 (arguing that antitrust law should promote efficiency, defined as the arrangement of resources that maximizes "consumer satisfaction"); Bork, *Rule of Reason*, *supra* note 75, at 829–30. However, the reliance on price theory identified here goes one step further, employing a construct derived from price theory—the exercise of market power to impose exclusionary contracts—to define subsidiary rules that implement a general command to ban all conduct that reduces wealth. Thus, price theory does more than tell courts what to look for. It also tells them how to look for it. Cf. THOMAS S. KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* 59 (1962) (explaining that background expectations determine the type of data that a scientist seeks); KARL R. POPPER, *THE LOGIC OF SCIENTIFIC DISCOVERY* 106 (1961) (explaining how true science "needs points of view, and theoretical problems" to drive and inform its fact-gathering); Ronald H. Coase, *The New Institutional Economics*, 140 J. INSTITUTIONAL AND THEORETICAL ECON. 229 (1984) (chiding institutional economists for gathering innumerable facts with no theory to guide them as to what was relevant).

<sup>150</sup> See Bork, *Rule of Reason*, *supra* note 75 at 805; Meese, *Rule of Reason*, *supra* note 74, at 89–92.

<sup>151</sup> See ROBERT H. BORK, *THE ANTITRUST PARADOX* 117 (1978) [hereinafter, BORK, *ANTITRUST PARADOX*] ("There is no body of knowledge other than conventional price theory that can serve as a guide to the effects of business behavior upon consumer welfare."); *id.* at 107–08 (contending that price theory's partial equilibrium trade-off model can illustrate all antitrust problems); Robert H. Bork, *Resale Price Maintenance and Consumer Welfare*, 77 YALE L.J. 950, 952 (1968) (relying upon "basic price theory" to argue that minimum resale price maintenance creates "efficient utilization of resources"); Robert H. Bork, *The Role of Courts in Applying Economics*, 54 ANTITRUST L. J. 21, 24 (1985).

<sup>152</sup> See Posner, *supra* note 80, at 928.

Judge Posner also argued that the Chicago School's contributions to antitrust scholarship and doctrine were manifestations of applied price theory, which inhospitality scholars did not understand.<sup>153</sup> Perhaps, taking a cue from these Chicagoans, we should all celebrate courts' invocation of price-theoretic concepts and the resulting doctrines!

Still, Chicagoans did anything but celebrate the inhospitality tradition's condemnation of exclusive agreements. In particular, Chicago scholars took issue with the assumption that firms could profitably "use" preexisting market power to obtain more. Perhaps ironically, Chicagoans built their critique on a more explicit and coherent account of how, in fact, a firm could "use" market power to impose an agreement.

According to Chicagoans, a firm with monopoly or market power would presumably exercise that power by charging whatever the market would bear, pricing above cost to earn a monopoly profit.<sup>154</sup> If, however, a firm with power sought to charge a monopoly price *and* impose a discretion-limiting contract, purchasers would interpret the additional, onerous term as a premium over the monopoly price.<sup>155</sup> A firm that charged a monopoly price *and* imposed a discretion-reducing contract would see demand for its product and thus output fall below the profit-maximizing monopoly level. Thus, Chicagoans argued, firms that wished to maximize their profits *and* impose such agreements on trading partners would have to increase output and reduce the price of their products. Such a discount from the monopoly price would induce the purchaser to forgo its freedom of action and ensure that the monopolist could still maximize profits.<sup>156</sup>

Thus, while Chicagoans did not set out to offer a model of contract formation or otherwise buttress the "market power" account of

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153 *Id.* at 932 ("The Chicago school has largely prevailed with respect to its basic point: that the proper lens for viewing antitrust problems is price theory.").

154 See BORK, *ANTITRUST PARADOX*, *supra* note 151, at 306; George J. Stigler, *United States v. Loew's, Inc.: A Note on Block-Booking*, 1963 SUP. CT. REV. 152, 152-53 (1963).

155 See BORK, *ANTITRUST PARADOX*, *supra* note 151, at 306; POSNER, *supra* note 52, at 173 ("If the price of the tied product is higher than the purchaser would have to pay on the open market, the difference will represent an increase in the price of the final product or service to him, and he will demand less . . . of the tying product."); Robert H. Bork & Ward S. Bowman, Jr., *The Crisis in Antitrust*, 65 COLUM. L. REV. 363, 367 (1965) (noting that a seller can only induce agreement to exclusionary agreement by offering "some extra inducement").

156 See Bork & Bowman, *supra* note 155, at 366-67; see also POSNER, *supra* note 52, at 202-04 (invoking the *United Shoe Machinery* decision as an exemplar of this phenomenon); Aaron Director & Edward H. Levi, *Law and the Future: Trade Regulation*, 51 NW. U. L. REV. 281, 290 (1956).

exclusionary agreements, they in fact created just such a model. According to Chicagoans, a party seeking to induce acceptance of an exclusionary agreement would offer its potential trading partner two options. The first, high-priced option would leave the trading partner with complete discretion to buy or sell however he pleased. The second, lower-priced option would require assent to the exclusionary provision. If the firm in question possessed monopoly power, then presumably the price for the first, "no exclusion" option would equal the firm's profit-maximizing, monopoly price. The second option, on the other hand, would presumably entail a discount from the monopoly price. In this way, one might say, the defendant could "use" its monopoly power to induce acceptance of contractual terms its partner would not otherwise accept.<sup>157</sup>

Nonetheless, while Chicagoans explained how the use of power to impose contracts was *possible*, they also argued that such a strategy would usually constitute a zero-sum game for the monopolist. For one thing, the profits lost from discounting to induce acceptance of such agreements would offset or exceed the gains from maintaining a monopoly price.<sup>158</sup> Moreover, nothing would prevent a firm's rivals from offering purchasers similar inducements.<sup>159</sup> Finally, they said, purchasers would understand that exclusionary agreements could enhance their supplier's market power and thus injure them in the future. As a result, purchasers subject to such provisions could demand a *pro-tanto* price reduction to compensate them for any

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157 See *supra* notes 20, 71, 103, and 116 and accompanying text (explaining Chicago's argument that a monopolist seeking to impose an exclusive dealing contract would have to reduce its price or offer another inducement to the party to be bound by the agreement); see also *infra* note 164 and accompanying text (articulating a price differential model to explain the formation of non-standard agreements that reduce transaction costs); WILLIAMSON, *supra* note 105, at 33 (explaining how firms can employ price differentials to induce acceptance of non-standard contracts).

158 See POSNER, *supra* note 52, at 202–05 (explaining how price cuts necessary to "impose" exclusive dealing would dissipate any monopoly profits that manufacturers might otherwise earn due to such agreements); Director & Levi, *supra* note 156, at 290 ("Firms which have some monopoly power over prices and output can impose coercive restrictions on suppliers and customers. In the normal case, however, they will lose revenue if they do impose such restrictions, and this casts some doubt on how prevalent or continued the practice would be. Such firms would lose revenue because they cannot both obtain the advantage of the original power and impose additional coercive restrictions so as to increase their monopoly power. The coercive restrictions on customers are possible only if the price which would be charged without the restriction is reduced.").

159 See BORK, *supra* note 151, at 304 (arguing that rivals can presumably meet monopolist's discount that induces exclusivity); Bork & Bowman, *supra* note 155, at 366–67 (same).

expected enhancement of monopoly power.<sup>160</sup> Thus, any effort by a monopolist to expand its power in this way would be futile.<sup>161</sup>

There was, however, one exception to this futility conclusion: price discrimination. According to Chicagoans, monopolists could employ tying contracts to capture purchasers' full consumer surplus.<sup>162</sup> A firm with a monopoly over, say, adding machines could require all purchasers also to purchase the punch cards such machines employ when performing calculations.<sup>163</sup> By charging slightly less than the monopoly price for the machine, and slightly more than the competitive price for such cards, a monopolist could ensure that purchasers that used the machine more intensely ultimately pay more for the service, namely mechanical adding.<sup>164</sup> In this way, it was said, monopolists could exercise their power to impose provisions that helped them exercise even more.

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160 See BORK, *ANTITRUST PARADOX*, *supra* note 151, at 304-05 ("It is important to see that Alpha [the manufacturer that obtains an exclusive dealing contract] must offer something to the food canners to get them to sign the requirements contracts, and that it must offer that something for the life of the contract, which means that, in terms of cutting out rivals, the contract offers Alpha no advantages it would not have had without the contract. The advantage of the contract must be the creation of efficiency . . . and the fear of foreclosure is chimerical.").

161 See POSNER, *supra* note 52, at 203-04; Director & Levi, *supra* note 156, at 290.

162 See POSNER, *supra* note 52, at 173-75; Director & Levi, *supra* note 156, at 290; see also Frank H. Knight, *Demand and Supply and Price*, in *THE ECONOMIC ORGANIZATION* 67, 94 (1951) (contending that monopolists can price discriminate by "rent[ing] the monopolized good and charg[ing] in proportion to the amount used instead of selling it outright. This can be done by selling supplies for it at a monopoly price.").

163 This example is not hypothetical. See *IBM v. United States*, 298 U.S. 131 (1936) (evaluating requirement that purchasers of adding machines also purchase punch cards).

164 See POSNER, *supra* note 52, at 173 ("By providing the computer at cost and selling each card at a monopoly price, the computer monopolist can vary the charge for computation according to the amount of each purchaser's use."); Stigler, *supra* note 154, at 153-54. It should be noted that some scholars outside the Chicago School recognized that firms with market power could use price differentials to impose tying contracts. See KAYSER & TURNER, *supra* note 85, at 154 (noting that ties induced by sufficient price reductions are indistinguishable from outright ties); *id.* at 157; Alfred E. Kahn, *A Legal And Economic Appraisal of the "New" Sherman and Clayton Acts*, 63 *YALE L.J.* 293, 322-24 (1954) (treating tie obtained via price differentials as exercise of market power); Turner, *supra* note 107, at 63 (noting that a discount off the price of a tying product involves the exercise of market power where tied product is priced above the competitive level); *id.* at 66 (noting that a price reduction inducing tie is exercise of market power). However, these scholars did not model *all* such agreements as resulting from such differentials, and they rejected Chicago's policy conclusions.

Chicagoans did not assert that all such contracts facilitated price discrimination. In fact Chicagoans contended that such agreements often produced efficiencies, although this conclusion almost always took the form of an inference, drawn from the assumption that such contracts could not protect or accentuate market power.<sup>165</sup> At the same time, Chicagoans offered no explanation for how parties formed such pro-competitive agreements, seeming to concede that proponents “imposed” them on unwilling trading partners.<sup>166</sup> Even George Stigler, stalwart of the Chicago School, opined that sellers could only obtain agreement to tying and exclusive dealing contracts by exercising market power.<sup>167</sup>

To be sure, the equation of Chicago’s “price differential” model of contract formation with the “exercise” or “use” of market power is not free from doubt. As noted earlier, the actual formation of the contract and resulting transactions would entail a price *below* the monopoly price, and output *above* the level a profit-maximizing monopolist would otherwise choose.<sup>168</sup> It therefore seems awkward to characterize such agreements as a “use” or “exercise” of monopoly power. Still, one might characterize the agreement in question as the result of a *threat* to exercise such power, by selling the product unencumbered by a restraint at the monopoly price. Thus, while the resulting agreements are not ipso facto an exercise of monopoly power, it is not much of a stretch to attribute them to such an exercise.

### E. Legal Realism

Price theory was not the only possible external influence on anti-trust doctrine during the inhospitality era; there were other possible

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165 See BORK, ANTITRUST PARADOX, *supra* note 151, at 304–05 (contending that exclusive dealing could not produce harm and thus “must” produce efficiencies); POSNER, *supra* note 52, at 204 (concluding that exclusive leasing provisions in the *United Shoe Machinery* decision could not produce harm and were thus likely efficient); see also Robert H. Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, 75 YALE L.J. 373, 388–81, 389–90 (1966) [hereinafter Bork, *The Rule of Reason (part II)*] (articulating argument that absence of market power suggests that a restraint produces benefits).

166 See POSNER, *supra* note 52, at 145–65 (stating repeatedly that manufacturers “impose” vertical restrictions upon dealers); *id.* at 175 (asserting that firms “impos[e]” beneficial ties). Indeed Robert Bork, who argued vigorously that intrabrand restraints were beneficial efforts to overcome dealer free riding, nonetheless implied that dealers do not agree to such restraints. See Robert H. Bork, *A Reply to Professors Gould and Yamey*, 76 YALE L.J. 731, 739 (1967) (“This argument [in favor of resale price maintenance] rests upon the idea of consumer sovereignty. It does not depend upon the notion that the resellers may be said to have ‘agreed’ to r.p.m.”).

167 Stigler, *Preventative Antitrust Policy*, *supra* note 116, at 176.

168 See *supra* note 164 and accompanying text.

determinants as well. In particular, the Legal Realism movement gathered steam during this period and exercised significant influence over the manner in which courts and scholars assessed legal rules and relationships.<sup>169</sup> Realism offered a critique of classical laissez-faire jurisprudence, which treated markets as inherently competitive and contracts as generally voluntary efforts to advance the interests of both parties.<sup>170</sup> Realists admonished courts to look behind formal relationships, particularly market relationships, and examine their true empirical nature when constructing legal rules that addressed them.<sup>171</sup> Perhaps Realism, and not price theory, explains the "market power" model of contract formation and various resulting doctrines.<sup>172</sup>

According to Realists, many apparently voluntary market relationships were in fact "coercive," for two distinct reasons. First, one party to a contractual relationship often possessed "bargaining power," which Realists sometimes equated with market or monopoly power. In these cases, Realists said, the stronger party could impose contractual terms on unwilling parties.<sup>173</sup> Second, and more fundamentally, Realists noted that *all* contractual bargains depended upon the ownership of private property, which the state created and protected with force.<sup>174</sup> As a result, *any* bargain resulted from state coercion, without which one party could simply occupy and use "the other's" property without consent.<sup>175</sup> Many Realists even refer to private contracts as "private legislation."<sup>176</sup>

Certainly early antitrust jurisprudence reflected the strong influence of classical political economy and derivative liberty of contract, thereby presenting a tempting target for Realists.<sup>177</sup> Under this

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169 See Page, *Legal Realism*, *supra* note 28, at 1.

170 See Alan J. Meese, *Liberty and Antitrust in the Formative Era*, 79 B.U. L. REV. 1, 15-34 (1999) [hereinafter Meese, *Liberty and Antitrust*].

171 See Roscoe Pound, *Liberty of Contract*, 18 YALE L.J. 454 (1909).

172 See Page, *Legal Realism*, *supra* note 28 (exploring Realism's influence over anti-trust doctrine during this period).

173 See Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943).

174 See Robert L. Hale, *Bargaining, Duress and Economic Liberty*, 43 COLUM. L. REV. 603 (1943); see also BARBARA H. FRIED, *THE PROGRESSIVE ASSAULT ON LAISSEZ FAIRE* 76-89 (1998) (noting the state's inevitable role in shaping economic life).

175 See Hale, *supra* note 174, at 604-05; *id.* at 625 ("The market value of a property or a service is merely a measure of the strength of the bargaining power of the person who owns the one or renders the other, under the particular legal rights with which the law endows him, and the legal restrictions which it places on others.").

176 See W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking*, 84 HARV. L. REV. 529 (1971).

177 See, e.g., Meese, *Liberty and Antitrust*, *supra* note 170, at 34-68 (detailing influence of liberty of contract and classical political economy on early Sherman Act juris-

approach, contracts were presumed “normal” or “ordinary,” unless the plaintiff could show that they produced “monopoly or its consequences,” i.e., an exercise of market power leading to higher prices, reduced output, or reduced quality.<sup>178</sup> Exclusionary agreements, even if entered by a monopolist, were no exception. Such contracts, it was said, were completely voluntary and reflected each party’s judgment that the agreements worked to its respective advantage.<sup>179</sup> They were thus lawful absent proof that they produced the consequences of monopoly without offsetting benefits.<sup>180</sup>

Subsequent decisions employing the “abuse of power” formulation rejected various premises of classical political economy. Moreover, courts employing this formulation reached results that Realists would have found congenial. Indeed, at least one leading realist, Thurmond Arnold, expressly invoked concerns about the coercion of dealers and others when calling for more aggressive antitrust regulation of the supplier/dealer relationship.<sup>181</sup>

At the same time, the doctrinal landscape that ultimately emerged during the inhospitality era and survives to this day was more consistent with price theory than it was with Legal Realism. Realism, after all, merely counseled courts to examine relevant circumstances, but offered no explicit theory guiding such consideration. Price theory, on the other hand, with its theory of barriers to entry, helped explain why firms could possess and exercise market power without state assistance, thereby suggesting that private markets could produce “coercive” results.<sup>182</sup> Moreover, none of the antitrust doctrines

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prudence); William H. Page, *Ideological Conflict and the Origins of Antitrust Policy*, 66 TUL. L. REV. 1 (1991) [hereinafter Page, *Ideological Conflict*]; see also Meese, *Rule of Reason*, *supra* note 74, at 83–89 (detailing evolution of Rule of Reason from 1890 to 1911, including the influence of liberty of contract considerations).

178 See *supra* note 74 and accompanying text.

179 See *United States v. United Shoe Mach. Co.*, 247 U.S. 32 (1918) (rejecting challenge to exclusionary lease provisions entered by monopolist); see also *FTC v. Sinclair Ref. Co.*, 261 U.S. 463 (1923) (rejecting challenge to tying contract); *FTC v. Gratz*, 253 U.S. 421 (1920) (rejecting similar challenge to tying contract).

180 See *United Shoe Mach.*, 247 U.S. at 61–65 (rejecting challenge to exclusionary agreement because the contract made sense regardless of exclusionary impact).

181 See Page, *Legal Realism*, *supra* note 28, at 19–23 (detailing influence of Arnold’s views on enforcement policy).

182 See HOVENKAMP, *supra* note 75, at 287–91 (explaining how the rise of price theory convinced courts that market outcomes could produce coercive results absent state-created barriers to entry); see also Meese, *Liberty and Antitrust*, *supra* note 170, at 43–80 (demonstrating that the Supreme Court sustained regulation of private cartels because of a changed understanding of their economic impact); Page, *Ideological Conflict*, *supra* note 177, at 44–48 (offering a similar explanation for the Court’s willingness to sustain antitrust regulation that apparently abridged contractual liberty).

discussed above took Realist insights to their logical conclusion and declared all market relationships "coercive" because of the implicit involvement of state force. For instance, the "use of power" offense under § 2 required proof that the defendant possessed significant monopoly power.<sup>183</sup> Also, the *per se* rule against tying contracts required proof that the defendant in fact possessed "economic power" in the tying product market.<sup>184</sup> To be sure, Supreme Court dicta sometimes claimed that the mere existence of numerous ties suggested that proponents of agreements possessed the market power necessary to impose them.<sup>185</sup> However, this conclusion flowed from price theory's inability to identify a non-coercive method of forming such agreements.<sup>186</sup> Even here, however, the Court qualified these assertions by referencing defendants' market advantages and suggesting that defendants could avoid inferences of market power by proving that the restraints produced benefits explaining the purchaser's (voluntary) agreement.<sup>187</sup> Finally, as explained earlier, the Court retained the *in pari delicto* defense for those cases in which parties bargained on an equal footing, contrary to the apparent implications of Legal Realism.<sup>188</sup>

In summary, and more globally, it would be impossible to square antitrust's preference for atomistic competition with Realism's conclusion that even contracts entered in competitive markets were coercive.<sup>189</sup> Inhospitable era courts repeatedly invoked a "competitive market" as the *summum bonum* of antitrust policy—the ideal state of

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183 See *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 392–93 (1956) (holding that market power of the type created by product differentiation does not in fact give rise to the sort of "monopoly power" policed under § 2).

184 See, e.g., *N. Pac. Ry. Co. v. United States*, 356 U.S. 1, 6–7 (1958); see also *supra* notes 37–43 and accompanying text.

185 See *Fortner Enters., Inc. v. U. S. Steel Corp.*, 394 U.S. 495, 504 (1969); *Northern Pacific*, 356 U.S. at 7–8.

186 See *infra* Part III.

187 See *Northern Pacific*, 356 U.S. at 7 ("[Defendant's] land [the tying product] was strategically located in checkerboard fashion amid private holdings . . . . Not only the testimony of various witnesses but common sense makes it evident that this particular land was often prized by those who purchased or leased it and was frequently essential to their business activities."); *id.* at 7–8 (finding numerous ties evidence of economic power "at least where, as here, no other explanation has been offered for the existence of these restraints").

188 See *supra* notes 60–72 and accompanying text (describing law governing *in pari delicto*); see also *Perma Life Mufflers, Inc. v. Int'l Parts Corp.*, 392 U.S. 134, 138–41 (1968) (plurality opinion); *id.* at 145 (White, J., concurring).

189 See *Hale*, *supra* note 174 at 626–36.

economic affairs from which non-standard agreements departed.<sup>190</sup> This market, however, itself depended upon common law institutions of contract, property and tort; even perfect competition requires, as its foundation, well-defined property rights.<sup>191</sup> Absent such property, there would be no production, trading or resulting prices.<sup>192</sup> And yet, according to Realists, the specter of state force would render all bargains arising in such markets “coercive.” Presumably Realists would have said the same thing about all tying contracts, exclusive dealing contracts, and other non-standard agreements. Indeed, during this era, antitrust law even allowed firms to achieve monopoly, via “competition on the merits.”<sup>193</sup> In the end, then, price theory and the policy prescriptions that it offered, and not Legal Realism, set the boundaries of antitrust regulation during this period, including those doctrines that depended upon the market power model of contract formation.

### III. CRITIQUE OF PRICE THEORY (BOTH HARVARD AND CHICAGO)

As explained earlier, scholars and jurists have invoked a “market power” model of contract formation when interpreting exclusionary agreements. Indeed, significant current antitrust doctrine rests upon the assumption that firms use market power to coerce others into “agreeing” to exclusionary provisions. To be sure, the Chicago School took issue with these doctrines, arguing that using power to impose such provisions cannot increase a monopolist’s profits. Instead, Chicago said, such agreements are either efforts at (efficient) price discrimination or methods of minimizing the cost of generating (usually

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190 See *United States v. Topco Assocs., Inc.*, 405 U.S. 596 (1972); *FTC v. Brown Shoe Co.*, 384 U.S. 316, 321 (1966) (articulating “central policy of . . . § 1 of the Sherman Act . . . against contracts which take away freedom of purchasers to buy in an open market” (citations omitted)); *Klor’s Inc. v. Broadway-Hale Stores*, 359 U.S. 207 (1959); *Times-Picayune Publ’g Co. v. United States*, 345 U.S. 594, 605 (1953) (“Basic to the faith that a free economy best promotes the public weal is that goods must stand the cold test of competition; that the public, acting through the market’s impersonal judgment, shall allocate the Nation’s resources . . . .”); see also *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 221 (1940) (maintaining that the Sherman Act is a “charter of freedom” ensuring an atomistic marketplace).

191 See *supra* note 85 and accompanying text; *infra* notes 192–94 and accompanying text (collecting additional sources for this proposition).

192 See BARZEL, *supra* note 85, at 11–13 (stating that perfect competition depends upon perfect specification of property rights and costless transactions); Harold Demsetz, *The Exchange and Enforcement of Property Rights*, 7 J. L. & ECON. 11, 18 (1964) (explaining that private property enables private markets that reveal social values via prices).

193 See *supra* notes 14 and 42 and accompanying text.

undefined) efficiencies. However, Chicago did not question the market power model of contract formation, but ironically offered a more precise account of what such imposition entailed.

As shown below, price theory's model of contract formation rests upon numerous outmoded assumptions—what Ronald Coase would call “blackboard economics”—about the nature of markets and the firms and consumers that inhabit them. A more realistic paradigm, transaction cost economics (“TCE”), offers a superior framework for interpreting non-standard agreements, including those that exclude rivals from portions of the marketplace. TCE suggests that many non-standard agreements are contractual rearrangements of property rights that reduce the cost of relying upon markets to conduct economic activity by preventing or attenuating prospective opportunistic behavior by the proponent's trading partners.<sup>194</sup> This characterization suggests an alternative model of contract formation, so-called “Coasean Bargains” that have nothing to do with market power, and are instead examples of voluntary integration that redefines the parties' rights and obligations, indistinguishable from garden variety contracts that courts regularly enforce. Similar logic suggests that even exclusionary agreements that reduce welfare are equally voluntary as between the parties to them.

#### A. *TCE and a New Account of Non-Standard Contracts*

Price theory is no longer the sole basis for industrial organization or antitrust policy. Over the past few decades, economists and antitrust scholars have constructed a new economic framework, TCE, to rival price theory's interpretation of commercial phenomena.<sup>195</sup> TCE has challenged price theory's technological conception of the firm and offered benign explanations for partial integration in the form of non-standard contracts that price theory and the inhospitality tradition treated as harmful expressions of market power.

Practitioners of TCE examined the consequences of conducting economic activity in an atomistic market, where transactions take place unconstrained by nonstandard agreements.<sup>196</sup> According to TCE, atomistic transacting entails a cost, what practitioners of TCE

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194 See Demsetz, *supra* note 192, at 25–26; see also BARZEL, *supra* note 85, at 14 (explaining the centrality of contract to defining the boundaries of property rights and obligations in a free economy).

195 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 15.

196 See *supra* note 106 and accompanying text (describing this assumption of the perfect competition model); see also WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 3 (explaining how TCE treats the “transaction . . . as the basic unit of analysis” (citation omitted)); *id.* at 6, 18, 88 (same).

dubbed a “transaction cost.”<sup>197</sup> Scholars found these costs in certain departures from perfect competition. Ronald Coase famously began the transaction cost movement in 1937 by explaining the origin of firms, institutions that price theory had either taken for granted or treated as arising from technological considerations.<sup>198</sup> Reliance on the market, Coase said, entailed bargaining and information costs, costs that actors could avoid by conducting economic activity within a firm, a particular type of non-standard contract, thereby reducing the overall cost of production.<sup>199</sup> Others extended Coase’s analysis, emphasizing different departures from perfect competition, such as the passage of time, investments specific to a particular activity, and the risk that one’s trading partners will take advantage of the relationship by behaving in an opportunistic manner.<sup>200</sup> Given these conditions, they said, reliance upon an atomistic market could give rise to a

197 See R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 387 (1937) [hereinafter, Coase, *Nature of the Firm* (ECONOMICA)]; see also OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES* (1975) [hereinafter WILLIAMSON, *MARKETS*] (explaining the concept of transaction costs).

198 See Coase, *Nature of the Firm* (ECONOMICA), *supra* note 197; see also R. H. Coase, *The Institutional Structure of Production*, 82 *AM. ECON. REV.* 713, 714 (1992) [hereinafter Coase, *Institutional Structure*] (stating that the price-theoretic “economist does not interest himself in the internal arrangements within organizations but only in what happens on the market, [that is] the purchase of factors of production, and the sale of the goods that these factors produce.”); Harold Demsetz, *The Theory of the Firm Revisited*, 4 *J.L. ECON. & ORG.* 141, 143 (1988) (“‘Firm’ in the theory of price is simply a rhetorical device adopted to facilitate discussion of the price system.”); Lionel Robbins, *The Representative Firm*, 38 *ECON. J.* 387, 389–90 (1928) (explaining that the representative firm in Marshall’s “Principles of Economics” was an economic construct, independent of actual legal structure); *supra* note 105 and accompanying text (explaining how price theory treated firms as having technological origins).

199 See Coase, *Nature of the Firm* (ECONOMICA), *supra* note 197, at 390 (“The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism.”); *id.* at 389 & n.3 (noting that “planning” that takes place within the firm is voluntary and pursuant to contract); *id.* at 391 (“A factor of production (or the owner thereof) does not have to make a series of contracts with the factors with whom he is co-operating within the firm . . . . For this series of contracts is substituted one.”).

200 See WILLIAMSON, *MARKETS*, *supra* note 197, at 83–84 (contending that relationship-specific investment and resulting risk of opportunism can give rise to complete vertical integration); Coase, *Nature of the Firm* (ECONOMICA) *supra* note 197, at 390–91 (focusing on bargaining and discovery costs); Benjamin Klein, *Transaction Cost Determinants of “Unfair” Contractual Arrangements*, 70 *AM. ECON. REV.* 356 (1980) [hereinafter Klein, “Unfair” Contractual Arrangements] (examining the impact of relationship-specific investments on extent and type of contractual and complete integration); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 *J.L. & ECON.* 297 (1978) (examining the impact of relationship-specific investments on extent and type of contractual and complete integration).

risk of opportunism, a risk that “unified contracting” in the form of complete integration could eliminate.<sup>201</sup> These scholars agreed with Coase’s conclusion that “the firm” was a special non-standard contract giving its owners special control rights over their property and employees, rights that eliminated or reduced the risk of opportunism.<sup>202</sup> While price theorists had themselves recognized (and emphasized) certain departures from perfect competition, particularly when constructing and applying the workable competition model, they had not recognized the departures that gave rise to transaction costs, departures they often excluded by hypothesis while examining the implications of other departures.<sup>203</sup>

TCE thus offered a more convincing explanation for the existence of firms than price theory’s technological account, as the latter simply explained why certain activity should be conducted in close proximity, e.g., “under the same roof,” and not why actors should also bring activities under common ownership.<sup>204</sup> Practitioners of TCE also offered benign explanations for partial contractual integration. These scholars argued that such non-standard agreements could overcome market failures by, for instance, better aligning the incentives of vertically-related trading partners. Perhaps most famously, Robert Bork and Lester Telser argued that certain vertical restraints could overcome a failure in the market for promotional services by ensuring that dealers would recoup the benefits of their (specific) promotional investments.<sup>205</sup> Subsequently, scholars sought additional “market failure” explanations for non-standard contracts, including contracts previously deemed “exclusionary” and coercive. For instance, scholars argued that certain tying contracts could help franchisors combat free

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201 See *infra* note 202 (collecting authorities).

202 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 78 (equating internal organization with “unified contracting”); Scott E. Masten, *A Legal Basis for the Firm*, 4 J.L. ECON. & ORG. 181, 195 (1988) (noting that parties could replicate the various control properties associated with the firm by contract).

203 See *supra* note 125 and accompanying text.

204 See Victor P. Goldberg, *Production Functions and Transaction Costs*, 397, in *ISSUES IN CONTEMPORARY MICROECONOMICS & WELFARE* (George R. Feiwel, ed. 1985) (explaining that technical economies cannot explain boundaries of firms because, absent transaction costs, such economies can “be achieved equally well if the factors of production are owned by independent individuals.”).

205 See Bork, *The Rule of Reason (part II)*, *supra* note 165 (contending that exclusive territories can ensure that dealers recoup the benefits of promotional expenditures); Lester G. Telser, *Why Should Manufacturers Want Fair Trade*, 3 J.L. & ECON. 86 (1960) (contending that minimum resale price maintenance can ensure that dealers internalize the benefits of promotional expenditures).

riding by ensuring that franchisees purchased high quality inputs.<sup>206</sup> Others argued that some tying contracts could prevent breakdowns caused by inferior inputs, breakdowns that purchasers might otherwise attribute to some imagined fault in the manufacturer's own product, and thus protect the manufacturer's goodwill.<sup>207</sup>

Others offered transaction cost explanations for exclusive dealing agreements. Some argued that such contracts could encourage relationship-specific investment, by ensuring that firms making such investments would have a guaranteed outlet for their products.<sup>208</sup> Others offered additional explanations, including the claim that such agreements could create a sort of property right allowing manufacturers to reap the rewards of their promotional expenditures.<sup>209</sup> While these scholars did not always articulate explanations in explicit trans-

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206 See Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J.L. & ECON. 345 (1985) (arguing that franchise tying contracts can protect goodwill of the franchise system against opportunistic shirking by franchisees).

207 See, e.g., POSNER, *supra* note 52, at 175. Others argued that requiring purchasers of complex products also to purchase repair and maintenance services from the manufacturer would enable the manufacturer to produce information about the product, while independent service organizations would lack incentives to produce such information. See Meese, *Tying*, *supra* note 41, at 65–66.

Private parties successfully articulated the “goodwill protection” rationale for tying contracts before the advent of workable competition. See, e.g., *FTC v. Sinclair Ref. Co.*, 261 U.S. 463 (1923) (sustaining tie on this basis). However, price theory led the Supreme Court repeatedly to reject this rationale for tying contracts, because less restrictive means could supposedly produce identical benefits. See, e.g., *Int'l Salt Co., Inc. v. United States*, 332 U.S. 392, 397–98 (1947); *IBM v. United States*, 298 U.S. 131, 134 (1936).

208 See Benjamin Klein, *Vertical Integration as Organizational Ownership: The Fisher Body–General Motors Relationship Revisited*, 4 J.L. ECON. & ORG. 199, 201 (1988); see also *United States v. Addyston Pipe & Steel Co.*, 85 F. 271, 287 (6th Cir. 1898) (explaining how exclusive grant to sleeping car company to serve railroad line could induce the company to make specific investments); Bork, *The Rule of Reason (part II)*, *supra* note 165, at 398–402 (same); Milton Handler, *Statement Before The Small Business Administration*, 11 ANTITRUST BULL. 417, 424–25 (1966) (suggesting such a rationale before economists did).

209 See Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982) (contending that exclusive dealing contracts could prevent dealers from promoting inferior brands and thus free-riding on manufacturer's promotion). Such a strategy could enhance dealers' profits if a manufacturer expended more per unit of output on promotion than its competitors, with the result that a dealer could enhance its margins by steering customers toward products with lower wholesale prices. *Id.* at 7; see also Scott E. Masten & Edward A. Snyder, *United States Versus United Shoe Machinery Corporation: On the Merits*, 36 J.L. & ECON. 33, 42–43, 67–68 (1993) (offering a different transaction cost rationale for exclusive dealing); John Shepard Wiley Jr. et al., *The Leasing Monopolist*, 37 UCLA L. REV. 693, 710 (1990) (offering a different transaction cost rationale for exclusive dealing).

action cost terms, they in fact attempted to explain how non-standard contracts reduced the costs of reliance upon an unbridled market, by redefining background property rights and contractual obligations.<sup>210</sup> Practitioners of TCE articulated a presumption that partial and complete contractual integration was designed to reduce the cost of transacting.<sup>211</sup>

Thus, TCE did more than undermine price theory's technological conception of the firm and its concomitant account of complete vertical integration. The new paradigm also questioned price theory's more fundamental assumption that *all* efficiencies were technological and thus realized after the purchase of inputs and before the sale of a product to dealers or consumers.<sup>212</sup> By showing that contracts reaching beyond the firm and restraining an unbridled market could overcome market failures and enhance resource allocation, TCE demonstrated that some efficiencies are "contractual" in nature.<sup>213</sup> Moreover, TCE established that such efficiencies could arise over time, long after the production and sale of the product in question.

#### B. TCE and Contract Formation

The recognition that many non-standard contracts produced significant benefits by overcoming market failures led courts to reject numerous doctrines associated with the inhospitality tradition.<sup>214</sup> In particular, courts overruled or narrowed various decisions that had condemned, as unlawful per se, various non-standard contracts that were ancillary to otherwise valid transactions or relationships.<sup>215</sup> Courts also softened their approach to exclusionary agreements

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210 See Meese, *Market Failure*, *supra* note 103, at 52–54 (explaining how Telser's work did not invoke the transaction cost paradigm or refer to Coase).

211 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 28 (articulating this rebuttable presumption); see also R. H. Coase, *An Overview of the Antitrust Laws, in THE FIRM, THE MARKET, AND THE LAW* 26 (1988) (noting the ubiquity of transaction costs and resulting market failures in the real world).

212 See *supra* note 105 and accompanying text (explaining that price theory assumed that efficiencies were technological in nature and arose within the firm, before passage of title to the firm's product).

213 See *e.g.*, Meese, *Rule of Reason*, *supra* note 74, at 134–41 (explaining how TCE identified various contractual efficiencies produced by non-standard contracts).

214 See *id.* at 141–44 (detailing judicial rejection of various per se rules).

215 See *id.*, see also, *e.g.*, *State Oil Co. v. Khan*, 522 U.S. 3 (1997) (overturning per se ban on maximum resale price maintenance); *NCAA v. Bd. of Regents of the Univ. of Okla.*, 468 U.S. 85 (1984) (narrowing per se ban on horizontal price fixing and output limitation); *Cont'l T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977) (reversing per se ban on non-price vertical restraints); *Polk Bros. v. Forest City Enters.*, 776 F.2d 185 (7th Cir. 1985) (applying Rule of Reason to horizontal restraint).

entered by monopolists.<sup>216</sup> Still, neither these decisions nor TCE itself seemed to question the market power model of contract formation. Indeed, each benign account implicitly assumed that proponents of such agreements possessed market power, if only from product differentiation. So, for instance, the claim that minimum resale price maintenance or exclusive territories could encourage optimal promotion by dealers depended upon an assumption that manufacturers were selling a differentiated product and thus possessed modest market power.<sup>217</sup> Ditto for claims that exclusive dealing facilitated manufacturers' production of promotional information.<sup>218</sup> In a similar way, of course, practitioners of price theory had expressly recognized that practices that led to or preserved market power, including product differentiation and the realization of economies of scale, could simultaneously produce benefits that outweighed the harm associated with such power.<sup>219</sup> Professor Williamson formalized this result in 1968 by applying the so-called "partial equilibrium trade-off model," concluding that a small reduction in production costs would usually offset whatever harm flowed from the exercise of market power.<sup>220</sup> Indeed, in 1978, Robert Bork would argue that this model should form the basis for the analysis of *all* anti-trust problems.<sup>221</sup>

To be sure, Ronald Coase expressly claimed that a desire to reduce transaction costs explained integration independent of

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216 See *supra* notes 57–58 and accompanying text (explaining that courts applying § 2 now allow monopolists to offer justifications for otherwise unlawful exclusionary agreements).

217 See Telser, *supra* note 205, at 94–96 (explaining why this account of minimum rpm depends upon the presence of product differentiation and resulting market power); see also Bork, *The Rule of Reason (part II)*, *supra* note 165, at 431–34 (explaining how sales effort induced by such agreements facilitated local advertising associated with national trademarks).

218 See Marvel, *supra* note 209, at 8–11.

219 See *supra* notes 98–99 and accompanying text.

220 See Williamson, *Welfare Tradeoffs*, *supra* note 98, at 21–23. While Williamson was the first to formalize this insight, the law's historical preference for "competition on the merits," supported by scholars in the "workable competition" school, depended upon an implicit assumption that, say, economies of scale that might lead to or protect a monopoly produced benefits that outweighed the resulting harms. See, e.g., BAIN, *PRICE THEORY*, *supra* note 83, at 208–209 (explaining that monopoly can produce more output than a competitive market due to economies of scale or other efficiencies); Donald F. Turner, *The Scope of Antitrust and Other Economic Regulatory Policies*, 82 HARV. L. REV. 1207 (1969).

221 See BORK, *ANTITRUST PARADOX*, *supra* note 151, at 107–08.

monopoly considerations and that such integration was voluntary.<sup>222</sup> At the same time he did not, in his published writings anyway, explain how this voluntary integration took place.<sup>223</sup> Moreover, many exponents of the transaction cost approach were members of the Chicago School.<sup>224</sup> Despite their articulation and application of transaction cost principles, these scholars repeatedly endorsed "price theory" as the appropriate foundation for antitrust policy and invoked the market power model of contract formation in support of their argument against inhospitality era doctrines hostile to exclusionary agreements.<sup>225</sup> It should come as no surprise, then, that these and other practitioners of TCE were content simply with demonstrating that non-standard contracts produced significant benefits and did not overtly question price theory's account of contract formation.<sup>226</sup> For these scholars, the mere exercise of market power to "impose" an agreement would not itself suggest that the agreement reduced welfare. Indeed, when "challenged" by the argument that manufacturers "imposed" minimum resale price maintenance upon dealers against their will, Robert Bork's response was, basically, "so what?"<sup>227</sup> What

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222 See R.H. Coase, *The Nature of the Firm: Meaning*, 4 J. L. ECON. & ORG. 19, 26-27 (1988) ("In the early 1930s I was looking for an explanation for the existence of the firm which did not depend on monopoly. I found it, of course, in transactions costs."); Coase, *Nature of the Firm* (ECONOMICA), *supra* note 197, at 389 n.3 ("[F]irms arise voluntarily because they represent a more efficient method of organizing production.").

223 But see *infra* note 267 and accompanying text (discussing Coase's 1930s private correspondence on the subject).

224 Robert Bork and Richard Posner were the chief examples.

225 See *supra* notes 155-67 and accompanying text (discussing assertions by Robert Bork and Richard Posner that price theory was the only appropriate methodological foundation for antitrust doctrine); *supra* note 124-27 and accompanying text (describing Chicago School's opposition to inhospitality era doctrines); see also Oliver E. Williamson, *Why Law, Economics and Organization?*, 1 ANN. REV. L. & SOC. SCI. 369, 383 (2005) [hereinafter Williamson, *Why Law?*] ("[D]espite references by Chicagoans to 'price theory,' Chicago's approach to vertical restraints has never rested upon . . . price theory. Instead, the Chicago approach to vertical restraints is an application of [NIE/TCE reasoning].'" (second alteration in original) (citation omitted) (quoting Alan J. Meese, *Price Theory and Vertical Restraints: A Misunderstood Relation*, 45 UCLA L. REV. 143, 203 (1997))).

226 The one exception, it should be noted, was Professor Williamson, who expressly articulated a model of forming beneficial non-standard contracts. See *infra* note 306 and accompanying text. He did not, however, contrast this account with price theory's market power model.

227 Bork, *A Reply To Professors*, *supra* note 166, at 739 ("This argument [in favor of minimum resale price maintenance] rests upon the idea of consumer sovereignty. It does not depend in any way upon a notion that the resellers may be said to have 'agreed' to r.p.m."). It is of course ironic that Bork would imply that minimum r.p.m.

mattered for Bork and others was the *result* of such agreements, and not how they were formed.<sup>228</sup>

Not everyone, however, believes that the process of contract formation is irrelevant from the perspective of antitrust doctrine. As explained above, courts still treat certain non-standard contracts as expressions of market power and assume that the use of power to impose such agreements itself offends the Sherman Act, at least absent some justification.<sup>229</sup> Moreover, even if a defendant proves that a restraint produces benefits, courts assume that the benefits coexist with harms associated with the use of power to impose the restraint.<sup>230</sup> Also, courts still reject arguments that dealers are willing participants in anticompetitive contracts because sellers purportedly employ market power to impose such agreements.<sup>231</sup> As a result, proof that such contracts are not the result of market power could have significant implications for antitrust doctrine.

In fact, the application of TCE in light of other economic developments undermines the claim that non-standard agreements, including those that cause harm, are necessarily the result of market power. As noted earlier, TCE begins with the claim that reliance upon the sort of atomistic market imagined by price theory—transacting—entails a “transaction cost.”<sup>232</sup> Complete vertical integration and other non-standard contracts, it is said, can overcome or reduce these costs.<sup>233</sup>

These transaction costs do not fall upon the public at large but are instead internalized by actors that rely upon market transacting. As an economic matter, these costs are indistinguishable from other costs of production, such as the cost of steel, electricity, or manpower.<sup>234</sup> To be sure, and unlike technological efficiencies, some transaction costs may only manifest themselves at some point in the future, long after the purchase and sale that gave rise to the non-standard agreement in the first place. This is particularly so when the

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was the result of coercion. After all, one year earlier, Bork had argued that such agreements were examples of contractual integration of the sort identified by Ronald Coase in his pathbreaking work. See Bork, *The Rule of Reason (part II)*, *supra* note 165, at 472–73 (citing Coase, *Nature of the Firm* (ECONOMICA), *supra* note 197, at 386).

228 See POSNER, ANTITRUST LAW, *supra* note 52, at 145–65 (referring repeatedly to the “imposition” of restrictions by manufacturers).

229 See *supra* note 5 and accompanying text.

230 See *supra* note 59 and accompanying text.

231 See *supra* notes 60–71 and accompanying text.

232 See *supra* note 197 and accompanying text.

233 See *supra* note 205 and accompanying text.

234 See Carl J. Dahlman, *The Problem of Externality*, 22 J. L. & ECON. 141, 143–150 (1979).

transaction cost flows from specific investments and takes the form of *prospective* opportunism at the hands of a trading partner.<sup>235</sup> Nonetheless, a firm deciding whether to rely upon the market will still internalize these costs, just as a firm internalizes the prospective "cost" of offering a warranty that it must honor in the future.<sup>236</sup>

At the same time, such costs differ from other costs of production in an important respect: they are not necessarily exogenous to the firm that incurs them.<sup>237</sup> To be sure, such costs only arise because information and bargaining costs prevent parties from anticipating and guarding against them *ex ante*, and they often take the form of tort-like opportunism by trading partners.<sup>238</sup> Nonetheless, the prospect and magnitude of such costs can depend upon the nature of the institutional framework within which the firm operates and transacts with others.<sup>239</sup> Roughly speaking, this framework will have two components: (1) background rules of the game, such as the law of property and contract, promulgated and enforced by the state, and (2) contractual provisions that parties adopt that change those background rules.<sup>240</sup> By altering background rules, the state can alter this framework and thus alter the costs of transacting.<sup>241</sup> In the same way, private parties can alter these costs by altering the contractual rules that govern the transaction going forward.<sup>242</sup> Indeed, the whole point

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235 See, e.g., Klein, "Unfair" Contractual Arrangements, *supra* note 200 *passim*.

236 See George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297 (1981).

237 See *supra* note 86 and accompanying text (collecting authorities contending that most firms must take technology as given).

238 See Klein, "Unfair" Contractual Arrangements, *supra* note 200, at 356 (explaining that risk of opportunism arises because "complete, fully contingent, costlessly enforceable contracts are not possible"); *id.* at 356-57 (arguing that high information and monitoring costs make fully-contingent contracts impossible to negotiate and enforce in the real world).

239 See Coase, *Institutional Structure*, *supra* note 198, at 713 (explaining how the institutional framework impacts the cost of conducting economic activity).

240 See Williamson, *Why Law?*, *supra* note 225, at 385 ("[There is a distinction] between institutional environment (or rules of the game) and the institutions of governance (or play of the game)."); see also BARZEL, *supra* note 85, at 14 (explaining how contractual arrangements often determine actual scope and definition of property rights).

241 See Coase, *Institutional Structure*, *supra* note 198, at 716-18 (explaining how legal institutions can affect transaction costs); see also COASE, *THE FIRM*, *supra* note 106, at 28 (arguing that a change in background rules can increase or decrease the cost of entering transactions).

242 See, e.g., COASE, *THE FIRM*, *supra* note 106, at 6-7 ("The existence of transaction costs will lead those who wish to trade to engage in practices which bring about a reduction of transaction costs whenever the loss suffered in other ways from the adoption of those practices is less than the transaction cost saved. The people one deals

of TCE as applied to partial and complete integration is that certain forms of contractual integration will reduce the cost of transacting when compared to reliance upon an atomistic market.<sup>243</sup> Thus, just as firms will internalize the cost of relying upon the “spot” market, so too will they internalize the costs—be they higher or lower—of transacting in a market governed by given contractual provisions. These costs, of course, will constitute a portion of the cost of producing and distributing the product in question.

How is it, though, that a firm could induce trading partners—the very source of feared opportunism—to enter agreements that prevent future opportunism? Such agreements, after all, constrain such partners, often at the very moment they desire more autonomy.<sup>244</sup> Here one must consider a mundane aspect of the institutional framework: property law. Property law—including the law of intellectual property—empowers manufacturers to exclude potential purchasers, including dealers, from their product unless the purchaser pays a price that satisfies the seller.<sup>245</sup> This body of law will include the law of trademarks, which prevents firms from displaying the trademark of a manufacturer or a franchisor without the owner’s consent.<sup>246</sup> This clear assignment of rights will force potential opportunists to bargain with potential victims *before* opportunism can occur, in a setting of relatively low exchange costs.<sup>247</sup> As a result, manufacturers or

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with, *the type of contract entered into*, the kind of product or service supplied, will all be affected.” (emphasis added)); Klein, “Unfair” Contractual Agreements, *supra* note 200 *passim* (arguing that parties will adopt purportedly “unfair” contractual provisions as a means of minimizing transaction costs).

243 See *supra* note 205 and accompanying text.

244 See, e.g., *Perma Life Mufflers, Inc. v. Int’l Parts Corp.*, 392 U.S. 134, 140–41 (1968) (contending that franchisees bound by exclusive dealing contracts would prefer autonomy to purchase from supplier of their choice); *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43 (9th Cir. 1971) (adjudicating franchisees’ claim that tying agreement prevented them from purchasing inputs from low-cost suppliers).

245 See Hale, *supra* note 174, at 610; see also *supra* note 85 and accompanying text (explaining how competitive market depends upon state-enforced background rules of property and contract).

246 See J. THOMAS MCCARTHY, 1 TRADEMARKS & UNFAIR COMPETITION § 2:14 (4th ed. 2008) (“Undoubtedly, a trademark confers a defined ‘right to exclude’—a limited ‘exclusive right.’”); see also *Hanover Star Milling Co. v. Metcalf*, 240 U.S. 403, 412 (1916) (“Where a party has been in the habit of labeling his goods with a distinctive mark . . . others are debarred from applying the same mark . . .”).

247 See Meese, *Antitrust Balancing*, *supra* note 59, at 132–41 (describing such a process of contract formation in the franchise context); see also Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972) (describing how one effect of setting initial entitlements in the property and tort context is to reduce exchange costs).

franchisors will be able to recoup from purchasers the anticipated costs of opportunism that various contractual arrangements, including reliance on the spot market, will produce. That is to say, buyers will pay the transaction costs that the seller must incur, including the costs of their own potential opportunism, just as they will pay the seller's costs of steel or electricity.<sup>248</sup>

This may not be an equilibrium solution, however, as an outright sale is not the only option available to the parties in question.<sup>249</sup> Instead, a rational firm facing the prospect of opportunism may adopt various contracts or other practices that minimize the expected costs flowing from such opportunism, net of the costs of the practices themselves.<sup>250</sup> Other things being equal, theory would predict that the firm would choose that contractual arrangement minimizing the cost of future opportunism, thereby reducing the price it must charge trading partners.<sup>251</sup> In the same way, of course, the firm will, *ceteris paribus*, choose the product configuration minimizing the chance of breakdown or risk of injury to the purchaser.<sup>252</sup>

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248 See Dahlman, *supra* note 234, at 144–45 (explaining how transaction costs are indistinguishable from other input costs); cf. Klein, “Unfair” Contractual Arrangements, *supra* note 200, at 357 (explaining that employers will reduce the wages of shirking employees to reflect cost of employee opportunism).

249 See Langlois, *supra* note 101, at 11–12 (explaining that opportunism is not an equilibrium solution when parties can take steps to reduce such behavior); Klein, “Unfair” Contractual Arrangements, *supra* note 200, at 357 (explaining that opportunistic exploitation of relationship-specific investments is “not a long-run equilibrium phenomenon”); *id.* (“In many cases, . . . [simply] letting the party cheat and discounting his wage will not be an economical solution because the gain to the cheater and therefore his acceptable compensating wage discount is less than the cost to the firm from his cheating behavior.”).

250 See COASE, THE FIRM, *supra* note 106, at 6–7 (explaining that firms may reduce transaction costs by changing customers or suppliers and even the product offered); Klein, “Unfair” Contractual Arrangements, *supra* note 200, at 358 (“Individuals would be willing to expend real resources to set up contractual arrangements to prevent such opportunism.”); Oliver E. Williamson, *The Logic of Economic Organization*, 4 J. L. ECON. & ORG. 65, 72 (1988) (“The main case to which transaction cost economics subscribes has been stated by Frank Knight as follows: ‘Men in general, and within limits, wish to behave economically, to make their activities *and their organization* ‘efficient’ rather than wasteful. This fact does deserve the utmost emphasis . . . .’” (citation omitted) (quoting Frank H. Knight, *Anthropology and Economics*, 53 J. POL. ECON. 247, 252 (1941))).

251 See R.H. Coase, *Nature of the Firm: Influence*, 4 J. L. ECON. & ORG. 33, 39–40 (1988) [hereinafter Coase, *Influence*] (arguing that competition forces firms to choose the level of vertical integration that minimizes costs); Coase, *Nature of the Firm* (ECONOMICA), *supra* note 197, at 389 n.3 (“In a competitive system, there is an ‘optimum’ amount of planning.”).

252 Priest, *supra* note 236, at 1313.

To be sure, some such arrangements will constrain a firm's dealers or consumers, and such entities would, *ceteris paribus*, prefer complete autonomy. Still, other things may not be equal, since constraint may be the very tool needed to minimize the risk of future opportunism.<sup>253</sup> If so, then the proponent of such an agreement will presumably charge a lower price reflecting the reduced risk of opportunism than it would charge without such an agreement.<sup>254</sup> Thus, a dealer or consumer that desires a given product at the lowest possible price may have to accept restraints on its behavior in return, just as a purchaser that desires a low-priced warranty may have to accept restraints, such as a requirement not to use a consumer product for commercial purposes.<sup>255</sup> A purchaser that insists on the freedom to victimize its trading partner will pay a stiff price for this right.

Nothing about this account depends upon the seller's exercise of market power to obtain agreement to the restraint. To be sure, the seller may *hope* that, say, promotion induced by a restraint differentiates its product and thereby confers modest market power.<sup>256</sup> Still, acquisition of such power is not necessary for success of this strategy; the strategy may be (minimally) successful if the firm simply retains enough customers to earn a normal return.<sup>257</sup> Thus, such a tactic is no more an "exercise" or "use" of market power than the adoption of a new technological process that reduces production costs.<sup>258</sup>

The analysis thus far rests upon an unrealistic assumption, namely, that "other things" really are equal when firms are choosing between atomistic markets and integration. There is, however, a particular manner in which things are not entirely equal, *viz.*, the utility of the party to be bound by the restraint. To be sure, this party will

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253 See Frank H. Easterbrook, *Vertical Arrangements and the Rule of Reason*, 53 ANTI-TRUST L. J. 135 (1984) (reduction in competition is the tool that vertical restraints employ to reduce opportunism).

254 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 32–33 (explaining that firms will charge lower prices when there is a safeguard in place preventing or reducing the risk of opportunism); see also Alan J. Meese, *Price Theory and Vertical Restraints: A Misunderstood Relation*, 45 UCLA L. REV. 143, 186–88 (1997) [hereinafter Meese, *Vertical Restraints*] (explaining how firm adopting restraint minimizing opportunism will charge lower price for the product that the restraint accompanies).

255 See Priest, *supra* note 236, at 1313 (contending that consumers will demand cost-justified coverage exclusions in warranty contracts).

256 See Telser, *supra* note 205, at 87 (arguing that product differentiation produced by vertical restraints leads to market power).

257 See Meese, *Rule of Reason*, *supra* note 74, at 165–67.

258 *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 274–75 (2d Cir. 1979) (distinguishing between exercise of market power and realization of efficiencies derived from larger scale or integration of related functions).

value lower prices. The party will also value future autonomy allowing it to behave opportunistically, however.<sup>259</sup> So, for instance, a dealer will value its ability *not* to expend resources on promoting the manufacturer's product, hoping to free ride on promotional efforts of others.<sup>260</sup> Thus, a dealer would be willing to pay "something extra" to avoid restraints that combat opportunism. The process that results in the "imposition" of non-standard contracts reducing transaction costs must therefore involve more than simply single-firm cost-minimizing behavior. Instead, this process must somehow account for the preference that a firm's trading partners have for post-sale autonomy.

This sort of post-sale autonomy is, simply put, not free. As already explained, sellers will charge a price that reflects the costs they must bear under a given transactional relationship, including a premium that reflects the cost of anticipated opportunism resulting from an unconstrained sale and resulting buyer autonomy. Thus, potential opportunists will be forced to consider proposed contracts "in their entirety," that is, the complete package of contractual terms *and* accompanying price.<sup>261</sup> A contract allowing buyers post-sale autonomy will create a potential for mischief, a potential incorporated in the price of products sold without opportunism-reducing restrictions.<sup>262</sup> This premium will cause the purchaser fully to internalize potential harms from its hoped-for autonomy and possibly lead it to prefer a sale with an accompanying constraint and reduced price.<sup>263</sup>

Recognizing the interaction between price and contractual terms and the derivative importance of examining contracting in its entirety, we can reconceptualize the process of forming non-standard contracts that reduce the (prospective) cost of transacting. Assume for the sake of clarity that a manufacturer sells its product to dealers, and that unconstrained dealers might behave opportunistically by, for instance,

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259 Cf. Coase, *Nature of the Firm* (ECONOMICA), *supra* note 197, at 390 (explaining how, in isolated cases, individuals may desire autonomy for its own sake, thereby explaining reliance on the market).

260 See *supra* note 209 and accompanying text.

261 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 35 (explaining importance of considering "contracting in its entirety").

262 *Id.* at 35 ("Inasmuch as price and governance are linked, parties to a contract should not expect to have their cake (low price) and eat it too (no safeguard). More generally, it is important to study *contracting in its entirety*. Both the *ex ante* terms and the manner in which contracts are thereafter executed vary with the investment characteristics and the associated governance structures within which transactions are embedded.").

263 Cf. Klein, "Unfair" Contractual Arrangements, *supra* note 200, at 357-58 (explaining how shirking employees or managers will receive lower wages thereby forcing them to compare the social cost of shirking to the benefits they derive therefrom).

steering consumers to purchase rivals' products.<sup>264</sup> Imagine that each seller offers each dealer two options. Under option one, the seller offers to sell the relevant product "free and clear," without contractual restraint, satisfying the purchaser's preference for post-sale autonomy and resulting risk of opportunism. Under option two, the seller offers to sell the relevant product, accompanied by a restraint, such as an exclusive dealing contract.<sup>265</sup> Such exclusivity would modify the dealer's right to stock whichever goods it wished, thereby perfecting the manufacturer's own property right in the fruits of its promotional expenditures.<sup>266</sup>

Each option will entail the same technological production costs for the seller. At the same time, option one will entail higher transaction costs, of a non-technological origin. Absent price regulation, the final price of each option will reflect that cost difference.<sup>267</sup> Thus, the buyer will face a choice: the product plus autonomy at a high price, or the product plus restraint at a low price. So long as the cost of prospective opportunism and resulting price differential is greater than any autonomy benefits to the buyer, the buyer will choose the second option and resulting constraint. That is, the threat of opportunism will manifest itself in a price differential that induces the buyer to internalize the costs of its prospective opportunism and choose the option maximizing the joint welfare of the parties over time.<sup>268</sup> With *ex ante* bargaining costs low and a legal regime recognizing property and its right to exclude, prices will do more than simply reflect the cost of inputs—such as labor and material—recognized by price theory. Instead, this price—a single variable—will also impound the cost

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264 See Marvel, *Exclusive Dealing*, *supra* note 209, at 7–8.

265 *Id.* at 6–8 (explaining how an exclusive dealing contract can prevent this form of opportunism).

266 *Id.*

267 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 33–35 (explaining how sale price and governance terms are "fully interactive" and that seller's price will reflect the presence (or not) of contractual safeguards that prevent opportunism); Meese, *Vertical Restraints*, *supra* note 254, at 186–88. In (then-unpublished) 1932 correspondence, Professor Coase modeled such higher costs as an increased cost of capital related to a manufacturer's relationship-specific investment that gave rise to a risk of opportunism. See R.H. Coase, *Nature of the Firm: Origin*, 4 J. L. ECON. & ORG. 3, 13 (1988) [hereinafter Coase, *Origin*].

268 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 33 (explaining how firms will charge prices reflecting presence or not of contractual terms that prevent opportunism, and how such differentials can induce trading partners to agree to provisions that limit prospective opportunism); see also Meese, *Tying*, *supra* note 41, at 69–70 (explaining how cost-based price differentials can induce acceptance of tying contracts that reduce prospect of opportunism).

of possible opportunistic behavior by the buyer, stretching as far into the future as the parties might imagine.<sup>269</sup> Thus, the price system can operate to induce the negotiation of a contract redefining the property rights of the parties, voluntarily eliminating market failure, just as Coase predicted.<sup>270</sup>

This process might seem like a quintessential exercise of market power to “impose” a contract against the will of the buyer who, after all, “prefers” complete autonomy. As explained earlier, such an exercise can, as Chicagoans explained, be modeled as the threatened exaction of a monopoly price as a means of inducing buyers to agree to non-standard clauses.<sup>271</sup> Moreover, buyers that agree to non-standard provisions will pay a lower price for the seller’s product than they would without the restriction.<sup>272</sup> Indeed, the manufacturer likely possesses market power due to product differentiation, power the seller must, it seems, be exercising to “impose” the agreement.

Still, there is a critical difference between the use of power to impose a contract as imagined by Chicago School scholars, and the sort of “Coasean bargain” I have just described. That is, unlike the differentials associated with the “use” of market power, in which the higher price (by definition) exceeds cost, the differential inducing the Coasean bargain reflects the different costs of the different options offered. In particular, the higher price, which accompanies the sale without a contractual safeguard, simply reflects the prospective cost of opportunism that the seller expects to incur at the hands of an unconstrained buyer. While not a historical, technological cost, like the cost of steel or labor, it is a cost nonetheless.<sup>273</sup> Increasing one’s price to reflect this additional cost does not constitute an exercise of market power.<sup>274</sup> An automobile manufacturer that charges extra for leather

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269 See F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 526 (1945) (explaining how a single price can incorporate all of the information available to a particular party bearing on the cost of a transaction). There is, of course, an implicit assumption that the potential victim of opportunism will remain in the marketplace long enough to suffer such harm at the hands of its trading partner. A firm with a shorter time horizon, by contrast, will not fear such opportunism.

270 See R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 15 (1960) (referring to process of “rearrangement of legal rights through the market” by bargaining in an environment of low transaction costs).

271 See *supra* notes 155–56 and accompanying text.

272 See *supra* note 157 and accompanying text.

273 See, e.g., Coase, *Origin*, *supra* note 267, at 12, 15–16 (reproducing correspondence treating risk of opportunism as a source of higher capital costs).

274 I have previously made this point with respect to tying contracts. See Meese, *Tying*, *supra* note 41, at 66–70.

seats is not exercising market power, even if the premium “forces” the buyer to choose cloth or purchase from a different seller altogether.

To be sure, the right to exclude others from one’s property is “coercive,” because it depends upon state force.<sup>275</sup> Still, creation and enforcement of property and contract is also necessary to perfect competition.<sup>276</sup> Such production and exchange results in prices equal to cost, with no firm exercising market power. Property does not ipso facto confer market power according to price theory and antitrust.

Price theorists may nonetheless object to this conclusion. In perfect competition, each firm is a price taker.<sup>277</sup> A firm that attempts to pass idiosyncratic costs along to consumers will see its sales drop to zero.<sup>278</sup> It thus seems that the ability to charge a price higher than other firms in the same market necessarily reflects the possession and exercise of market power. Was Coase simply wrong when he claimed that his “transaction cost” rationale for vertical integration was independent of monopoly?<sup>279</sup>

Close reflection confirms Coase’s conclusion. Opportunism is not an isolated phenomenon, suffered by a single seller in a relevant market. If, say, one dealer poses a threat of opportunism to a particular seller, other dealers likely pose the same threat to similarly situated sellers as well. Thus, dealing with such unconstrained customers will impose the same costs on *all* firms in the marketplace. Moreover, the prospect of such opportunism would presumably induce *all* market participants to adopt mechanisms to avoid it, including, of course, non-standard agreements. If the costs of such opportunism exceeded the benefits of dealer autonomy, then one would expect a market equilibrium in which *all* firms minimized transaction costs by offering such price differentials and thereby securing agreement to such non-standard contracts.<sup>280</sup> Such a process of market-wide contract forma-

275 See, e.g., Hale, *supra* note 174, at 604.

276 See *supra* note 85 and accompanying text.

277 See STIGLER, COMPETITIVE PRICE, *supra* note 85, at 21–22, 149.

278 *Id.* at 156 (“[In perfect competition,] no firm can sell any amount above the ruling price . . .”); *id.* at 149 (explaining how historical cost does not determine the price a firm can charge in a competitive market).

279 See *supra* note 222 and accompanying text.

280 See Klein, “Unfair” Contractual Arrangements, *supra* note 200, at 362 (“When all firms in a particular industry use similar contractual provisions . . . [s]uch uniformity suggests the existence of independent attempts within a competitive environment to solve an important common problem . . .”); Meese, *Rule of Reason*, *supra* note 74, at 166 (explaining that market participants may simultaneously rely upon partial integration to differentiate their products). In other contexts, courts have recognized that apparently parallel conduct may reflect independent decision making by firms responding to similar market stimuli. See *Matsushita Elec. Indus. Co. v. Zenith Radio*

tion would be indistinguishable from the process through which all firms in the market end up offering the same or similar warranties.<sup>281</sup> Parties bound by such agreements may have no economically meaningful choice but to sign them and adhere to their provisions. In the same way, however, purchasers of a home appliance may have “no choice” but to accept a warranty that excludes recovery for damages incurred because the product was used for commercial purposes.<sup>282</sup>

Moreover, unlike the world of perfect competition, this process will not take place in an instant; different firms might adopt different solutions on the unsteady path to equilibrium.<sup>283</sup> Some firms may adopt idiosyncratic solutions, responsive to their own peculiar circumstances, groping for best practices through a process of trial and error.<sup>284</sup> Over time firms will settle upon a particular solution, such as

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Corp., 475 U.S. 574, 588 (1986) (holding that parallel conduct equally consistent with normal competition cannot support inference of conspiracy); *Theatre Enters., Inc. v. Paramount Film Distrib. Corp.*, 346 U.S. 537, 540–42 (1954) (same); *Williamson Oil Co. v. Philip Morris USA*, 346 F.3d 1287, 1303 (11th Cir. 2003) (same). Indeed, alleged ties are *per se legal* when all firms in the marketplace require purchasers to take the putative tied product to obtain the seller’s version of the tying product. *See Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 20–23 (1984). Such universal bundling establishes that selling such items separately will increase production costs. *Id.* at 21.

281 To be sure, some sellers may expend resources attempting to distinguish opportunistic customers from those who are trustworthy. *See WILLIAMSON, ECONOMIC INSTITUTIONS*, *supra* note 105, at 48 (“[I]f the propensity to behave opportunistically is known to vary among members of the contracting population, . . . gains can be realized by expending resources to discriminate among types.”). Moreover, firms may adopt strategies reducing the risk of opportunism. *See Klein & Saft*, *supra* note 206, at 348 n.15 (explaining how one franchisor granted franchise opportunities far from superhighways and prohibited in-store dining, thereby maximizing the number of repeat customers and reducing franchisees’ incentive to shirk). Still, the mere fact that some firms combat opportunism in this manner does not establish that firms that do adopt non-standard agreements have employed market power to impose them.

282 *See Priest*, *supra* note 236, at 1313 (explaining that consumers will demand contractual exclusions from warranty coverage when the resulting cost borne by the consumer will be less than the cost to the manufacturer of bearing the loss excluded from coverage).

283 *See Hayek*, *supra* note 85, at 101–02 (“[I]n conditions of real life the position even of any two producers is hardly ever the same . . . . At any given moment the equipment of a particular firm is always largely determined by historical accident, and the problem is that it should make the best use of the given equipment (including the acquired capacities of the members of its staff) and not what it should do if it were given unlimited time to adjust to constant conditions.”); *see also KNIGHT, RISK, UNCERTAINTY, AND PROFIT*, *supra* note 84, at 78 (noting that, in perfect competition, production and exchange are instantaneous).

284 *See Alan J. Meese*, *Monopoly Bundling in Cyberspace: How Many Products Does Microsoft Sell?* 44 ANTITRUST BULL. 65, 87–89 (1999) (explaining how different firms

complete or partial integration. Firms that fail to locate the optimal solution will find themselves at a disadvantage compared to those that do.<sup>285</sup> Invariably, antitrust litigation will capture only a snapshot of this evolutionary process, which may or may not appear to involve the “use” or “exercise” of market power.

It therefore seems plain that firms may obtain voluntary agreement to certain non-standard contracts, including those that “exclude” rivals, without “using” or “exercising” market power. Of course, some firms that obtain such agreements do, in fact, possess preexisting market power. Still, the mere fact that a firm possesses even monopoly power does not mean that the firm employs that power whenever it negotiates a contractual term with a trading partner. For instance, an automobile manufacturer that possesses monopoly power may offer a particular engine in each car, an engine that consumers feel compelled to accept. Absent price regulation, there is no reason to believe that the resulting sale reflects the seller’s “use” or “exercise” of power.<sup>286</sup> To be sure, the firm will exercise its monopoly power, by reducing the output of automobiles and thereby increasing prices. There is, however, no reason for the firm to “employ” such power to reduce the quality of engines that it offers. Indeed, the very concept makes little sense. If consumers value a particular engine and are willing to pay for it, then a (greedy) monopolist will maximize profits by offering that engine and charging what the market will bear.<sup>287</sup>

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might face trading partners with different propensities toward opportunism and therefore adopt different mechanisms to deal with this phenomenon).

285 See Coase, *Influence*, *supra* note 251, at 39–40 (arguing that competition forces firms to choose the level of vertical integration that minimizes costs); Coase, *Nature of the Firm* (ECONOMICA), *supra* note 197 at 389 n.3 (stating that, in a private market, there is an optimal amount of planning); see also JOSEPH SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* 84–85 (1943) (arguing that price competition is “a matter of comparative indifference” when compared to “the competition from the new commodity, the new technology, the new source of supply, [or] the new type of organization.” (emphasis added)); Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 214–21 (1950).

286 See generally Richard Craswell, *Freedom of Contract*, in CHICAGO LECTURES IN LAW & ECONOMICS 81, 83–84 (Eric A. Posner ed., 2000) (arguing that competitive markets will produce efficient (i.e., cost-justified) contractual terms on the assumption that sellers are able to alter their prices to recover the cost of various contractual terms).

287 See David Besanko, Shabtai Donnenfeld, & Lawrence J. White, *Monopoly and Quality Distortion: Effects and Remedies*, 102 Q. J. ECON. 743 (1987); Richard Schmalensee, *Market Structure, Durability, and Quality: A Selective Survey*, 17 ECON. INQUIRY 177 (1979); A. Michael Spence, *Monopoly, Quality, and Regulation*, 6 BELL J. ECON. 417 (1975). This is not to say that market structure will have no impact on product attributes. Because a monopolist will reduce its output below the “competitive” level, the

Similar logic applies to contractual terms. Take warranties. In a well-functioning competitive market with sellers free to adjust prices, firms will offer only those warranty terms that are "cost-justified" from the perspective of consumers.<sup>288</sup> The same result will obtain if the seller has a monopoly.<sup>289</sup> In the case of monopoly a desire to maximize profits will induce the seller to offer whatever warranty terms consumers are willing to pay for.<sup>290</sup> Similar logic applies to all contractual terms.<sup>291</sup> Inferior terms

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"marginal" consumers to whom it sells may have different preferences from those of the marginal consumers in a competitive market. If the firm makes its quality decision based upon efforts to attract and retain marginal consumers, the existence of a monopoly may thereby alter the nature of the engine and other accessories that the firm chooses to offer. See Spence, *supra*, at 417-21; see also Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979) (explaining how firms may respond to preferences of marginal consumers). Even if a monopoly alters product quality for this reason, there is no reason to assume that this change reduces social welfare as compared to the quality produced by a competitive market. Moreover, even if a monopolistic reduction in output *does* reduce welfare for this reason, it does not appear that this quality reduction is "imposed" on purchasers via the exercise of market power. Instead, the reduction reflects efforts by the monopolist to satisfy the preferences of some consumers in the marketplace. While this effort may reduce the welfare of other, *infra*-marginal consumers, such a result is not uniquely the result of market power. Instead, *infra*-marginal consumers can suffer identical harm in a competitive market, where firms might also cater to the preferences of some consumers, to the detriment of others. See generally Bork, *A Reply to Professors*, *supra* note 166, at 742-43.

288 See Craswell, *supra* note 286, at 83-84; Priest, *supra* note 236, at 1313 (contending that cost-justified warranty disclaimers and exclusions "can be said to be demanded by consumers because of the relative cheapness of consumer allocative investments or of self-insurance").

289 See Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053, 1071-76 (1977) (possession of market power will not alter content of manufacturer warranties).

290 Indeed, Professor Craswell suggests that monopolists might be *more* likely to offer efficient contractual terms, because such firms will not face marketplace rivals who "free ride" on their discovery and use of new contractual terms. See Craswell, *supra* note 286, at 86-87.

291 Professor Craswell has summarized this logic as follows:

[M]onopolists usually will not have an incentive to choose inefficient contract terms. The monopolist may have an incentive to charge a high price, of course, but this does not mean that she'll also have an incentive to distort any of the other contract clauses. If consumers know what the monopolist is doing—an important qualification . . . —then any attempt by the monopolist to insert an inefficient term will be seen by consumers as an increase in the 'total price' of the product . . . . But if the monopolist wants to exploit buyers, she can usually do better by raising the monetary price of the product, rather than by raising the 'total price' by using an inefficient contract term. The problem with raising the total price indirectly, by using an ineffi-

will only arise if firms face price ceilings or imperfect information.<sup>292</sup>

Of course, not all non-standard contracts involve express price differentials of the sort hypothesized by these models, though many do.<sup>293</sup> Take, for example, *Brown Shoe Co.*, where the Commission challenged Brown's contractual requirement that shoe stores purchase most of their shoe requirements from Brown.<sup>294</sup> Brown offered stores two options. First, stores could purchase Brown's shoes "free and clear," i.e., with no accompanying contractual restraint. Second, a firm could participate in Brown's franchise program and thus receive various benefits including discounts on certain shoes, insurance, below-cost outdoor neon signs, and similar assistance.<sup>295</sup> However, participation also obligated these dealers to concentrate their efforts on marketing Brown's products and to refuse to sell "conflicting lines"

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cient contract term, is that—by definition—an inefficient contract term hurts buyers by more than it helps the monopolist. By contrast, a higher monetary price helps the monopolist by exactly the same amount that it hurts the buyers: the amount of the higher price. This is why the monopolist will usually be better off exploiting buyers by charging a higher monetary price, rather than by inserting an inefficient contractual term.

Craswell, *supra* note 286, at 85; *see also* Schwartz, *supra* note 289, at 1072 ("If a monopolist's customers prefer to have warranties rather than disclaimers, and if these customers will pay the premium for additional warranty protection, the monopolist would be irrational not to offer a warranty. Offering only a disclaimer would cost him potential profits.").

292 *See supra* notes 106, 286–87.

293 *See, e.g.,* *IBM Corp. v. United States*, 298 U.S. 131, 134 (1936) (reporting that one customer obtained right to manufacture its own version of the tied product by paying a fifteen percent premium for the tying product); *FTC v. Sinclair Refining Co.*, 261 U.S. 463 (1923) (evaluating an arrangement whereby a refiner provided pumps at a discount on the condition that retail stations employ them exclusively with refiner's gasoline); *Acquaire v. Can. Dry Bottling Co. of N.Y.*, 24 F.3d 301 (2d Cir. 1994) (evaluating an agreement setting maximum prices for dealers that received promotional discounts from the manufacturer); *Shamrock Mktg., Inc. v. Bridgestone Bandag, LLC*, 777 F. Supp. 2d 972, 977, 980–81 (W.D. Ky. 2011) (describing and evaluating franchise program that provided discounts to franchisees that purchased materials supplied by the franchisor); *United States v. Am. Can Co.*, 87 F. Supp. 18, 24 (N.D. Cal. 1949) (describing requirements contracts and related discount program that "serves as an inducement for canners to purchase all of their needs from a single manufacturer"); *see also* *United States v. Loew's, Inc.*, 371 U.S. 38, 52, 54–55 (1962) (approving decree permitting film distributors to set prices reflecting cost reductions attributed to tying inferior films to popular films).

294 62 F.T.C. 679 (1963).

295 *Id.* at 687–89 (citing initial decision describing the benefits received); *id.* at 710 n.17 (incorporating this finding by reference); *id.* at 703 (describing reciprocal obligation to concentrate business in Brown's various shoe lines).

of shoes.<sup>296</sup> The Commission expressly found that these discounts induced participating franchisees to agree to restrictions on their purchasing freedom, restrictions that “foreclose[d]” rivals from selling to Brown’s dealers.<sup>297</sup> If such “line concentration” was justified, the Commission said, dealers would so-concentrate voluntarily, that is, without contractual requirement.<sup>298</sup>

Still, there are cases in which defendants “imposed” such agreements simply by refusing to deal with trading partners who decline to enter the exclusionary provision.<sup>299</sup> However, the absence of express price differentials in particular cases does not undermine the Coasean bargain model of contract formation. For one thing, an “outright refusal” may operate as a de facto price differential, if the purchaser can only obtain a substitute for the seller’s product elsewhere for a higher price.<sup>300</sup> Buyers would then face the following choice: purchase the high-priced substitute, or purchase the defendant’s product at a discount, accompanied by the exclusionary agreement. Moreover, a refusal to sell can be seen as the equivalent of offering to sell the underlying product without the offending provision, but at an infinite price.<sup>301</sup> Thus, the “price differential” model of contract formation describes a larger class of conduct than initially supposed.

Finally, exclusive focus on refusals to sell during a finite period ignores the temporal and evolutionary aspect of economic activity. The facts of a particular case are basically a “snapshot” of an economic process that continues to unfold over time in light of ever-changing conditions and stimuli. Struggling firms may employ non-standard contracts for good reasons in one period, only to “forget” a decade later why they adopted the practice.<sup>302</sup> Other firms may simply copy

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296 *Id.* at 703.

297 *Id.* at 709–17.

298 *Id.* at 709.

299 *See, e.g.,* *Atl. Ref. Co. v. FTC*, 381 U.S. 357 (1965); *Standard Oil Co. v. United States*, 337 U.S. 293 (1949) (analyzing exclusive dealing contracts apparently imposed in this manner).

300 *See Fortner Enters., Inc. v. U.S. Steel Corp.*, 394 U.S. 495, 503 (1969) (explaining that even a complete monopolist will lose some sales by raising his price).

301 *See* Meese, *Tying*, *supra* note 41, at 13.

302 *See* Easterbrook, *Limits of Antitrust*, *supra* note 52, at 5 (“Firms try dozens of practices. Most of them are flops, and the firms must try something else or disappear . . . . In a competitive struggle the firms that use the best practices survive. Mistakes are buried. Why do particular practices work? The firms that selected the practices may or may not know what is special about them. They can describe *what* they do, but the *why* is far more difficult.” (internal citation omitted)); Alan J. Meese, *Farewell to the Quick Look: Redefining the Scope and Content of the Rule of Reason*, 68 ANTITRUST L.J. 461, 485 (2000) (“Firms are simply collections of individuals, who adopt practices and then

successful rivals' practices. Antitrust litigation often arrives long after the parties have adopted a challenged contract, leaving tribunals and scholars to examine only *the result* of a bargaining process that took place years ago. In these circumstances, courts may have to guess just how defendants induced acceptance of such agreements in the first place.<sup>303</sup> Since antitrust law has not made anything turn on the existence of such differentials, but simply asserted that all such agreements are the result of coercion, it should be no surprise that differentials do not always reveal themselves in the records of particular cases.<sup>304</sup> Thus, the absence of an observed express differential in a given case could simply reflect an *outcome* of a continuous bargaining process that once included them.<sup>305</sup>

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move on—or retire. Efficient practices—and the firms that adopt them—will survive, even if firms cannot “remember” why they were adopted.”).

303 See *United States v. Dentsply Int'l, Inc.*, 399 F.3d 181, 185 (3d Cir. 2005) (reviewing policy in place for “more than fifteen years”); see also Alchian, *supra* note 285, *passim*; Easterbrook, *Limits of Antitrust*, *supra* note 52, at 5; Stigler, *Economies of Scale*, *supra* note 136, at 54–57 (discussing so-called “survivor principle”).

304 Cf. Oliver E. Williamson, *Allocative Efficiency and the Limits of Antitrust*, 59 AM. ECON. REV. 105, 113 (1969) (“[O]nce an economies defense is admitted in principle, incentives are set in motion to sharpen up the specification of economies of various sorts.”). It may also be the case that, after contemplating the prospect of offering two separate agreements, the proponent of an exclusionary agreement determines that its partners will always or almost always opt for one of them. If so, offering each option to all purchasers may not be cost-justified.

305 Importantly, background rules governing form contracting may reduce the likelihood that proponents of such agreements will expressly offer trading partners more than one contractual option. Once some parties agree to exclusive provisions, a seller that allows others to elect different provisions will not be able to represent that contracts containing exclusionary provisions are “standard” and thus will not be able to rely upon any presumption that its partners assented to these provisions. See RESTATEMENT OF CONTRACTS (SECOND) § 211. Without this presumption, the proponent seeking enforcement of the agreement will have to prove that the party to be bound was in fact aware of the provision and thereby subjectively assented to it. *Id.* Thus, allowing trading partners to choose between various contractual options may impose significant costs of bargaining and negotiation on proponents of such agreements. While such background rules are the product of state law and thus exogenous to antitrust law, they may well influence the manner in which negotiations play out, if not the content of bargains themselves. See COASE, *THE FIRM*, *supra* note 106, at 28 (noting that the law can “make transactions more or less costly by altering the requirements for making a legally binding contract”); Coase, *Institutional Structure*, *supra* note 198 at 717–18 (stating that background rules construct an institutional framework that impacts the allocation of resources).

C. *The Voluntary Formation of Anticompetitive Contracts*

TCE does not suggest that all non-standard agreements are beneficial and thus the result of the sort of “Coasean bargain” just described.<sup>306</sup> Nor does TCE purport to exclude the possibility that *some* such contracts are harmful and thus perhaps the result of the “exercise” of market power.<sup>307</sup> Thus, at the most, the analysis to this point would seem only to undermine a conclusive presumption that such agreements are the harmful result of market power. The analysis would not seem to establish a contrary presumption, namely, that such agreements are always or even *usually* the result of voluntary integration.

Still, realization that some exclusionary agreements produced benefits opened the door to a larger reconsideration of the impact of such contracts. Indeed, just as TCE was achieving its status as an alternative paradigm, scholars were reconsidering the harmful potential of non-standard agreements. These scholars noted that many supposed instances of “abuse” of market power to obtain more arose in markets whose structure precluded this strategy.<sup>308</sup> They also conceded the

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306 *But cf.* WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 28 (articulating a rebuttable presumption that non-standard agreements are beneficial methods of reducing transaction costs); WILLIAMSON, *MARKETS*, *supra* note 197, at 20 (arguing for such a presumption); Meese, *Rule of Reason*, *supra* note 74, at 99–101 (explaining how current structure of Rule of Reason analysis rests upon the assumption that restraints that avoid per se treatment are in fact beneficial, subject only to contrary proof by a plaintiff).

307 *See supra* notes 214–221 and accompanying text (explaining how proponents of TCE have articulated a *rebuttable* presumption that non-standard agreements have efficiency purposes).

308 Two cases involving the Brown Shoe Company exemplified this insight. In the first, *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962), the Department of Justice successfully challenged Brown’s acquisition of Kinney corporation and its retail outlets, because the transaction supposedly “foreclosed” Brown’s rivals from access to Kinney’s outlets. In fact, the merger foreclosed less than five percent of the retail market. *Id.* at 327. Second, in *Brown Shoe Co., Inc.*, 62 F.T.C. 679 (1963), the Commission challenged a non-exclusive dealing arrangement between Brown Shoe and one percent of the nation’s shoe dealers, because the arrangement “foreclosed” other manufacturers from selling their products to such dealers. The Supreme Court agreed with the Commission, finding that the arrangement offended the “central policy” of the Sherman Act and violated § 5 of the FTC Act. *FTC v. Brown Shoe Co.*, 384 U.S. 316, 320–21 (1966). Scholars subsequently pointed out that the absence of market concentration undermined any claim that the merger or arrangements with dealers were efforts to obtain or maintain market power. For these scholars, the absence of plausible anticompetitive harm prompted an inference that the restraints produced competitive benefits. *See* BORK, *ANTITRUST PARADOX*, *supra* note 151, at 205 (contending that a trend toward concentration in an unconcentrated market “indicates that there are emerging efficiencies or economics of scale”); *id.* at 302–303

insights of TCE, namely, that some such restraints produced benefits.<sup>309</sup> At the same time, these scholars rejected Chicago's broad-brushed attack on the "abuse of power" test.<sup>310</sup>

If some such agreements produced benefits, and many produced no harm, antitrust law would need a more discerning method for distinguishing harmful agreements from those that produced benefits.<sup>311</sup> The result was the so-called "raising rivals costs" (RRC) paradigm. RRC did not question TCE's conclusion that non-standard agreements could rearrange property rights and contractual obligations and thus maximize the joint welfare of the parties to them.<sup>312</sup> Instead, RRC purported to explain how these rearrangements could sometimes interfere with rivals' access to inputs, raise the costs of those third parties, and thereby confer market power on the proponent of such an agreement.<sup>313</sup> Take exclusive dealing contracts. While dealers ordinarily have the right to sell the goods of as many manufacturers as they please, such agreements obligate the dealer to distribute the goods of a single manufacturer, to the exclusion of others. By depriving rival manufacturers of access to low-cost distribution of their products, it was said, the proponent of such agreements could force rivals to employ more costly distribution techniques, including less efficient dealers, thereby raising rivals' costs and prices and allowing the proponent to exercise market power by pricing above its own lower costs.<sup>314</sup>

The RRC paradigm did not conclude that all "exclusionary agreements" are plausible cost-raising strategies. Instead, a successful RRC strategy required the coincidence of several restrictive necessary conditions, a coincidence that proponents of RRC admitted was relatively

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(explaining how exclusive dealing contracts could not produce anticompetitive harm given trivial portion of market's dealers bound by such restraints); POSNER, *supra* note 52, at 204 (concluding that exclusive leasing provision could not be anticompetitive and thus likely produced efficiencies).

309 See Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209, 228–29, 277–80 (1986) [hereinafter Krattenmaker & Salop, *Anticompetitive Exclusion*].

310 See *supra* notes 54–57 and accompanying text.

311 See *Mytinger & Casselberry, Inc.*, 57 F.T.C. 717, 741–42 (1960) (declaring exclusive arrangements between manufacturer and door-to-door salesmen a violation of § 3 of the Clayton Act).

312 See *supra* note 194 and accompanying text (explaining this conclusion of TCE).

313 See Krattenmaker & Salop, *Anticompetitive Exclusion*, *supra* note 309; Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983).

314 See Krattenmaker & Salop, *Anticompetitive Exclusion*, *supra* note 309, at 223–27; *id.* at 226 (explaining how retail distribution can best be viewed as an input in the overall process of manufacture and distribution).

rare.<sup>315</sup> Indeed, proponents of RRC took issue with several inhospitality era decisions condemning exclusionary agreements, conceding that many such agreements could reduce transaction costs without creating harm.<sup>316</sup>

In any event, RRC did not undermine the Coasean account of contract formation sketched above or otherwise suggest that harmful contracts are imposed via market power. In fact, RRC theory was self-consciously addressed to situations in which proponents of agreements did *not* possess preexisting market power, but instead employed such agreements *to obtain* power.<sup>317</sup> In this way, these scholars avoided the Chicago critique, described earlier, that a firm with monopoly power could not use that power to obtain additional monopoly profits.<sup>318</sup>

However, RRC theorists have not explained how parties obtain agreement to harmful exclusionary rights contracts. The chief proponents of the RRC paradigm, Professors Krattenmaker and Salop, have divided market power into two varieties: "Bainian power," *viz.*, power that a restraint *creates* by raising the cost that some market participants pay for inputs, and "Stiglerian" power, *i.e.*, the preexisting power a firm might possess independent of any restraints, perhaps because economies of scale result in concentration and barriers to entry.<sup>319</sup> Exclusionary rights contracts, they say, create the former, Bainian power. At the same time, Professors Krattenmaker and Salop have repeatedly emphasized that firms need not possess preexisting Stiglerian power to obtain such agreements, without explaining how a firm without power can induce acceptance of them.<sup>320</sup>

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315 *Id.* at 223–30 (describing various conditions necessary for a successful raising rivals' costs strategy); *id.* at 267 ("Certainly, in most industries, exclusionary rights contracts cannot be profitably employed for anticompetitive ends."); *cf.* B. F. Goodrich Co., 110 F.T.C. 207 (1988) (rejecting proposed enforcement action against vertical merger because conditions outlined by raising rivals' costs paradigm were not met).

316 See Krattenmaker & Salop, *Anticompetitive Exclusion*, *supra* note 309, at 228–29.

317 *Id.* at 248–49; *id.* at 251 ("[A] firm need not enjoy or acquire traditional market power to gain the ability to price above pre-exclusionary-rights competitive levels."); Thomas G. Krattenmaker et al., *Monopoly Power and Market Power in Antitrust Law*, 76 GEO. L.J. 241 (1987) (distinguishing between preexisting "Stiglerian" power and "Bainian" power created by restraints that raise rivals' costs).

318 See *supra* Part II.D.

319 See Krattenmaker, *supra* note 317, at 249; see also GEORGE J. STIGLER, *THE THEORY OF PRICE*, 195–99 (3d ed. 1966).

320 See Krattenmaker & Salop, *Analyzing Anticompetitive Exclusion*, 56 ANTITRUST L.J. 71, 79 (1987); Steven C. Salop & R. Craig Romaine, *Preserving Monopoly: Economic Analysis, Legal Standards, and Microsoft*, 7 GEO. MASON. L. REV. 617, 626–28 (1999) (endorsing result in *Eastman Kodak*).

Moreover, nothing about the possession of Stiglerian power *prevents* firms from employing exclusionary rights agreements to obtain Bainian power. For instance, technological conditions that once raised entry barriers and conferred Stiglerian power could change, leaving a firm facing the prospect of stiffer competition.<sup>321</sup> A firm might then obtain an exclusionary rights contract from various customers and/or input suppliers, preserving its market power.<sup>322</sup> Certainly *these* agreements involve the “use” of (preexisting, Stiglerian) market power to impose them.<sup>323</sup>

Actually, they do not. Instead, parties can form such agreements in exactly the same way that firms form agreements that reduce transaction costs, i.e., by employing cost-based price differentials to induce their acceptance. To understand how, assume for a moment that a firm without market power hopes to achieve it by employing exclusive dealing contracts to raise rivals’ costs and thereby obtain market power.<sup>324</sup> The firm could proceed in the following manner. First, it could offer to sell the product to dealers with no accompanying contractual restraint, charging the ordinary, profit-maximizing price. The firm could also offer to sell the product to dealers at a discount, if the dealer enters an exclusive dealing arrangement.

This differential could induce dealers to accept the exclusive dealing arrangement, even if they might otherwise prefer to retain their autonomy. To be sure, this differential “looks like” the differential that price theorists attributed to an exercise of market power.<sup>325</sup> Still, by hypothesis, the firm in question has no such power, but instead merely possesses the “power” possessed by all firms, that is, the

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321 For instance, technology could change, reducing the minimum viable scale required for profitable production. Or, market demand could expand sufficiently, increasing sales available to a new entrant, thereby rendering such entry profitable. See DEPARTMENT OF JUSTICE & FEDERAL TRADE COMMISSION, HORIZONTAL MERGER GUIDELINES § 3.3 (1992) (detailing link between concept of minimum viable scale and prospect of new entry); STIGLER, *THE THEORY OF PRICE*, *supra* note 319, at 220–23.

322 See Richard A. Posner, *Keynote Address: Vertical Restrictions and “Fragile” Monopoly*, 50 ANTITRUST BULL. 499, 501–02 (2005) (explaining via example how a monopolist might be willing to offer discounts to secure exclusive dealing arrangements if its monopoly became fragile).

323 See *Eastman Kodak v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992) (finding that monopolist had violated § 2 by “using” monopoly power via tying contracts).

324 See Krattenmaker & Salop, *Anticompetitive Exclusion*, *supra* note 309, at 223–27.

325 See *supra* note 45 and accompanying text.

“power” to exclude others from its property, and thus the “power” to make contracts that bind trading partners in future periods.<sup>326</sup>

The price differential just described, then, simply reflects the relative costs (to the manufacturer) of the two arrangements. By declining to include the exclusive dealing arrangement in the first class of contract, the firm incurs an opportunity cost, namely, the additional (supracompetitive) profits that it could have earned had it entered contracts raising its rivals’ costs.<sup>327</sup> From the firm’s perspective, this cost is indistinguishable from any other cost, be it a production cost or the cost of opportunism.<sup>328</sup> Thus, the price differential inducing acceptance of such agreements reflects a cost-based distinction between the two contracts and thereby entails voluntary integration.<sup>329</sup>

The proponent of the agreement may hope to achieve market power in the next period, and the premium it will charge for sales unencumbered by an exclusive dealing contract will reflect the expected value of that power. Still, this expectation may not be realized. Moreover, the mere fact that a firm engages in certain conduct in the *hope* of achieving market power does not render that conduct an *exercise* of power that may never be achieved. For instance, a firm might construct a large factory, hoping to realize economies of scale, driving rivals from the market, and obtaining market power.<sup>330</sup> The firm might even pay a premium price for the inputs needed to construct the factory, hoping to speed their delivery or preempt rivals.<sup>331</sup> No one could assert, however, that the construction of the factory or payment of a premium constitutes an “exercise” of market power anal-

326 See Hayek, *supra* note 85, at 110–16 (contending that well-functioning competitive order depends upon properly-designed “legal framework” of contract, property, tort and business law).

327 See *supra* Part III.C.

328 See Coase, *Problem of Social Cost*, *supra* note 270, at 40–43 (contending that decision-makers take opportunity costs into account when evaluating the impact of alternative arrangements).

329 See Meese, *Antitrust Balancing*, *supra* note 59, at 146–48 & n.170 (contending that franchisees will not object to exclusionary rights contracts creating market power because franchisor will share the fruits of such power with them); Alan J. Meese, *Exclusive Dealing, The Theory of the Firm, and Raising Rivals’ Costs: Toward a New Synthesis*, 50 ANTITRUST BULL. 371, 408–409 (2005) [hereinafter Meese, *Exclusive Dealing*] (explaining that RRC paradigm suggests that exclusive dealing contracts raising rivals’ costs are purely voluntary).

330 See *supra* notes 256–58 and accompanying text (explaining that such conduct is lawful under § 2).

331 Cf. *Bon-Ton Stores, Inc. v. May Dep’t Stores Co.*, 881 F. Supp. 860 (W.D.N.Y. 1994) (evaluating failed bidder’s challenge to dominant firm’s prevailing bid to purchase and merge with rival and thus allegedly fortify market power).

ogous to output restriction and above-cost pricing. Indeed, courts and scholars who have distinguished between “competition on the merits,” on the one hand, and the “use” or “exercise” of market power on the other have expressly held that the realization of economies of scale is the quintessential example of the former and beyond the scope of antitrust regulation.<sup>332</sup>

To be sure, dealers or other parties may “prefer” not to be bound by such agreements, *other things being equal*.<sup>333</sup> One might therefore say that such contracts are imposed against their “will.”<sup>334</sup> Indeed, this is the rationale for the Supreme Court’s refusal to recognize the defense of *in pari delicto* in the supplier/dealer context.<sup>335</sup> Still, one could say the same thing about any number of agreements that bind dealers or others in subsequent periods. For instance, a franchisee that agrees to an exclusive territory may later wish to sell outside that territory.<sup>336</sup> Or, a consumer who purchases a thirty-six-month warranty may “prefer” a longer warranty when her car breaks down forty-two months later. However, neither the franchisee nor the consumer paid for the terms they now desire, and the subsequent creation of new terms would simply countenance opportunistic behavior against the manufacturer or franchisor.<sup>337</sup> Here again, consideration of the entire contract—terms *plus* associated price—brings things into proper focus.<sup>338</sup> Enforcement of an exclusionary rights agreement is no more “coercive” than the enforcement of other garden-variety contractual term.

Far from being victims of coercion, input suppliers who are parties to exclusionary rights agreements are best viewed as willing par-

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332 See *Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 274 (2d Cir. 1979) (“A firm that has lawfully acquired a monopoly position is not barred from taking advantage of scale economies by constructing, for example, a large and efficient factory. These benefits are a consequence of size and not an exercise of power over the market.”).

333 See *Perma Life Mufflers, Inc. v. Int’l Parts Corp.*, 392 U.S. 134, 138 (1968) (describing how dealers who reaped “enormous profits” from franchise opportunity nonetheless challenged portions of the franchise agreement).

334 See *supra* notes 253–55 and accompanying text.

335 See *Perma Life*, 392 U.S. at 140–41 & n.5 (contending that the plaintiff dealers would not voluntarily agree to restrictions preventing them from purchasing inputs from the cheapest source available at any given moment).

336 See *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 39–40 (1978) (detailing dealer’s decision to open new store in different city in contravention of location clause).

337 See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 105, at 371 (observing that the desire to “have your cake (low price) and eat it too (no restrictions)” is inconsistent with the theory and practice of contract).

338 See *supra* notes 264–69 and accompanying text.

ticipants who may benefit handsomely from a successful RRC strategy.<sup>339</sup> Recall in this connection that dealers, for instance, receive a discount from the manufacturer for participating in the scheme. This discount compensates the dealer, who begins with the right to supply distribution services to *any* manufacturer, for conveying a portion of that property right to the manufacturer orchestrating the RRC scheme. By paying dealers a premium for such rights, putative predators basically share *expected* monopoly profits. Indeed, it seems entirely possible that dealers, and not the predator, will reap most of the rewards from such agreements given that they, and not the predator, possess the initial right to exclude that forms the basis for the exclusionary rights strategy. This conclusion follows from a corollary of the Coase Theorem: absent transaction costs, the initial allocation of a right has no impact on its ultimate allocation but *does* impact the distribution of income between parties that bargain over it.<sup>340</sup> Indeed, in some cases, input suppliers might credibly threaten to “hold out,” thwarting the scheme altogether or charging exorbitant prices for such exclusionary rights.<sup>341</sup>

Thus, it seems, participants in exclusionary rights agreements are analogous to participants in horizontal cartels who collectively set output and divide the profits among themselves.<sup>342</sup> These cartelists, of course, are behaving in a purely voluntary manner, lured simply by the prospect of higher than normal profits.<sup>343</sup> Participation in a raising rivals’ costs scheme is equally voluntary and not the result of “coercion.”<sup>344</sup> Moreover, unlike the market power model, this insight

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339 Cf. Wiley, *Prisoner's Dilemma*, *supra* note 112, at 1906–07 (explaining that consumer-harming cartels are the result of voluntary cooperation between rivals).

340 See Coase, *supra* note 270, at 5 (explaining that initial allocation of entitlements will impact the relative income of bargaining parties).

341 See Thomas G. Krattenmaker & Steven C. Salop, *Competition and Cooperation in the Market for Exclusionary Rights*, 76 AMER. ECON. REV. 109, 111–12 (1986) (explaining how input suppliers might have incentive to “hold out” and thereby thwart raising rivals’ costs scheme).

342 See Herbert Hovenkamp, *Mergers and Buyers*, 77 VA. L. REV. 1369, 1376–77 (1991) (persuasively contending that customers and suppliers can cooperate to create and share monopoly profits); Wiley, *Prisoner's Dilemma*, *supra* note 112, at 1906–07 (explaining how participation in a cartel is generally voluntary).

343 See Wiley, *Prisoner's Dilemma*, *supra* note 112, at 1906–07.

344 See generally Meese, *Antitrust Balancing*, *supra* note 59, at 146 (explaining how franchisees would eagerly cooperate in a successful raising rivals’ cost scheme). See also Meese, *Exclusive Dealing*, *supra* note 329, at 409; Elhauge, *supra* note 9, at 340–41. It should be noted that Professor Elhauge’s conclusion that dealers will not oppose certain raising rivals’ costs schemes depends upon the (plausible) claim that collective action problems will thwart dealers’ efforts to resist efforts by upstream firms to raise their rivals’ costs. However, even if one assumes that dealers could overcome such

explains findings, such as those in *Perma Life*, that those bound by exclusionary rights agreements will enthusiastically participate in such schemes in pursuit of “enormous profits.”<sup>345</sup> While input suppliers may at some point resist enforcement of a particular exclusionary rights provision, such resistance does not suggest that such agreements are coercive. Instead, such resistance suggests that dealers or other participants are trying to “have their cake and eat it too,” i.e., reap the benefits (initial lower prices for the manufacturer’s product and higher downstream prices) without any restriction on their autonomy. In the same way members of a cartel agree to reduce their respective levels of output and drive up price. Having done so, each cartel member has an individual incentive to secretly increase its output, so as to reap an undue share of the benefits of collusive output reduction.

#### IV. IMPLICATIONS FOR ANTITRUST DOCTRINE

The recognition that most plausible instances of non-standard contracts—whether beneficial or not—involve voluntary integration has significant implications for antitrust doctrine, as explained below. In particular, courts and the enforcement agencies should adjust all aspects of this doctrine so as to eliminate explicit or implicit reliance upon the notion that firms with market power “use” that power to impose non-standard agreements. The following subsections outline what direction such reform should take.

##### A. Monopolization

As explained earlier, significant § 2 decisions rest upon the premise that firms with monopoly power employ that power to coerce dealers and consumers to accept non-standard contracts such as tying and exclusive dealing agreements.<sup>346</sup> Indeed, some courts have opined, albeit in dicta, that the existence of such agreements itself implies the presence of monopoly power.<sup>347</sup> To be sure, modern courts allow defendants to offer justifications for such agreements,

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collective action problems, they may still voluntarily participate in a scheme whereby the manufacturer forces rivals to raise the prices they charge consumers, thereby conferring market power on the manufacturer and its dealers. The manufacturer could then share this power with dealers by setting its price somewhere between the competitive and monopolistic level, thereby ensuring that both manufacturer and dealers earn higher margins than before the scheme.

<sup>345</sup> See *supra* notes 61–64, and 333 and accompanying text.

<sup>346</sup> See *supra* Part I (summarizing these decisions).

<sup>347</sup> See *supra* notes 11, 185 and accompanying text.

thereby avoiding automatic condemnation. Still, the standards that courts employ when considering such justifications rest upon the implicit assumption that any such benefits coexist with some harm, apparently the exercise of power to impose the agreements in the first place.<sup>348</sup>

Recognition that firms need not employ “power” to impose such agreements requires courts to revamp this test from the ground up. For one thing, the mere existence of an agreement does not suggest that the firm “imposing” it possesses market power. Moreover, proof that a monopolist has entered a non-standard agreement does not justify any presumption that the contract is the result of an “exercise” or “use” of such power or otherwise warrant a requirement that a defendant offer evidence explaining or justifying such an agreement. Instead, courts should require plaintiffs to show that the challenged agreement actually produces economic harm by raising rivals’ costs and thereby protecting or enhancing the monopolist’s power over price. In so doing, plaintiffs should have to establish the several necessary conditions for such a strategy to be successful.<sup>349</sup> Absent such proof, any challenge to such agreements should fail. Moreover, if courts nonetheless allow such challenges to proceed, they should alter the manner in which they currently evaluate defendants’ claims that such agreements produce benefits. In particular, courts should not assume that such benefits coexist with harms in the form of an “exercise” of monopoly power employed to impose the agreement. Instead, proof that the restraint produces benefits should undermine entirely any presumption that a seller has “used” power to impose an agreement on unwilling purchasers or suppliers and thus itself end any case premised upon a claim that a defendant “used” power to impose such an agreement.<sup>350</sup>

### B. Tying

Under current law, tying contracts are unlawful per se if the proponent of the agreement possesses economic power in the market for the tying product.<sup>351</sup> The “per se” rule rests upon the assumption that firms with market power use that power to coercively force such agree-

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348 See *supra* note 59 and accompanying text.

349 See *supra* note 315 and accompanying text (collecting authorities detailing necessary conditions for success of raising rivals’ costs strategy).

350 Cf. Meese, *Rule of Reason*, *supra* note 74, at 145–67 (explaining how proof that a restraint produces significant benefits undermines presumption arising under current law that restraint produces anti-competitive effects).

351 See *supra* Part I.B (articulating tying doctrine and its rationale).

ments on unwilling purchasers. At the same time, neither courts nor commentators who support the per se rule have offered any explanation of how firms without market power obtain such agreements. While a few lower courts have allowed defendants to justify such agreements, the standards governing such justifications rest upon the assumption that any benefits produced by such agreements necessarily coexist with the “harm” that courts irrebuttably presume once the plaintiff proves that proponents of the agreement possess market power.<sup>352</sup>

The recognition that such agreements may well be examples of voluntary integration entirely undermines current law and the presumption of “coercive forcing” on which it rests. Many such agreements reduce transaction costs and produce efficiencies, even if the proponent of the agreement possesses market power. Moreover, while firms might theoretically employ market power to impose such agreements, there is no reason to assume that they will in fact do so.

As a result, courts should reject the per se rule against tying contracts announced during the Harvard-inspired inhospitality era. Mere proof that a firm that obtains a tying contract possesses market power simply does not suffice to establish that the agreement produces anticompetitive harm. Instead, courts should analyze such contracts under the Rule of Reason, as they do with other agreements. In particular, courts should examine whether such agreements significantly raise the costs of the proponent’s rivals by, for instance, depriving independent suppliers of substitutes for the tied product of sufficient scale to realize efficiencies.<sup>353</sup> Plaintiffs that cannot establish the necessary conditions for a raising rivals’ costs strategy should see their cases bounced out of court. Moreover, establishing these conditions would not entitle plaintiffs to judgment. Instead, such a prima facie case would simply shift the burden to the defendant to bring forward evidence that in fact, the restraint produced benefits by, for instance, reducing the costs of transacting.

It should be emphasized that, under the approach offered here, market power over the tying product would not be a *necessary* condition for liability, either, as some jurist and scholars, particularly those associated with the Chicago School, have suggested.<sup>354</sup> Instead, as explained earlier, a firm with no preexisting market power can adopt

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352 See *supra* note 59 and accompanying text.

353 See Meese, *Antitrust Balancing*, *supra* note 59, at 145–48 (describing how such a strategy could theoretically succeed in the franchising context).

354 See *supra* notes 51–52 and accompanying text (collecting authorities contending that proof of preexisting market power should be a necessary condition for liability under the Rule of Reason, including where tying contracts are concerned).

agreements that raise the rivals' costs and therefore create market power that did not previously exist.<sup>355</sup> Thus, contrary to the suggestions of some, the mere absence of market power in the tying product market should not preclude a plaintiff from establishing that the restraint produces harms greater than any offsetting benefits.<sup>356</sup> In the same way, a plaintiff challenging an exclusive dealing agreement should not be required to show that the proponent of such an agreement, say a manufacturer, possesses preexisting power over its product market.

### C. *In Pari Delicto*

At common law, plaintiffs who were parties to anticompetitive or otherwise illegal agreements were barred from challenging such contracts on the grounds that plaintiffs were themselves equally at fault for the existence and enforcement of the agreement.<sup>357</sup> However, more than four decades ago, the Supreme Court reversed course, holding that a plaintiff could challenge an agreement to which it was a party if the negotiation of the agreement was not voluntary, that is, if the defendant employed economic power to coerce or compel the plaintiff into entering the agreement.<sup>358</sup> In such cases, the Court said, plaintiffs should be perfectly free to challenge these agreements and recover whatever damages they might have suffered as a result of their enforcement.<sup>359</sup> This exception to the *in pari delicto* doctrine quite obviously rested upon the assumption that defendants sometimes employ preexisting market power to coerce or force plaintiffs into entering agreements they otherwise would not have entered. The quintessential example of such purported coercion was a manufacturer's "use" of market power to "force" dealers to enter exclusive dealing or tying contracts.<sup>360</sup>

TCE undermines the economic premises that informed the "coercion" exception to the *in pari delicto* defense. In particular, proponents of TCE contend, and with good reason, that most non-standard agreements are purely voluntary methods of reducing the (transaction) costs of relying upon the market to conduct economic

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355 See *supra* notes 317–18 and accompanying text; see also Meese, *Antitrust Balancing*, *supra* note 59, at 145–48 (explaining how raising rivals' costs strategy can succeed in the franchising context despite absence of preexisting market power).

356 See *supra* notes 317–18 and accompanying text.

357 See *supra* note 60 and accompanying text.

358 See *supra* notes 61–71 and accompanying text.

359 See *Perma Life Mufflers, Inc. v. Int'l Parts Corp.*, 392 U.S. 134, 138–41 (1968).

360 See *supra* note 35 and accompanying text.

activity.<sup>361</sup> In these circumstances, then, there is simply no basis for concluding that defendants have forced plaintiffs to enter such agreements. One would hope, of course, that agreements that in fact reduce such costs would survive Rule of Reason scrutiny, thereby eliminating the necessity of any such defense in the first place. Nonetheless, even in this class of cases, the availability of such a defense to *any* challenge to non-standard agreements could reduce the cost of litigation by obviating the need for a fact-intensive analysis of such agreements to determine whether, in fact, they produce more benefits than harms.

To be sure, TCE does not teach that *all* non-standard agreements are methods of reducing transaction costs. Instead, the so-called “raising rivals’ costs” school contends that such agreements can, in narrow circumstances, be methods of denying rivals access to reasonably-priced inputs, thus raising those rivals’ costs and conferring market power on the proponent of the agreement.<sup>362</sup> While such agreements may appear to be the result of market power, close analysis suggests that they are instead the result of purely voluntary integration, to wit, a process of contract formation whereby the proponent of the agreement offers the input supplier a discount if it agrees to the exclusive arrangement, thereby sharing expected market power with the supplier.<sup>363</sup> Thus, such agreements are no more “coercive” than a garden-variety cartel agreement, whereby rivals voluntarily decide to reduce output and thus collectively exercise market power.

In the end, then, TCE, combined with raising rivals’ costs theory, entirely undermines the economic premises that animate the “coercion” exception to the *in pari delicto* defense. Moreover, the interpretation of harmful agreements as purely voluntary suggests that failure to recognize such a defense may actually encourage the formation of such agreements in the first place. That is to say, input suppliers faced with the option of entering such agreements may view assent to such contracts as a “win win” situation.<sup>364</sup> If the agreement “works out,” in the sense of conferring shared market power on the parties, the supplier will prosper. If, on the other hand, the agreement does not confer market power, or if the supplier believes that it has received an unfairly modest share of that power, the supplier can chal-

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361 See *supra* note 306 and accompanying text.

362 See *supra* notes 309–29 and accompanying text.

363 See *supra* Part III.C.

364 See Alan J. Meese, *Property, Aspen, and Refusals to Deal*, 73 ANTITRUST L.J. 81 (2005).

lenge the agreement in court, hoping at least to obtain some damages (or a settlement) to compensate it for any loss it has suffered.

None of this is to say that courts should *necessarily* invoke the defense to bar any and all actions challenging contracts a party has entered. There may well be other reasons for allowing such actions, even if a plaintiff voluntarily entered an agreement. The argument here is much narrower, *viz.*, that courts should not premise a rejection of the *in pari delicto* defense upon an assumption that plaintiffs entered such agreements involuntarily.

#### CONCLUSION

Several antitrust doctrines rest upon a “market power” model of contract formation, i.e., the assumption that firms employ preexisting economic power to coerce dealers and consumers to enter non-standard agreements. This Article has shown that the “market power” model derives from neoclassical price theory and its workable competition model, both of which heavily influenced antitrust law and scholarship during antitrust’s inhospitality era. Application of the workable competition model in particular led scholars and courts to conclude that non-standard agreements produced no benefits and that firms used preexisting market power to impose them.

More recently, transaction cost economics has emerged as a competitor to workable competition as a method of explaining the origin and impact of non-standard agreements. TCE concludes that such agreements are presumptively methods of voluntarily rearranging property rights and thus reducing the cost of transacting, that is, relying upon the private market to conduct economic activity. Such contracts are not “imposed” on dealers or consumers, but are instead the result of purely voluntarily bargaining, whereby proponents of such agreements offer dealers and consumers cost-justified discounts to induce them to assent to non-standard provisions.

TCE does not deny that some non-standard agreements can be anti-competitive. Still, even agreements that raise rivals’ costs and confer market power on their proponents are the result of purely voluntary contractual integration that rearranges property rights to achieve this result. Thus, there is simply no reason to premise any antitrust tests upon a search for a “use” of monopoly or market power to “impose” such agreements on unwilling purchasers. Courts that in fact articulate and apply such tests are looking for a phenomenon that does not exist, at least in any sense relevant to the antitrust laws. Doctrines that rest upon the “market power” model of contract formation must be discarded.