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1975

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#### Recommended Citation

Richard A. Posner, "Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions," 75 *Columbia Law Review* 282 (1975).

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# ANTITRUST POLICY AND THE SUPREME COURT: AN ANALYSIS OF THE RESTRICTED DISTRIBUTION, HORIZONTAL MERGER AND POTENTIAL COMPETITION DECISIONS

RICHARD A. POSNER\*

There has been little systematic examination and appraisal of the Supreme Court's performance in the antitrust field. Although individual decisions, and sometimes doctrines, are analyzed exhaustively, it is rare for anyone to step back and examine the entire field—or at least some large part of it—for the purpose of answering the question whether the Court is discharging satisfactorily its responsibility for soundly interpreting and applying the antitrust laws.<sup>1</sup> This article is an attempt to correct that neglect.

One can define judicial rulemaking as "satisfactory" if two conditions are met: the rules must (1) have a coherent theoretical basis and (2) be reasonably precise and objective in the sense of limiting the discretion of judges to decide cases according to purely personal values or preferences. As to (1), it is not my position in this article that the only acceptable basis for an antitrust rule is economic theory; I ask only that the rule be consistent with some general theory of antitrust liability.

These conditions are surely not excessively demanding, and one can fairly say of a court that does not fulfill them that it is failing to do its job—as distinct from simply disagreeing with its critics' views of law and public policy. But this minimum test of judicial adequacy the Supreme Court has, in my opinion, flunked in the antitrust field (which is not to say that the Justices bear sole or primary responsibility for the Court's failure). I shall attempt to substantiate this criticism by reference to the major areas of antitrust in which the Court has been most active in recent years—manufacturers' restrictions on the distribution of their goods, and mergers between competing or potentially competing firms. These are not the least satisfactory areas of the Court's recent antitrust jurisprudence,<sup>2</sup> but simply the busiest ones.

What follows may at times seem to be, but is not intended as, a criticism

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1. Levi & Director, *Law and the Future: Trade Regulation*, 51 Nw. U.L. REV. 281 (1956); Kauper, *The "Warren Court" and the Antitrust Laws: of Economics, Populism, and Cynicism*, 67 MICH. L. REV. 325 (1968), come perhaps closest to the kind of general evaluation of the Court's antitrust jurisprudence that I have in mind here.

2. The least satisfactory areas are probably tie-ins and price discrimination. See *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 U.S. 495 (1969), discussed in Dam, *Former Enterprises v. United States Steel: "Neither a Borrower, Nor a Lender Be"*, 1969 SUP. CT. REV. 1; *Utah Pie Co. v. Continental Baking Co.*, 386 U.S. 685 (1967), discussed in R. POSNER, *ANTITRUST: CASES, ECONOMIC NOTES, AND OTHER MATERIALS* 747-48 (1974).

of the "Warren Court." Although most of the decisions to be discussed were decided during Chief Justice Warren's tenure, not all were by any means; and we shall see that the Court's difficulties in formulating coherent theories of antitrust liability, particularly in the area of restrictions on distribution, long antedate the Warren Court and do not appear to be a matter of the accidents of judicial appointment. The last part of the Article is a tentative inquiry into the reasons for the Court's poor showing.

## I. THE DISTRIBUTION CASES

### A. *Why Manufacturers Restrict Distribution*

In the absence of an antitrust prohibition it is common for manufacturers to restrict competition among the dealers (or other distributors) of their products. At first glance such behavior seems irrational. The difference between the price at which the manufacturer sells to the dealer and the dealer's price to the consumer is the manufacturer's cost of distribution,<sup>3</sup> and any seller (even a monopolist) wants to minimize his costs. Looked at another way, a higher retail price reduces the demand for the manufacturer's good, and so his sales revenues, without benefiting him in any way.<sup>4</sup> One would have supposed, therefore, that the manufacturer would seek to encourage rather than restrict competition among his dealers, in order to minimize the retail price of his product.

Why, then, do manufacturers in fact often restrict competition among their dealers? Economic analysis suggests two possible answers (I am not aware of any other form of analysis that suggests an answer to this question). One is that the manufacturer is the cat's paw of cartelizing dealers. The dealers want to fix prices, and they somehow coerce or otherwise enlist the manufacturer (perhaps they pay him) to act as their agent in administering the cartel. He does this either by fixing a uniform retail price for his goods or by assigning non-overlapping sales territories to the dealers.<sup>5</sup>

The other possible reason for a minimum retail price is that the manufacturer wants to increase the amount of nonprice competition among his dealers in order to stimulate the provision of point-of-sale services in the distribution of his product.<sup>6</sup> Perhaps the product cannot be marketed effec-

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3. For the sake of simplicity, I shall assume a simple two-tiered distribution system in which manufacturer sells directly to retailer.

4. To illustrate, suppose that the price to the dealer is \$5, and the retail price is \$7 if the dealers compete and \$10 if they do not. In both cases the manufacturer receives \$5 but in the former he sells more units since consumers will purchase a larger quantity of a product when it costs them \$7 than when it costs them \$10.

5. Presumably the dealers do this with all manufacturers of the product. Otherwise the principal effect of the cartel price would be to induce consumers to substitute another manufacturer's brand, for while there are some differences among competing brands of the same product, they are by definition very close substitutes for one another (the term "product" implies a grouping of close substitutes).

6. See Telsler, *Why Should Manufacturers Want Fair Trade?*, 3 J. LAW & ECON. 86 (1962).

tively unless the dealer maintains an elaborate showroom, a large inventory, a repair service, a trained sales force, etc. If the manufacturer fixes a minimum resale price that exceeds the cost of reselling his product without any point-of-sale services, and nonprice competition among the dealers is not constrained, the dealers will step up such competition among themselves—that is, they will increase the provision of point-of-sale services—in an effort to engross as much as possible of the difference between the retail price (which is fixed) and the (old) cost of distribution. They will continue spending more and more money on nonprice competition until the marginal cost of distribution has risen to meet the resale price. When that point is reached, the retailers will not be receiving any monopoly profits; instead they will be furnishing the level of services desired by the manufacturer. Given effective nonprice competition among the dealers, the level at which the manufacturer pegs the retail price above the cost of bare-bones distribution will automatically determine the level of retailers' services that his pricing policy will evoke.<sup>7</sup>

The reader may object that the manufacturer's method of obtaining point-

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7. This result is illustrated in Figure 1.  $P$  is the retail price set by the manufacturer, and  $C$  the marginal cost of distribution without point-of-sale services. The retailers compete among themselves by expending resources on the provision of point-of-sale services, thereby increasing both the cost of distribution and the demand for the product. Equilibrium is reached at  $q'$ , where the marginal cost of distribution ( $C'$ ) intersects the new demand curve ( $dd'$ ) at  $P$ .

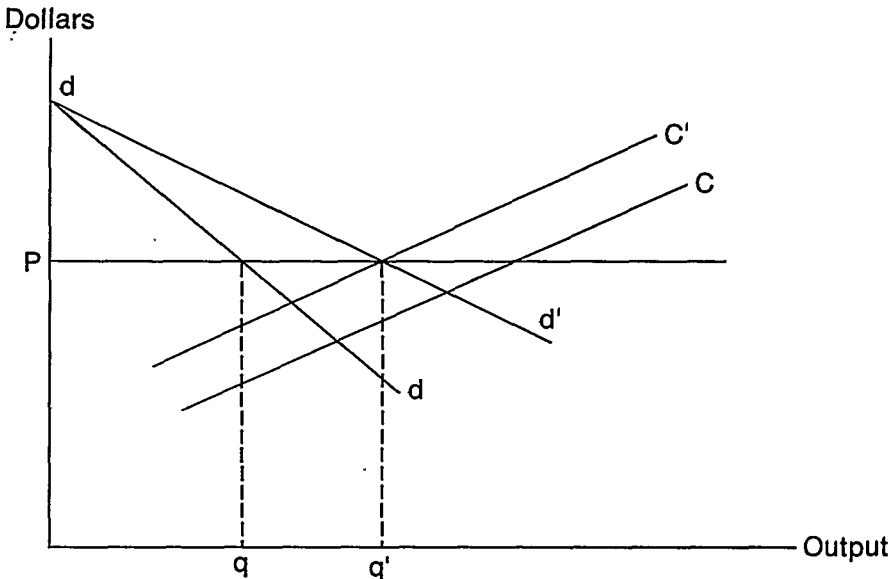


FIG. 1

of-sale services is unnecessarily circuitous. If the consumer demands such services, why don't the retailers provide them without prompting and raise their prices to cover the higher costs of distribution? The reason is that some retailers will prefer to provide no services and instead take a "free ride" on those retailers who do. An example<sup>8</sup> will illustrate. Let automobile dealer *A* provide the elaborate showroom and other services that consumers demand and raise his price to cover the costs of the services. Dealer *B*, rather than provide any services, can suggest to his customers that they first utilize *A*'s services to pick the car model they want and then return to *B* for the purchase. *B* can offer a lower price than *A* since *B* does not incur the expenses that *A* incurs in providing services. Faced with *B*'s lower-priced competition, *A* will eventually stop providing services (or provide fewer of them) and the automobile manufacturer's desire for point-of-sale services will be frustrated. Although the free-riding problem could be eliminated by *A*'s charging separately for point-of-sale services, it should be obvious why the manufacturer might not consider an admission fee to a dealer's showroom a satisfactory alternative to a minimum retail price, which eliminates the incentive for free riding by preventing *B* from undercutting *A*.

An alternative to retail price fixing in the special-service situation is to grant each dealer an exclusive sales territory, either explicitly or implicitly in exchange for the dealer's commitment to provide the desired point-of-sale services. This eliminates the free-riding problem; and competition to become an exclusive dealer will assure that dealers do not exploit their monopoly to the detriment of the manufacturer.<sup>9</sup>

Neither the "dealer cartel" nor the "special services" theories of restricted distribution have been tested empirically. Nor is it clear how one would go about doing so.<sup>10</sup> And it is impossible to exclude certain other explanations.<sup>11</sup> All this makes the task of the courts in resolving antitrust challenges to restricted distribution schemes a difficult one. But that cannot explain why for several generations now the Supreme Court has been deciding restricted distribution cases without any theory *at all* as to why manufacturers restrict distribution.

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8. Based on the facts of *United States v. General Motors Corp.*, 384 U.S. 127 (1966), discussed in R. POSNER, *supra* note 2, at 554-55.

9. Cf. Demsetz, *Why Regulate Utilities?*, 11 J. LAW & ECON. 55 (1968).

10. The problem is that even with a dealers' cartel one may still observe the provision of elaborate point-of-sale services, as the members of the cartel increase their expenditures on nonprice competition in an effort to engross as large a part as possible of the monopoly profits generated by the cartel price. See Posner, *The Costs of Monopoly and Regulation*, J. POL. ECON. (forthcoming). The difference between the services induced by dealer cartelization and those induced by the manufacturer's voluntary imposition of resale price maintenance is that in the former case the services are provided beyond the point at which their value to the consumer is just equal to their cost to the dealer.

11. See Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, II, 75 YALE L.J. 373, 453-64 (1966).

### B. *The Evolution of Doctrine in the Supreme Court*

In the earliest case, *Dr. Miles Medical Co. v. John D. Park & Sons Co.*,<sup>12</sup> a manufacturer of patent medicines had set minimum retail prices at which his product could be sold by dealers, and the Supreme Court held that the agreement between the manufacturer and the dealers was unenforceable because contrary to the public policy declared in the Sherman Act. The relevant portion of the opinion begins with the following statement, which is not further explained: "[t]hat these agreements restrain trade is obvious."<sup>13</sup> This bare assertion is used by the Court to shift to Dr. Miles the burden of proving that it is "entitled" to restrict price competition among its dealers.<sup>14</sup> Various places (such as the patent law) are searched, but no source of such an "entitlement" is found.

In dealing with Dr. Miles' argument that it has been damaged by price cutting, the Court finally gets to the point:

The bill asserts the importance of a standard retail price and alleges generally that confusion and damage have resulted from sales at less than the prices fixed. But the advantage of established retail prices primarily concerns the dealers. The enlarged profits which would result from adherence to the established rates would go to them and not to the complainant [Dr. Miles]. It is through the inability of the favored dealers to realize these profits, on account of the described competition, that the complainant works out its alleged injury. If there be an advantage to a manufacturer in the maintenance of fixed retail prices, the question remains whether it is one which he is entitled to secure by agreements restricting the freedom of trade on the part of dealers who own what they sell. As to this, the complainant can fare no better with its plan of identical contracts than could the dealers themselves if they formed a combination and endeavored to establish the same restrictions, and thus to achieve the same result, by agreement with each other. If the immediate advantage they would thus obtain would not be sufficient to sustain such a direct agreement, the asserted ulterior benefit to the complainant cannot be regarded as sufficient to support its system.<sup>15</sup>

The Court begins by saying that the profits generated by the minimum retail price inure to the dealers rather than to Dr. Miles. This should have made the Court wonder why Dr. Miles was in court defending the agreements. As we saw earlier, if the only effect of resale price maintenance is to increase dealers' profits, not only is the manufacturer not benefiting, he is losing since he is paying more for distribution than the competitive price. At this point in the passage the Court seems assailed by misgivings and it admits the possibility that there may be some advantage to Dr. Miles from minimum retail prices after all. But the implications of this concession are not pursued. The

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12. 220 U.S. 373 (1911).

13. *Id.* at 400.

14. *Id.*

15. *Id.* at 407-08.

only issue in the Court's view is whether Dr. Miles is "entitled" to whatever advantage it derives from resale price maintenance, and the Court holds that it is not entitled to any such advantage because it may not impose a restriction that if created by agreement among the dealers would amount to a dealers' cartel. But the Court does not suggest that the case in fact involves a dealers' cartel, with Dr. Miles as its agent.

Because the Court has in fact no view as to why the challenged agreements were made, it naturally fails to grasp the importance of the source of the restraint. It makes all the difference whether minimum retail prices are imposed by the manufacturer in order to evoke point-of-sale services or by the dealers in order to obtain monopoly profits.<sup>16</sup> The same restraint has in the first case nothing to do with cartelization or other anticompetitive conduct, and in the second is a garden-variety violation of the Sherman Act's prohibition against price-fixing agreements between competitors.<sup>17</sup>

Having decided in *Dr. Miles* that resale price maintenance was illegal per se, the Court in *United States v. Colgate & Co.*<sup>18</sup> and *United States v. General Electric Co.*<sup>19</sup> inexplicably condoned two methods by which sellers might circumvent the new rule. Under the rule of *Colgate* a manufacturer is free (1) to announce a policy of refusing to sell to dealers who fail to charge the manufacturer's suggested retail price, and (2) to terminate non-adhering dealers. The usual criticism of the *Colgate* rule is that the permitted conduct amounts to an agreement between the manufacturer and the adhering retailers to fix retail prices in violation of the principle established in *Dr. Miles*.<sup>20</sup> I have no trouble with this characterization of the conduct permitted by *Colgate*. Yet it seems to me that *Colgate*, viewed apart from *Dr. Miles*, is not an unreasonable decision and that had the order of the cases been reversed one could have argued forcefully that *Dr. Miles* was erroneously decided because it departed from the *Colgate* rule.

The key passage in *Colgate* is the following:

In the absence of any purpose to create or maintain a monopoly, the [Sherman] act does not restrict the long recognized right of trader or manufacturer engaged in an entirely private business, freely to

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16. A third possibility, analytically identical, however, to the first, is that the minimum prices originate with the dealers but are imposed not in order to generate monopoly profits but to overcome the free-rider problem created by the provision of point-of-sale services for which no extra charge is imposed. It is in the interest not only of the manufacturers, but of those dealers who employ resources that are specialized to the provision of services, to overcome that problem. Hence retailer support of Fair Trade laws does not prove that resale price maintenance is generally a method of dealer cartelization. On distinguishing among the possible motives for resale price maintenance see notes 59-62 and accompanying text *infra*.

17. In both cases there are point-of-sale services, but in the second they are excessive from the standpoint of efficiency. See note 10 *supra*.

18. 250 U.S. 300 (1919).

19. 272 U.S. 476 (1926).

20. See, e.g., Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655, 686-91 (1962).

exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to sell.<sup>21</sup>

In other words, since the manufacturer is presumptively the one best equipped to know whether or not it is efficient to distribute his product through price cutters, his decision (whether or not viewed as creating an agreement) should be honored in the absence of evidence of monopolistic purpose (his or, presumably, the dealers'). This presumption could easily have been used to decide *Dr. Miles* the other way. The weakness of the *Colgate* opinion, as of *Dr. Miles* (including Holmes' dissent in *Dr. Miles*,<sup>22</sup> which the *Colgate* opinion resembles), is the failure to understand, or at least to explain, why a manufacturer might find it more efficient to avoid dealing with price cutters.

In the *General Electric* case the Court approved resale price maintenance where the dealer was a consignee of the manufacturer and therefore the manufacturer's agent rather than a purchaser.<sup>23</sup> No reason was suggested why a contract of agency should be treated differently from a sales contract. Finding the elements of agreement required by section 1 of the Sherman Act<sup>24</sup> was not the problem. There was an explicit contract between the manufacturer and the dealers, and since it fixed the dealers' prices it was a contract in restraint of trade under *Dr. Miles*. To be sure, there was not, as in *Dr. Miles*, a technical "restraint on alienation," since title had not passed to the dealers; but *Dr. Miles* does not seem to require proof of a restraint on alienation.<sup>25</sup> The principle of *Dr. Miles* is, rather, that a manufacturer may not impose a restraint that the dealers would be forbidden to impose by agreement among themselves. This principle is clearly violated by the uniform resale price resulting from the consignment agreements in the *General Electric* case.

It may be thought that distinguishing between sale and agency is necessary to avoid the absurdity of interpreting the Sherman Act to forbid a firm's sales manager from telling his salesmen what prices to charge. But there was no danger of mistaking intrafirm for interfirm transactions in *General Electric*. The retail dealers were not owned or controlled by the manufacturer, but were independent drugstores and hardware stores which carried many items besides GE light bulbs. The fact that they sold GE's light bulbs on consignment did not make them branches of GE.

It is hard to believe that *Colgate* and *General Electric* would have been

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21. 250 U.S. at 307.

22. 220 U.S. at 409-13.

23. 272 U.S. 476 (1926). There had been consignment agreements in *Dr. Miles* also, but the Court had found that they did not create a genuine agency relationship, 220 U.S. at 389.

24. 15 U.S.C. § 1 (1970).

25. The Court in *Dr. Miles* had mentioned that *Dr. Miles'* resale price maintenance agreements with its dealers imposed a restraint on alienation, but only by way of reply to *Dr. Miles'* claim that it had a common law right to fix the resale price of its products. See 220 U.S. at 404-05.



decided the way they were if the Court had had a definite opinion as to what is wrong (or right) with resale price maintenance. If the objection was to cartelization by dealers, why suggest two methods by which dealers could continue to cartelize with the assistance of their suppliers? If resale price maintenance was thought sometimes to serve the legitimate interests of manufacturers, why require them to use the *Colgate* privilege or consignment in order to control their dealers' prices, rather than explicit sales contracts?

*Colgate* and *General Electric* have never been explicitly overruled, but their vitality has been sapped by later decisions.<sup>26</sup> Two in particular stand out. In *United States v. Parke, Davis & Co.*<sup>27</sup> the Court held that a manufacturer may not threaten to cut off wholesalers for selling to retailers who fail to adhere to the manufacturer's suggested retail price. Hence the *Colgate* privilege is available only to manufacturers who deal directly with their retail dealers, rather than use wholesalers. This result was said to follow from the fact that the *Colgate* privilege is limited to the "mere announcement of . . . [the manufacturer's] policy [of not dealing with price cutters] and the simple refusal to deal."<sup>28</sup> But the Court failed to explain why the *Colgate* privilege must be defined so narrowly as to be unavailable to manufacturers who happen to use wholesalers in the distribution of their product, though it remains usable by manufacturers who deal directly with retailers. Surely not to help manufacturers large enough to do their own wholesaling!

In *Simpson v. Union Oil Co.*<sup>29</sup> the Court held that a producer of gasoline could not lawfully fix retail prices by consignment agreements with service stations. The Court noted various differences between the terms of the consignment agreement involved in *Simpson* and those in *General Electric*, which provoked a stinging dissent from Justice Stewart who pointed out that the agreements in the two cases were virtually indistinguishable.<sup>30</sup> But Justice Stewart was allowing himself to be deflected to a side issue—whether the Court was overruling *General Electric* (the Court coyly refused to admit that it was). Given *Dr. Miles*, which the Court was not about to overrule, *General Electric* was untenable and might as well have been overruled.

What is interesting, indeed scandalous (yet unremarked by the dissent),

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26. After being sued a third time by the Justice Department, GE has finally abandoned the agency system of distributing light-bulbs.

27. 362 U.S. 29 (1960).

28. 362 U.S. at 44. It has been suggested that the implicit theory of *Parke, Davis* is that the combination between *Parke, Davis* and its wholesalers to cut off price-cutting retailers amounted to, or at least resembled, a boycott, which is a per se violation of the Sherman Act. See Turner, *supra* note 20, at 686; Levi, *The Parke, Davis—Colgate Doctrine: The Ban on Resale Price Maintenance*, 1960 SUP. CT. REV. 258, 325. This is not a satisfactory explanation. Resale price maintenance is also a per se violation of the Sherman Act, but it is permitted by *Colgate* when the method there prescribed is used. If so, why should not boycotts also be permitted when effectuated by exercise of the method approved in *Colgate*?

29. 377 U.S. 13 (1964).

30. *Id.* at 25-31.

is the reason the Court in *Simpson* offered for holding that resale price maintenance imposed through consignment agreements was unlawful after all. It is that *Parke, Davis* forbids a seller to use *coercion* to achieve his dealers' adherence to a resale price maintenance scheme, and the consignment agreement in *Simpson* was coercive given the disparity in economic power between producer and dealer. The agreement took away from the service stations—who are “small struggling competitors”—“the only power they have to be wholly independent businessmen.”<sup>31</sup> Resale price maintenance is bad, in short, because it unfairly oppresses dealers.

This rationale for the rule against resale price maintenance stands *Dr. Miles* on its head. According to the Court in *Dr. Miles*, resale price maintenance benefits dealers (at least “primarily”) and is bad because it has the same effect as a dealers' cartel. According to the Court in *Simpson*, resale price maintenance is bad because it benefits the manufacturer and oppresses the dealer by taking from the latter the power to price competitively. The two grounds for outlawing resale price maintenance cannot be reconciled. And the new ground is less tenable than the old one. *Simpson* was terminated for selling below the price fixed by Union Oil. He must have believed that he would enjoy greater profits (or smaller losses) at the lower price. But it does not follow that placing a floor under retail dealers' prices is a device that manufacturers use with the purpose, or likely effect, of reducing their dealers' earnings. A manufacturer *might* set a retail price so high that the resulting reduction in the quantity demanded of his product decreased the retailer's earnings by a greater amount than the higher price increased them, but he has no incentive to do such a thing (it would reduce his own profits), and such mistakes must be relatively rare. The possibility of the manufacturer's misconceiving his self-interest is a flimsy foundation for a per se rule against resale price maintenance.

The submerged conflict between *Dr. Miles* and *Simpson* came to the surface in *Albrecht v. Herald Co.*,<sup>32</sup> where a newspaper publisher terminated a distributor for exceeding the retail price set by the publisher. The Herald Company was in effect a purchaser of distribution. The price it paid was the difference between what the distributor paid it and what he received from the retail customers. Albrecht, the distributor, raised his price to the Herald Company by increasing the retail price of its newspaper, thereby enlarging the spread between the wholesale and retail prices. The Herald Company reacted by terminating Albrecht and substituting a distributor who was willing to adhere to the old spread—that is, who was willing to charge the Herald Company a lower price for distributing the newspaper. It is very difficult to see what proper antitrust question is raised by such conduct. It amounts to

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31. *Id.* at 20-21.

32. 390 U.S. 145 (1968).

searching out the lowest bidder, which would appear to be just the sort of conduct the antitrust laws are intended to foster.<sup>33</sup>

But I am concerned here with a different matter—the Court's extraordinary treatment of the basis for the rule forbidding resale price maintenance. Justice Harlan, in dissent, pointed out very sensibly that the imposition of a ceiling on the dealers' price to the consumer could hardly be viewed as equivalent in purpose or effect to a cartel among the dealers, and hence that the rule of *Dr. Miles* was inapposite.<sup>34</sup> To this the Court replied:

Our Brother HARLAN seems to state that suppliers have no interest in programs of minimum resale price maintenance, and hence that such programs are "essentially" horizontal agreements between dealers even when they appear to be imposed unilaterally and individually by a supplier on each of his dealers. Although the empirical basis for determining whether or not manufacturers benefit from minimum resale price programs appears to be inconclusive, it seems beyond dispute that a substantial number of manufacturers formulate and enforce complicated plans to maintain resale prices because they deem them advantageous. As a theoretical matter, it is not difficult to conceive of situations in which manufacturers would rightly regard minimum resale price maintenance to be in their interest. Maintaining minimum resale prices would benefit manufacturers when the total demand for their product would not be increased as much by the lower prices brought about by dealer competition as by some other nonprice, demand-creating activity.<sup>35</sup>

This is a competent statement of the special-services theory of resale price maintenance—and it demolishes the intellectual foundations of the rule forbidding resale price maintenance. The Court is saying that a dealer-cartel rationale for outlawing resale price maintenance is not supportable, because in many cases the manufacturer is pursuing his own interests rather than the dealers'; and it is also implicitly rejecting the dealer-exploitation rationale of *Simpson*, for the special-services argument carries no overtones of exploitation of dealers. What then is the rationale for the rule against resale price maintenance?

The Court does not tell us, except insofar as the reasons that it gives for why fixing *maximum* resale prices is illegal per se may suggest an answer. These reasons are that (1) the maximum price may be set at too low a level for the dealer to provide services demanded by the consumer; (2) it may channel distribution through large dealers who might otherwise have to face significant nonprice competition; and (3) the maximum price may become the

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33. As a detail, observe that no agreement as required by section 1 of the Sherman Act was proved either. The logical inference from Albrecht's conduct is that he did *not* agree to adhere to the publisher's resale-price policy. In disregarding this point, the Court may have inadvertently, or perhaps covertly, overruled *Colgate*. See *id.* at 150 n.6.

34. *Id.* at 157-58.

35. *Id.* at 151 n.7 (citations omitted).

minimum price.<sup>36</sup> The first reason implies that manufacturers misconceive their self-interest, and seems hardly an appropriate basis for a per se rule. It also undermines the case for forbidding the setting of *minimum* resale prices, by emphasizing the importance of point-of-sale services which, as the Court recognized, are encouraged by setting minimum resale prices. The second and third reasons are ingenious rather than substantial, and taken together the three reasons do not so obviously outweigh the manufacturer's interest in minimizing his distribution costs as to justify a per se rule against terminating a high-priced dealer. Nor do they provide a basis for a per se rule against setting minimum resale prices, once the dealer-cartel rationale of *Dr. Miles* is discarded.

In the same general period in which *Simpson* and *Albrecht* were decided, the rationale of *Dr. Miles* was being undermined from another direction. In *White Motor Co. v. United States*<sup>37</sup> the Court was asked to hold illegal per se the practice of a manufacturer in assigning exclusive sales territories to his distributors. It refused to do so, though as Justice Clark pointed out in dissent, the case was clearly governed by the statement in *Dr. Miles* that "the complainant can fare no better with its plan of identical contracts than could the dealers themselves if they formed a combination and endeavored to establish the same restrictions, and thus to achieve the same result, by agreement with each other."<sup>38</sup> An agreement to divide markets is a classical method of cartelization. It has the advantages compared to price fixing that the parties do not have to negotiate a common price and do not have the problem of dissipating cartel profits in nonprice competition.<sup>39</sup> If consumers are highly mobile, however, market division may not be an effective method of cartelization. Adherence to the agreement will be difficult to police and a supplementary price-fixing agreement may be necessary to maintain an "equitable" division of the cartel's profits among its members.

Price fixing and market division are thus alternative methods for achieving the same thing—monopoly pricing and profits—with the choice governed by the circumstances facing the cartel. There is no basis for choosing between the methods on social grounds. If resale price maintenance is like dealer price fixing, and therefore bad, a manufacturer's assignment of exclusive sales territories is like market division, and therefore bad too—if *Dr. Miles* is to be followed.

The Court's holding in *White Motor* was a very narrow one. Territorial

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36. As a detail, notice that the Court considers the third possibility increasingly likely as the maximum price approaches (from below) the dealer's cost. *Id.* at 153. Suppose it reached it. Then price would be at the competitive level. The objection to resale price maintenance, however, is that it keeps price above the competitive level.

37. 372 U.S. 253 (1963).

38. *Id.* at 282, citing *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 408 (1911).

39. See note 10 *supra*.

restrictions were not endorsed. The Court did not even hold that they were to be tested by the Rule of Reason. It held that the appropriate rule of law, whatever it might be, was not to be formulated until after trial (the district court had granted the Government's motion for summary judgment). The Court did, however, suggest that territorial restrictions "may be allowable protections against aggressive competitors or the only practicable means a small company has for breaking into or staying in business."<sup>40</sup> This formulation seems to be a variant of the special-services argument. If the manufacturer of a new product wants to induce a dealer to make a large initial investment in the promotion of the product, an investment that will be lost if the product fails to gain consumer acceptance, he is asking the dealer to incur a substantial risk and must compensate him for that risk. One way of doing this is to assure the dealer freedom from competition in the distribution of the product, as by giving him an exclusive territory. Without such protection the dealer may be unwilling to carry the untried product. If it fails to win consumer acceptance, he has lost his investment in promoting it; if it gains consumer acceptance, the manufacturer will begin distributing through other dealers who, not having made the initial promotional investment and not having incurred the same risk as the first dealer, will be able to set a retail price that will prevent the first dealer from recouping his investment with a return commensurate with the risk he bore. The subsequent dealers are free riders, much as in the standard special-services case discussed earlier.<sup>41</sup>

But if this is a good justification for exclusive territories, it is an equally good justification for resale price maintenance, which as we have seen is simply another method of dealing with the free-rider problem. Retailers argue that they need Fair Trade laws to protect them against "aggressive competitors," the big chain retailers and discount houses. A small or new firm might find it difficult to obtain distribution without offering its dealers freedom from price competition. In fact, *any* argument that can be made on behalf of exclusive territories can also be made on behalf of resale price maintenance.<sup>42</sup> Just as they are alternative methods of dealer cartelization, so they are alternative methods of buying services in distribution, and the choice turns on considerations irrelevant to any proper concern of the antitrust laws. In the case of a very expensive item such as a truck (the product in *White Motor*), where consumers will invest significant travel time in making their purchase, a manufacturer can reach the consuming public through relatively few, relatively dispersed dealers, and he can induce those dealers to provide whatever level of services he deems appropriate by assigning them exclusive territories. Competition among potential dealers to obtain the exclusive franchises

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40. 372 U.S. at 263.

41. See text following note 7 *supra*.

42. See Bork, *supra* note 11, at 429-64.

will lead them to offer successively more extensive point-of-sale services, until at the margin the cost of these services will equal the price increment that the dealer can command for the manufacturer's product by virtue of being free from the competition of other dealers in it. But if the product in question is not an expensive one, so that consumers are unwilling to invest substantial travel time in purchasing it, the dealers will have to be more numerous and proximate to one another and a system of exclusive territories will be unmanageable.<sup>43</sup> In this situation resale price maintenance is the more efficient method of evoking the desired services.

Resale price maintenance may be more efficient in general than exclusive territories because of its greater flexibility. The manufacturer can choose any level of point-of-sale services that he desires his dealers to provide, and by setting the minimum resale price appropriately he can assure that precisely that level of services is provided. Exclusive territories do not lend themselves to this sort of fine tuning: the level of services evoked by the territorial method will be that level—no more, no less—which reduces the expected monopoly profits of the dealer to zero when he charges the monopoly price.<sup>44</sup> If the manufacturer prefers a lower retail price and fewer services, he will have to place a ceiling on the dealer's price—as was done, in fact, by the defendant in *Albrecht*.<sup>45</sup>

Justice Douglas, writing for the majority in *White Motor*, did not deign to reply to Justice Clark's argument that price fixing and market division are the same animal. Justice Brennan in a concurring opinion did—and offered still another rationale for the rule of *Dr. Miles*:

The analogy to resale price maintenance agreements is also appealing, but is no less deceptive. Resale price maintenance is not only designed to, but almost invariably does in fact, reduce price competition not only *among* sellers of the affected product but quite as much *between* that product and competing brands.<sup>46</sup>

While it is true that industry-wide resale price maintenance might facilitate cartelizing,<sup>47</sup> one cannot reason from this point (not mentioned by the Justice) to the conclusion that resale price maintenance "almost invariably"

43. Imagine the costs of enforcement, and the effects, of a rule that forbade a retail seller of a particular brand of toothpaste to sell to consumers residing outside of the immediate neighborhood of the retail store.

44. This assumes that there is competition to become a dealer, *see* note 9 and accompanying text *supra*, and that the manufacturer is able to enforce the dealer's commitment to provide the agreed upon level of services. Enforcement is not required in the case of resale price maintenance, where competition among dealers will induce each dealer to provide the desired level of services.

45. By adjusting the size of the territories or the duration of the exclusive right, the manufacturer could affect the expected monopoly profits of each dealer and hence the level of services provided by the dealers. But these seem clumsy methods of regulating the level of services provided, compared to adjusting a minimum resale price.

46. 372 U.S. at 268 (emphasis in original).

47. *See* R. POSNER, *supra* note 2, at 134.

reduces competition among manufacturers practicing it. To see why, assume that manufacturers, being prevented from inducing retailers to provide point-of-sale services through resale price maintenance, take over the retailing function themselves, provide the services, and set a retail price that covers the costs of those services, a price equal to the price they would have required their retailers to set had they been permitted to use resale price maintenance. Clearly, there would be no obstacle to price or other competition among the manufacturers, albeit that competition would now occur at the retail rather than the wholesale level.

Another practice challenged in the *White Motor* case was the reservation by White Motor of certain large accounts. The Court did not discuss this practice separately but Justice Brennan in his concurring opinion suggested that it was of dubious legality because he could not imagine a compelling justification for its use.<sup>48</sup> That the Court should have considered this "customer limitation" a practice so similar to exclusive territories as not to warrant separate discussion shows how far it had gone toward abandoning the original rationale of *Dr. Miles*. Whatever the customer limitation is, it is not in effect or conceivable purpose a method of dealer cartelization.<sup>49</sup> It is not in the dealers' interest to be prevented from bidding on certain accounts. The objection to customer limitations, if there is any, has to be based on very different grounds from those of *Dr. Miles*.

The limbo created by *White Motor* existed for four years, until *United States v. Arnold Schwinn & Co.*,<sup>50</sup> where the Court held that both the territorial and customer restrictions involved in *White Motor*, and all other restrictions placed on the resale of a manufacturer's goods,<sup>51</sup> are illegal per se because they violate "the ancient rule against restraints on alienation and open

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48. 372 U.S. at 272-75.

49. To be sure, the dealers might find it difficult to make an equitable allocation among them of the very large accounts that are typically subject to a manufacturer's reservation. But they can hardly profit from being forbidden to bid on such accounts.

50. 388 U.S. 365 (1967). Some mention should be made here of *United States v. Sealy, Inc.*, 388 U.S. 350 (1967), decided the same day as *Schwinn*, and *United States v. Topco Associates, Inc.*, 405 U.S. 596 (1972). In *Sealy* and *Topco* small manufacturers had gotten together to sell their products under a common brand name, and had assigned exclusive territories to each member of the group in order to encourage each to promote the brand vigorously. Without exclusive territories (or minimum prices) members might have attempted to take a free ride on the promotional efforts of other members, just as in the case of dealers whose supplier wants them to provide point-of-sale services. The Court held the territorial arrangements in these two cases illegal per se because they were horizontal rather than vertical market divisions. This misses the point. These market divisions were not efforts to monopolize (and could not have succeeded if they had been, because of the small aggregate market share of the groups involved), but efforts to maximize brand-name promotion. The outcome of these cases illustrates the pitfalls of attempting to organize the antitrust field on a "horizontal"-vertical axis. See Posner, *Exclusionary Practices and the Antitrust Laws*, 41 U. CHI. L. REV. 506, 508 (1974).

51. In *Schwinn* the manufacturer, besides assigning territories, forbade both its wholesalers and its franchised retail outlets to sell to nonfranchised retail outlets, presumably to protect the franchised outlets against free riding. See R. POSNER, *supra* note 2, at 554-55.

the door to exclusivity of outlets and limitations of territory further than prudence permits."<sup>52</sup> These grounds are inadequate, however. The "ancient rule" against restraints on alienation, although mentioned in *Dr. Miles*, was not the ground of decision in that case,<sup>53</sup> and apparently would not have been violated by the kind of restriction that *White Motor* or *Schwinn* imposed on its dealers.<sup>54</sup> More important, the common law of restraint of trade was not a product of concern with promoting competition<sup>55</sup> and was not enacted into federal law by the Sherman Act; there is no occasion to consider what a nineteenth-century judge interpreting a confusing body of English precedents would have done if confronted by methods of distribution unknown in his time. As for the dictates of "prudence," cited by the Court as reinforcing the teachings of the "ancient rule," nowhere is it explained why it would be "imprudent" to permit restrictions on distribution.

The second part of the opinion holds that while restrictions on distribution may not be imposed in a contract of sale, they may be imposed in a consignment agreement. We are back in the world of the *General Electric* case. *Simpson* is cited but distinguished, without further explanation, as involving "culpable price fixing."<sup>56</sup> Restricting distribution in contracts of consignment is justified, the Court states, "by the demonstrated need of the franchise system to meet [the] competition" of "mass merchandisers."<sup>57</sup> But if this is so, why should not Schwinn be allowed to restrict distribution in a contract of sale as well as in one of consignment? If, as the Court states, the "net effect" of the challenged restrictions "is to preserve and not to damage competition in the bicycle market,"<sup>58</sup> why cannot Schwinn include a price term in its consignment agreements that would serve the same purpose (evoking special services from its retailers) as the nonprice restrictions? On what theory would a price term "damage competition in the bicycle market"?

I do not wish to be understood as suggesting that the restricted distribution cases are muddled because there is no *economic* difference between imposing restrictions by sales contract and by agency contract, and between price fixing and market division. I would be content if the Court had indicated *any* difference related to *anyone's* notion of the purposes of the Sherman Act. The Court is not protecting small business by these distinctions, because we know that small retailers would very much like to be permitted to enter into

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52. 388 U.S. at 380.

53. See note 25 and accompanying text *supra*.

54. See Handler, *The Twentieth Annual Antitrust Review 1967*, 53 VA. L. REV. 1667, 1684-86 (1967).

55. See P. AREEDA, *ANTITRUST ANALYSIS: PROBLEMS, TEXT, CASES* 40-43 (2d ed. 1974); R. POSNER, *supra* note 2, at 14-20; Letwin, *The English Common Law Concerning Monopolies*, 21 U. CHI. L. REV. 355 (1964).

56. 388 U.S. at 380.

57. *Id.* at 381.

58. *Id.* at 382.



resale price maintenance agreements with their suppliers and that relatively small manufacturers like White Motor and Schwinn seem particularly desirous of imposing restrictions on distribution.<sup>59</sup>

The distribution cases have no economic rationale, and no other rationale either. They are not even unified by the rule once suggested by Justice Stewart for merger cases: that the Government always wins.<sup>60</sup> The dispensations, like *Colgate* and *White Motor* and *General Electric* (and *Schwinn* in part), are as arbitrary as the condemnations. The essential distinctions that the Court has drawn—between price fixing and market division, and between sale and consignment—as well as a key failure to draw a distinction—between minimum and maximum resale price fixing—cannot be referred to any rational antitrust policy.

The basic problem is a failure to think about the antitrust laws in terms of policy and purpose, and it goes back (in this line of cases) to *Dr. Miles*. The Court held there that resale price maintenance was bad because it had the same effect as a dealers' cartel (which was surely bad)—the elimination of price competition among dealers. This illustrates the danger of reasoning analogically rather than logically. It cannot be that the antitrust laws forbid all transactions that eliminate competition simply because a cartel eliminates competition. That would mean that every merger between competing firms was illegal. The Court in *Dr. Miles* should have paused to ask itself whether it was really a purpose of the antitrust laws to compel price competition among dealers in a particular manufacturer's brand. Posing that question might have led the Court to consider why a manufacturer might not desire price competition among his dealers and then to see how resale price maintenance, when imposed voluntarily by the manufacturer, might (like some mergers) have an additional effect that was not present in a cartel—the provision of an optimum quantity of point-of-sale services.

The point the Court failed to grasp in *Dr. Miles* was a rather subtle economic point and it should not be judged too harshly for having missed it. The later decisions cannot be excused so lightly. There is no excuse for attaching different antitrust consequences to sales and consignments without even considering how the purposes of the antitrust laws might be furthered by such a distinction; for jettisoning the rationale of *Dr. Miles* (in *Simpson* and *Albrecht*) without either proposing an alternative rationale or reconsidering the rule; for distinguishing between price fixing and market division without explanation; for adopting a forgotten and irrelevant common law rule, again without explanation; or for burying and then exhuming the consignment exception to *Dr. Miles*—again without any explanation.

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59. See also note 50 *supra*.

60. *United States v. Von's Grocery Co.*, 384 U.S. 270, 301 (1966) (Stewart, J., dissenting).

### C. *A Suggested Approach*

The reader is entitled to insist that, having criticized the Court's approach to restricted distribution, I propose a better one. As should be clear from the previous discussion, I believe that the law should treat price and nonprice restrictions the same and that it should make no distinction between the imposition of restrictions in a sale contract and their imposition in an agency contract. The difficult question is whether the law should treat price and non-price restrictions in distribution, however imposed, permissively or prohibitively. The answer is not an easy one to give because, as mentioned earlier, restricted distribution can be a method either of increasing the efficiency of distribution or of monopolizing it. In some cases it will be one and in some cases the other, and it will not be easy in practice to distinguish them.<sup>61</sup> Economic theory suggests that the restrictions will more commonly be of the manufacturer-imposed, efficiency-enhancing type than of the dealer-imposed, monopolizing type. The number of firms in, and the ease of entry into, most branches of distribution would seem to militate strongly against effective cartelization; dealer cartels should, therefore, be relatively uncommon.

This would seem to rule out a per se rule against restricted distribution, unless anyone can suggest a noncartel rationale for the rule (no one to my knowledge has ever suggested one). But I do not think that we yet know enough about restricted distribution to adopt a rule of per se legality either. Hence the Justice Department (and other antitrust plaintiffs) should be permitted to continue bringing cases challenging restrictions in distribution; but they should be required to prove that the challenged restriction was imposed as part of a scheme of distributor cartelization. This will not be easy to do. It will not be enough for the plaintiff to establish that the challenged restriction was imposed at the urging of the dealers. To make legality turn on whether the restriction was "horizontal" or "vertical" would be to make the same mistake that the Court made in *United States v. Sealy, Inc.*<sup>62</sup> Like the manufacturers in *Sealy*, who divided territories not in order to charge monopoly prices but in order to encourage the advertising of their joint trademark, dealers have a legitimate, nonmonopolistic interest in seeking to overcome, through joint action, serious free-rider problems.<sup>63</sup> It will be necessary in every case to determine whether the objective of the challenged restriction is

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61. I do not share the confidence of Professor Bork, *supra* note 11, at 408-10, that it will be easy to tell when resale price maintenance is imposed by a dealer cartel. One problem that he overlooks is that it will be difficult in particular cases to evaluate the dealers' argument that the purpose of their scheme was to overcome a genuine free-rider problem. The source of the restraint (manufacturer or dealers), even if that can be determined easily (which I doubt), is not crucial. This is the point the Court missed in *United States v. Sealy, Inc.*, 388 U.S. 350 (1967); note 50 *supra*.

62. 388 U.S. 350 (1967); see note 50 *supra*.

63. See note 16 *supra*; *United States v. General Motors Corp.*, 384 U.S. 127 (1966), discussed in R. POSNER, *supra* note 2, at 554-55.

to increase the provision of point-of-sale services or to generate monopoly profits.

In *Sealy* itself the defendant sellers' small combined market share negated an inference of monopolistic purpose or effect. This suggests a rule for deciding some restricted distribution cases: the lawfulness of the restriction should be conclusively presumed if the aggregate market share of the distributors who are imposing the restriction is too small to confer power over price—say less than two thirds.<sup>64</sup> Beyond this, I can think of no shortcuts to the decision of these cases that can be justified on the basis of our present knowledge of the purposes and effects of restricted distribution.

## II. MERGERS

The body of Supreme Court antitrust doctrine relating to restrictions on distribution can be expressed as a set of reasonably precise rules; unfortunately, the rules lack a rational structure. The body of antitrust doctrine relating to mergers between competing (or potentially competing) firms had, in the beginning, neither reasons nor rules. It moved rapidly into a period of hard-edged rules without any reasons behind them. An as yet unanswerable question is whether the Court is on the threshold of returning to the era of neither reasons nor rules.

### A. Mergers Between Competitors

1. *Columbia Steel and the 1950 Amendments to Section 7 of the Clayton Act*. The modern development of horizontal merger law begins in 1948 with *United States v. Columbia Steel Co.*<sup>65</sup> The case involved the acquisition by U.S. Steel of Consolidated Steel Corporation, a competitor in steel fabrication. Under the view of the relevant market most favorable to the Government, the market shares of the firms were 13 and 11 percent respectively. Was such a merger forbidden by section 1 of the Sherman Act? The Court's answer ("no") is less interesting than the standard applied:

In determining what constitutes unreasonable restraint, we do not think the dollar volume is in itself of compelling significance; we look rather to the percentage of business controlled, the strength of the remaining competition, whether the action springs from business requirements or purpose to monopolize, the probable develop-

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64. The question at what point the combined market share of a group of sellers is too small for collusion among them to increase the market price significantly is a difficult one to answer, depending as it does on the rapidity and cost with which the remaining sellers can expand their sales. U.S. Steel's original market share of 50-60 percent was apparently not too small. See G. Stigler, *The Dominant Firm and the Inverted Umbrella*, in *THE ORGANIZATION OF INDUSTRY* 108 (1968). But it would seem that in most branches of distribution, additions to capacity either by existing firms or by new entrants would proceed much more rapidly than in the steel industry. Cf. text accompanying notes 103-04 *infra*.

65. 334 U.S. 495 (1948).

ment of the industry, consumer demands, and other characteristics of the market. We do not undertake to prescribe any set of percentage figures by which to measure the reasonableness of a corporation's enlargement of its activities by the purchase of the assets of a competitor. The relative effect of percentage command of a market varies with the setting in which that factor is placed.<sup>66</sup>

Apart from the failure to provide any guidance, the striking thing about this list is the evident lack of any theory behind the inclusion of the enumerated items. We are told that the dollar volume involved in the merger is not "of compelling significance"—but not why it has any significance. The percentage of business controlled is mentioned, but as a factor apparently of no greater weight than several others including "the strength of the remaining competition." Why is the strength of the remaining competition not simply the market share of the firms in the market that are not parties to the merger? Why are the market shares of the merging firms and of the remaining firms considered different factors rather than alternative ways of looking at the same factor? Why is intent important? Why must attention be given to "the probable development of the industry" and to "consumer demands"? What do these expressions mean anyway?

The Court, I suggest, had no idea as to how a merger that did not create a firm having a monopoly market share could affect the market price and hence be said to restrain trade, yet also had no conviction that it could not have such an effect. Now a firm that has 100 percent of a properly defined market, or even somewhat less, will charge a price higher than the competitive level, and this price will persist for a time, perhaps a long time, notwithstanding the incentive it creates for new firms to enter the market and existing firms to expand their output.<sup>67</sup> But it is highly improbable that a firm having 24 percent of a market could do this.<sup>68</sup> The Court, I think, sensed this, and had no alternative theory of how such a merger might affect competition, but was not sufficiently confident of its premises to announce a clearly permissive standard for nonmonopolistic mergers.

*Columbia Steel* was decided at a time when Congress was considering whether to amend section 7 of the Clayton Act to plug the "asset loophole." As originally enacted in 1914, section 7 had been limited to stock acquisitions,<sup>69</sup> and since a merger is an asset acquisition the statute was held to be inapplicable to mergers.<sup>70</sup> As a result cases like *Columbia Steel* had to be

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66. *Id.* at 527-28 (citations omitted).

67. See G. Stigler, *supra* note 64, at 109; R. Posner, *supra* note 2, at 376-79.

68. To be sure, if none of the other firms in the market could expand their output at all, a reduction in output by the firm would result in an increase in the market price above the competitive level; but the assumption of a completely inelastic supply is unrealistic.

69. Act of October 15, 1914, c. 323, § 7, 38 Stat. 731-732.

70. See *United States v. Philadelphia National Bank*, 374 U.S. 321, 337-40 (1963).

brought under section 1 of the Sherman Act, and the decision in that case suggested that section 1 was not effective in dealing with nonmonopolistic mergers: either they were permissible, or the statutory standard was too vague and multifactored to be workable.

Section 7 was amended in 1950 to include asset acquisitions,<sup>71</sup> but the original statutory standard (which forbade an acquisition if its effect might be to lessen competition substantially) was retained, and the meaning of that standard was not clear. No rules had evolved out of the (very few) cases brought under the original statute. The extent to which cases decided under other sections of the Clayton Act were to be regarded as precedents under the amended statute was unclear; tying, exclusive dealing, price discrimination and the other practices governed by the other provisions of the Clayton Act bear no resemblance to horizontal mergers.<sup>72</sup>

Professor Bok,<sup>73</sup> and later the Supreme Court in *Brown Shoe Co. v. United States*,<sup>74</sup> thought they had discovered a fundamental theme in the legislative history of the 1950 amendments—concern with an allegedly “rising tide of economic concentration” in the American economy. Concentration refers to the degree to which a few firms in a market account for most of its sales. There are two senses in which it might be thought relevant to public policy, and both are reflected in the legislative history of the 1950 amendments. Concentration might result in a supracompetitive price level, by facilitating a kind of collusion among the sellers in the market that might be difficult or impossible to detect and therefore unreachable under the Sherman Act;<sup>75</sup> and, less clearly, the reduction in the number of firms implied by rising concentration<sup>76</sup> could be thought to endanger social values associated with the preservation of small firms. But while both of these concerns with con-

71. Act of Dec. 29, 1950 (Celler-Kefauver Antimerger Act), c. 1184, 64 Stat. 1125-1126; now codified as 15 U.S.C. § 18 (1974).

72. In any event, the most recent non-section 7 precedent, *Standard Oil Co. of California v. United States*, 337 U.S. 293 (1949), was itself ambiguous. The decision could be read as predicated on the dollar volume of sales under the exclusive-dealing contract, on the market share of the supplier, or on the combined market share of all of the suppliers in the relevant market who used exclusive-dealing contracts.

73. Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 234-37 (1960).

74. 370 U.S. 294, 315 (1962).

75. Some economists draw a sharp distinction between explicit and tacit collusion, the latter sometimes called “conscious parallelism” or “oligopolistic interdependence.” The utility of the distinction has been questioned. See Posner, *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 STAN. L. REV. 1562 (1969); R. POSNER, *supra* note 2, at 116-35, discussing the legal and policy implications of George Stigler’s theory of oligopoly as tacit collusion, G. Stigler, *A Theory of Oligopoly*, in THE ORGANIZATION OF INDUSTRY 39 (1968). For present purposes the issue is unimportant. It is sufficient that there exist some forms of supracompetitive pricing that are very difficult to detect or prevent by Sherman Act enforcement, but that can perhaps be prevented by not permitting markets to become highly concentrated since high levels of concentration facilitate such pricing.

76. But note that an increase in concentration could be associated with an increase in the dispersion of the size of firms rather than with a decrease in their absolute number.

centration are reflected in the legislative history,<sup>77</sup> they do not have the same significance in interpreting the statute. The economic concern is inescapably relevant to the competitive effects of a horizontal merger, for it furnishes the theory, which eluded the Court in *Columbia Steel*, of how a merger that does not create a monopoly market share may nonetheless result in a substantial lessening of competition. The social concern with concentration, however, is at most a reason why some members of Congress may have wanted horizontal mergers to be tested by a stricter standard than that of the Sherman Act as interpreted in *Columbia Steel*. If Congress had intended the social concern to enter into the decision of actual cases, it presumably would not have retained the standard of illegality of the original section 7 and the other Clayton Act provisions, a standard of competitive effect rather than of small-business protection.<sup>78</sup>

2. *From Brown Shoe to Von's—and Back.* In *Brown Shoe*, the first case under the amended section 7 to be decided by the Court with a full opinion, the economic concerns over concentration were mixed together in an unsavory omelette.

Typically, the part of the opinion that discusses the general standard of illegality under the statute is an enumeration of relevant factors rather than an attempt to formulate a definite legal test. One of the factors mentioned is Congress' concern with the "rising tide of economic concentration," and the "keystone" of this concern, in the Court's view, is the "provision of authority for arresting mergers at a time when the trend to a lessening of competition in a line of commerce was still in its incipency."<sup>79</sup> This passage is ambiguous. Is the Court simply referring to the fact that Congress thought (erroneously, as it turns out)<sup>80</sup> that the economy was becoming more concentrated? If concentration were on the rise, a vigorous program of section 7 enforcement might preserve some markets from becoming highly concentrated (depending on *why* markets were becoming concentrated<sup>81</sup>).

An alternative reading, however, is that a merger is more dangerous in a market that, for some reason, is becoming more concentrated. The latter proposition, which is probably what the Court meant, is quite dubious. At one extreme, suppose that a market is becoming concentrated because of changes in the conditions of supply or demand that have increased the minimum efficient firm size. In such a case forbidding mergers will not prevent, but only postpone, the concentration of the market, which will occur as some firms expand to take advantage of the economies of scale, and others are

77. See, e.g., S. REP. NO. 1775, 81st Cong., 2d Sess. (1950) at 3, 5.

78. That is presumably why the Robinson-Patman Act, the clearest example of protectionist legislation in the antitrust field, in amending section 2 of the Clayton Act modified the Act's competitive effect standard. See 15 U.S.C. § 13 (1974).

79. 370 U.S. at 317.

80. See Bok, *supra* note 73, at 232-33.

81. See text following notes 97, 107 *infra*.

squeezed out of the market. Nor is it clear that one wants to prevent concentration in these circumstances. Prices may be higher with less concentration, due to the greater costs of operating at an inefficient scale of production. At the other extreme, suppose that there is no underlying economic trend toward concentration but we somehow know that the firms in the market want to make acquisitions that will eventually result in a high level of concentration—perhaps because they want to fix prices but more probably because of tax or other reasons unrelated to the efficient organization of the market. In this case we can intervene and stop the merger trend whenever we think that another merger will carry the market across the threshold that separates acceptable from unacceptable levels of concentration. In neither case, nor in the intermediate cases, is it tenable to regard the mere existence of a trend toward concentration as evidence that a merger should be forbidden that does not in itself create an unacceptable level of concentration.

Another consideration stressed by the Court is that Congress wanted to prevent only mergers “having demonstrable anticompetitive effects”; in fact, “the legislative history illuminates congressional concern with the protection of *competition*, not *competitors*, and its desire to restrain mergers only to the extent that such combinations may tend to lessen competition.”<sup>82</sup> This appears to be a decisive rejection of the social theory of excessive concentration, and a ringing endorsement of the economic. But no standard for implementing the economic approach is proposed. Instead, the Court finds that Congress rejected any simple rule of illegality. Congress did not “adopt a definition of the word ‘substantially,’ whether in quantitative terms of sales or assets or market shares or in designated qualitative terms, by which a merger’s effects on competition were to be measured.”<sup>83</sup> Indeed, the congressional deliberations reflect “a conscious avoidance of exclusively mathematical tests.”<sup>84</sup> The no-simple-rules theme is elaborated as follows:

Congress indicated plainly that a merger had to be functionally viewed, in the context of its particular industry. That is, whether the consolidation was to take place in an industry that was fragmented rather than concentrated, that had seen a recent trend toward domination by a few leaders or had remained fairly consistent in its distribution of market shares among the participating companies, that had experienced easy access to markets by suppliers and easy access to suppliers by buyers or had witnessed foreclosure of business, that had witnessed the ready entry of new competition or the erection of barriers to prospective entrants, all were aspects, varying in importance with the merger under consideration, which would properly be taken into account.<sup>85</sup>

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82. 370 U.S. at 319-20 (emphasis in original).

83. *Id.* at 321.

84. *Id.* at 321 n.36.

85. *Id.* at 321-22.

There is further embellishment in a footnote:

Subsequent to the adoption of the 1950 amendments, both the Federal Trade Commission and the courts have, in the light of Congress' expressed intent, recognized the relevance and importance of economic data that places [*sic*] any given merger under consideration within an industry framework almost inevitably unique in every case. Statistics reflecting the shares of the market controlled by the industry leaders and the parties to the merger are, of course, the primary index of market power; but only a further examination of the particular market—its structure, history and probable future—can provide the appropriate setting for judging the probable anti-competitive effect of the merger.<sup>86</sup>

In *Brown Shoe*, as in *Columbia Steel*, one has no sense that the Court has any notion of how a nonmonopolistic merger might affect competition. The social concern with concentration is rejected but the economic concern is not explained. A clue to the Court's confusion is its reference to "market power."<sup>87</sup> Clearly, the Court thinks that the possession of "market power" is highly relevant, perhaps crucial, to finding a violation of section 7. But what does the Court mean by the term? If it means monopoly power, the Court has backed into the *Columbia Steel* standard. Is "market power" perhaps some debased form of monopoly power—the power of a single firm, not acting in cooperation with competing sellers, to maintain a price slightly above the competitive level? Few economists think that a firm lacking a monopoly market share (not necessarily 100 percent,<sup>88</sup> but much more than involved in the usual section 7 case) can unilaterally maintain a supracompetitive price. The real point about concentration, but one that is obscured by the term market power and that seems to have eluded the Court's understanding in *Brown Shoe*, is that it facilitates collusion, express or tacit, among the firms in the market, by reducing the costs of collusion and of detecting cheating.<sup>89</sup> Once this point is grasped, inquiry can proceed to the critical question: at what level of concentration does the danger of undetectable collusion become substantial? The point was not grasped in *Brown Shoe*.

This is further shown by the Court's application of its "standard" to the facts of the case (I confine my attention to the horizontal aspect). In some cities, the Court found,<sup>90</sup> the combined share of Brown and Kinney (the acquired firm) of retail shoe sales was very large—as much as 57 percent. The Court seems not to have cared, however, how large the market shares were, so long as they exceeded five percent. Thus, after noting that the com-

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86. *Id.* at 322 n.38.

87. *Id.*

88. See note 64 and accompanying text *supra*.

89. See note 75 and accompanying text *supra*. See also G. STIGLER, *THE THEORY OF PRICE* 216-20 (3d ed., 1966).

90. Incorrectly, as pointed out in Peterman, *The Brown Shoe Case*, *J. LAW & ECON.* (forthcoming).



bined market share of the merging firms exceeded five percent in 118 cities, the Court states: “[i]f a merger achieving 5% control were now approved, we might be required to approve future merger efforts by Brown’s competitors seeking similar market shares.”<sup>91</sup> The implication that the difference between a five percent and a 57 percent market share is not crucial in the application of section 7 is a clue that the Court’s real concern is not with competition, despite its earlier statement to that effect. A 57 percent market share might give a firm power over price, regardless of the number or size distribution of its competitors.<sup>92</sup> But without knowing something about the overall concentration of the market, one cannot attach any significance to a five percent market share. If the largest firm in the market has five percent (the situation in *Brown Shoe*) there must be at least 20 competitors in the market, and possibly a great many more. Most economists would doubt that the danger of the sorts of collusion that cannot be effectively reached under the Sherman Act would be acute in an industry of 20 or more sellers of roughly similar size.

The Court’s confusion is underscored by the weight it attaches to the *absence* of concentration in shoe retailing. “In an industry as fragmented as shoe retailing,” the Court states, “the control of substantial shares of the trade in a city may have important effects on competition.”<sup>93</sup> The Court has gotten the point backwards: the less concentrated a market is, the *less* significance should be attached to the market share of the merging firms. If a market has 100 firms all of equal size, the fact that five of them consolidate, creating a single firm having five percent of the market, has virtually no competitive significance. The difficulty of colluding will not be reduced substantially, because the leading firm must still collude with a large number of other firms in order to be able to raise price significantly above the competitive level. In contrast, in a market of only five firms, the merger of the two smallest to create a new firm having five percent of the market might conceivably have some adverse effect, by reducing from five to four the number of firms that must collude in order to monopolize the market completely.

We soon discover that the objection to the merger of Brown and Kinney has nothing to do with the probability of collusion between the resulting firm and competing shoe retailers. The real point is that Brown-Kinney’s possession of manufacturing facilities will enable it to outcompete its nonintegrated competitors at the retail level. As John Peterman makes clear in a recent article,<sup>94</sup> the Court’s concern is not that Brown-Kinney might charge a higher price as a result of the merger but that it might charge a lower price and thereby hurt its competitors. This is bad, in the Court’s view, even if the

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91. 370 U.S. at 343-44.

92. See note 67 and accompanying text *supra*.

93. 370 U.S. at 343.

94. See note 90 *supra*.

lower price is made possible by genuine social cost savings due to integrated operation:

Of course, some of the results of large integrated or chain operations are beneficial to consumers. Their expansion is not rendered unlawful by the mere fact that small independent stores may be adversely affected. It is competition, not competitors, which the Act protects. But we cannot fail to recognize Congress' desire to promote competition through the protection of viable, small, locally owned businesses. Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization. We must give effect to that decision.<sup>95</sup>

First the Court says that the Act protects competition, not individual competitors, and in the next breath it says that the Act protects higher-cost from lower-cost competitors.

A decision that seeks to prevent a competitor from realizing opportunities for cost savings is inconsistent with the economic objection to concentration. In the end, then, the decision is seen to rest on what I have called the social objection, which is that concentration involves the elimination of small firms that the Court values although the consumer does not. I suggested earlier why it is improper to view the amended section 7 as enacting the social theory of concentration,<sup>96</sup> and it is peculiar, to say the least, that the Court should not have mentioned that theory in discussing the factors that Congress supposedly wanted it to consider in applying section 7 to particular cases.

In any event, the decision in *Brown Shoe* does not really further the ultimate objective of the social theory. If an integrated firm like Brown has lower costs than nonintegrated retailers, it will expand its share of the retail shoe market whether or not it acquires Kinney.<sup>97</sup> The principal effect of a very strict rule against horizontal mergers is not (fortunately!) to retard economic progress, but to reduce the sale value of small firms by making it difficult for their large competitors—an important class of potential purchasers of small firms—to buy them.

The next major merger case to be decided by the Court was *United*

95. 370 U.S. at 344.

96. See text accompanying note 76 *supra*.

97. This point is obscured by the Court's discussion of the difference between expansion via internal growth and via merger:

A company's history of expansion through mergers presents a different economic picture than a history of expansion through unilateral growth. Internal expansion is more likely to be the result of increased demand for the company's products and is more likely to provide increased investment in plants, more jobs and greater output. Conversely, expansion through merger is more likely to reduce available consumer choice while providing no increase in industry capacity, jobs or output.

370 U.S. at 345 n.74. From the standpoint of less efficient competitors, whether the more efficient competitors entered the market by internal expansion or by merger is a detail; the consequence is the same in either event—the contraction or demise of the less efficient firms.

*States v. Philadelphia National Bank*.<sup>98</sup> Although it follows *Brown Shoe* by only a year, the opinion in *Philadelphia Bank* reflects a radically different conception of section 7. Whereas the Court in *Brown Shoe* rejected any simple quantitative test of illegality, the Court in *Philadelphia Bank* begins its discussion of the applicable legal standard by warning of "the danger of subverting congressional intent by permitting a too-broad economic investigation," and suggesting that "in any case in which it is possible . . . to simplify the test of illegality, the courts ought to do so in the interest of sound and practical judicial administration."<sup>99</sup> Whereas the Court in *Brown Shoe* lacked a clear idea of why concentration is a bad thing, the Court in *Philadelphia Bank* assumes that the objection to concentration is the economic one, and uses the economic literature on oligopoly pricing as the source of a specific test of illegality. The test is that a merger which (1) creates a firm having 30 percent of the market and (2) thereby increases concentration among the leading firms by at least 33 percent is presumptively unlawful.<sup>100</sup>

*Philadelphia Bank* represents the high point of rationality in the Court's merger decisions.<sup>101</sup> The rule declared in that decision meets both conditions stated at the beginning of this article for a minimally adequate body of legal doctrine. It is precise and objective, and thus workable, and it is plausibly related to the fundamental purpose of the statute, which is to protect competition. It was soon abandoned.

I shall skip over some decisions that deal primarily with the vexing question of how to define the market for purposes of calculating the merging firms' market shares<sup>102</sup> and come directly to the next major attempt by the Court, in *United States v. Von's Grocery Co.*,<sup>103</sup> to formulate a test of illegality under section 7. The market shares involved in *Von's* were much smaller than in *Philadelphia Bank*. But the Court in the latter case had not suggested that the particular percentages specified in its rule were the minimum that would trigger the presumption of illegality. And the Government in its brief in *Von's* remained within the intellectual framework of the *Philadelphia Bank* opinion. It pointed out that, with the three largest sellers in the relevant market (retail grocery sales in Los Angeles) accounting on the eve of the merger for about 19 percent of the total sales of the market, and the eight largest for about

98. 374 U.S. 321 (1963).

99. *Id.* at 362.

100. *Id.* at 363-65. The function of the second part of the rule is to exclude the case where although the firm resulting from the merger has a 30 percent or greater market share, the merger had no significant effect on the level of concentration because the market share of the acquired firm was trivial.

101. I do not refer to that portion of the opinion which holds that bank mergers are subject to section 7 of the Clayton Act. 374 U.S. at 335-49. Nor do I mean to suggest that the rule of *Philadelphia Bank* cannot be improved upon. See text accompanying note 120 *infra*.

102. For the main cases, and my generally critical views of them, see R. POSNER, *supra* note 2, at 434-52, 475-84.

103. 384 U.S. 270 (1966).

39 percent, the market was sufficiently concentrated to be classified as a "loose oligopoly," in which there was at least some possibility of tacit collusion. After the merger, the three largest firms had 23 percent of the market and the eight largest, 42 percent. Thus, the merger involved a perceptible if modest increase in concentration in a market that, in the Government's view for which some economic support could be marshalled, was already dangerously concentrated.

The most glaring deficiency in the Government's case was the obvious ease and rapidity of entry into the retail grocery business. The record indicated that a modern supermarket able to compete on terms of substantial equality with the leading firms in the market could be started with a capital investment of only \$700,000. It is highly unlikely that the grocery chains in Los Angeles could have fixed prices without inducing such rapid and widespread entry by new firms as to force price back to a competitive level before the cartel could obtain substantial monopoly profits. In such circumstances fixing prices is not very attractive in the first place, even if it can be done with impunity.

The Government's theory of illegality was ignored by the Court. The opinion contains no reference to oligopoly, entry, or other concepts that might be relevant to an appraisal of the effect of the merger on competition. The core of the opinion is an eccentric history of the antitrust laws. We are told that their original purpose was not to protect consumers from having to pay prices in excess of competitive levels but, on the contrary, to prevent "powerful business combinations" from "driving out of business the small dealers and worthy men whose lives have been spent therein, and who might be unable to readjust themselves to their altered surroundings."<sup>104</sup> (The Court's quotation was from a passage in an early cartel case, a passage entirely gratuitous in the context of that case since cartelization, by raising prices above the competitive level, makes it easier rather than more difficult for smaller and less efficient firms to prosper.) Because "the Sherman Act failed to protect the smaller businessman from elimination through the monopolistic pressures of large combinations which used mergers to grow ever more powerful,"<sup>105</sup> Congress passed the original section 7. When that failed to stop mergers (not that it was ever intended to apply to mergers), Congress amended the statute in 1950. The Court makes clear that the statute embodies the social objection to concentration: "the basic purpose of the 1950 . . . Act was to prevent concentration in the American economy by keeping a large number of small competitors in business."<sup>106</sup> Nothing here about competition

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104. *Id.* at 274, quoting *United States v. Trans-Missouri Freight Ass'n*, 166 U.S. 290, 323 (1897). Apparently, the Court in *Von's* was unfamiliar with Bork, *Legislative Intent and the Policy of the Sherman Act*, 6 J. LAW & ECON. 7 (1966).

105. 384 U.S. at 274-75.

106. *Id.* at 275.

—the Court does not suggest that “a large number of small competitors” is a necessary condition for competitive pricing.

In applying the social theory of concentration to the facts of the case, the Court emphasized that the number of single-store grocery companies in Los Angeles had been declining rapidly before the merger (from 5,365 in 1950 to 3,818 in 1961). The relevance of this observation is unclear. Shopping Bag, the acquired firm, was not a single-store grocery company but a substantial chain. Why then was its disappearance as an independent firm relevant to preserving single-owner stores? The Government had argued that the merger had increased the likelihood of supracompetitive pricing in the relevant market. Such prices would help the single-owner stores—which are presumably less efficient than the chains (why else has their number declined steadily over time?)—cover their costs. The Court, however, thought the merger would make the merging firms “even more powerful” than they had been before the merger.<sup>107</sup> We are back in the world of the *Brown Shoe* opinion. Mergers are bad because they enable the merging firms to injure their small competitors by underpricing them.<sup>108</sup> The Court in *Von's* cited no evidence, and there was no evidence it could have cited, for the proposition that the merger would reduce the costs of the merging firms or otherwise increase their “power” vis-à-vis single-owner stores. But what is more remarkable is that the Court should have decided the case for the Government on the theory that the firm resulting from the merger would charge *lower* prices than before the merger, when the Government had argued that the firm resulting from the merger would charge *higher* prices. And what is most remarkable is that the same Justices who three years earlier in *Philadelphia Bank* had thought horizontal mergers were bad because they led to higher prices should have agreed with Justice Black in *Von's* that they were bad because they led to lower prices.

Furthermore, even if one believes that the protection of small business, rather than the protection of the competitive process, is the controlling policy in the interpretation and application of section 7, it is very difficult to see how that policy is served by making virtually any nontrivial horizontal merger illegal, the apparent rule of the *Von's* case.<sup>109</sup> If large grocery chains have lower costs than single-store or other small grocery companies, they can

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107. *Id.* at 278.

108. The Court in *Brown Shoe* explicitly stated that the way in which the merged firm would hurt its small competitors was by passing on the cost savings made possible by the merger (or a portion of them) to the consumer, that is, by reducing price. The mode of injury is not specified in *Von's* but is presumably the same. It is not inconceivable that a more efficient competitor might injure the less efficient without underpricing him (for example, by paying a higher rent for choice locations), but it is unlikely, especially if the more efficient competitor confronts enough equally or more efficient competitors which constrain it to charge the competitive price.

109. Some room for maneuver was left, perhaps, by the Court's emphasis on the merging firms' being “powerful.” 384 U.S. at 278.

increase their output relative to that of the small companies even if forbidden to make any mergers at all, and will do so if competitive. The only hope for the small, less efficient groceries is that the large chains will charge supracompetitive prices, which will reduce the chains' output and enable more small grocers to survive despite their higher costs. A permissive policy toward horizontal mergers will foster supracompetitive pricing. It is possible that the interests of small business would be best served by a rule permitting all horizontal mergers, including plainly monopolistic ones. To be sure, some horizontal mergers would harm small competitors either by enabling economies of scale to be exploited earlier or by facilitating predatory practices. But these effects are likely to be dominated by the tendency of monopolistic or oligopolistic firms to charge prices that exceed their costs and thereby place an umbrella over less efficient competitors.

There is also the related question, ignored by the Court in *Von's*, of what constitutes a small business entitled to the protection of the statute. Shopping Bag, with its 36 stores, was no corporate giant; its \$90 million in sales a year is insignificant compared to the sales of an A&P or the other national food chains. It was a family firm (as was *Von's*) and the merger with *Von's* was motivated by the usual considerations that induce family firms to seek to be acquired, such as the need for more readily marketable stock with which to pay estate tax. Companies in the size range of Shopping Bag are clearly hurt by the Court's rule, yet from the standpoint of fostering an economy of numerous relatively small firms they should receive at least as much judicial solicitude as the Mom and Pop stores, whose progressive demise cannot possibly be halted by judicial fiat.

The rule of the *Von's* case may have been impaired by the decision last term in *United States v. General Dynamics Corp.*<sup>110</sup> The opinion in that case, which upheld the challenged merger, was written by Justice Stewart, a frequent dissenter from the Warren Court's merger decisions (including *Von's*); and although it is carefully written to preserve a facade of continuity with *Von's*, one is once again conscious of a grinding shift of mental gears. The case involved a merger of leading coal producers and resulted in increasing the market share of the two largest firms in the two geographical markets involved from 45 to 49 percent, and from 44 to 53 percent, respectively. And the merger took place against a background of a rapid and deep decline in the number of coal producers (from 144 to 39 between 1957 and 1967, in one of the markets). Given *Von's*, one might have thought these facts established a clear-cut violation of section 7. But the Court reached back to *Brown Shoe* for the proposition that while market-share percentages are "the primary index of market power . . . only a further examination of the particular

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110. 415 U.S. 486 (1974).

market—its structure, history and probable future—can provide the appropriate setting for judging the probable anticompetitive effect of the merger.’”<sup>111</sup> This requirement of “further examination” had, of course, been dropped in *Philadelphia Bank*, and the whole approach utterly rejected in *Von’s*. Examining further, the Court in *General Dynamics* found that the acquired firm’s market share overstated its competitive position. Virtually all of the firm’s coal reserves were already committed under long-term contracts, and no other reserves were available for it to acquire—they also were committed under long-term contracts. Thus, the acquired firm’s ability to compete for new business was so limited that it could not be considered an important potential source of supply for new customers. Its disappearance as an independent firm would not be noticed.

The Court is saying in effect that since the acquired firm was incapable of making any significant new sales it ought to be discounted as a competitive factor in the market—like a firm that had gone out of business but was still receiving income from previous installment sales. Conceivably, even the *Von’s* Court might have considered the acquired firm in this case sufficiently powerless not to fall within the ban on mergers between “powerful” firms. But one doubts it.<sup>112</sup> If the Court’s quotation from *Brown Shoe* is taken at face value, the rule is now to be that market shares are just the starting point for analysis. Some effort to assess their significance in the particular economic setting of the merger must also be made. This would seem to imply that a firm in *Von’s* position could now argue that the extraordinary ease and rapidity of entry into the retail grocery business greatly weakened the significance to be attached to large market shares—shares that would be significant in a market like steel where the creation of new competition is at best a gradual process. The new dispensation of the *General Dynamics* case cannot in logic be—and has not been—limited to the special case of a firm that can no longer obtain an essential input.<sup>113</sup>

Is the Court returning to the *Columbia Steel* era, one of freewheeling inquiry into all relevant aspects of the merger, with little guidance to what is relevant since the purpose of the law being applied is not clearly grasped? Is any evidence now to be admissible that tends to show that a merger does (or does not) offend either the social or the economic objections to concentration? One hopes not. It would be depressing to think that one had to choose

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111. *Id.* at 498, citing *Brown Shoe Co. v. United States*, 370 U.S. 294, 322 n.38 (1962).

112. The two Justices who had been in the majority in *Von’s* and were still on the Court when *General Dynamics* was decided (Douglas and Brennan) dissented. 415 U.S. at 511.

113. A few months later, in *United States v. Marine Bancorporation*, 418 U.S. 602 (1974), the Court held that market-share percentages do not have their ordinary significance in a case where state law limitations on branch banking confined a bank to a single office in the relevant market.

between *Von's* and *Columbia Steel*. There is a third alternative: a return to the basic approach of the *Philadelphia Bank* case, which involves deducing a simple rule from the economic objection to concentration. Perhaps this is what the Court has in mind.<sup>114</sup> Or perhaps we are entering a period in which the Court will continue to pay lip service to the rule of the *Von's* case, and the protection-of-small-business philosophy that underlies it, while allowing progressively greater exceptions to it yet without articulating any theory to explain and justify those exceptions.

3. *Improving on Philadelphia Bank*. When the *Philadelphia Bank* case was decided, most students of industrial organization believed that if one seller had at least 20 to 25 percent of the sales in his market, there was a serious danger that the market price would be above the competitive level.<sup>115</sup> This scholarly consensus has collapsed. A growing literature suggests that much higher levels of concentration may be necessary to create a substantial danger of the sorts of supracompetitive pricing that are hard to reach under the Sherman Act,<sup>116</sup> in part because many other factors besides concentration are relevant to the feasibility of such pricing.<sup>117</sup> Scholarly thinking has also changed with respect to the costs of preventing mergers between competing firms. There is less confidence than formerly that economies of scale are likely to be fully realized at levels of concentration well below the point at which the prohibitions of section 7 might come into play.<sup>118</sup> Of course, blocking a merger or series of mergers aimed at attaining efficient firm size will delay rather than prevent attainment of that goal. Firms will expand internally to take advantage of the available economies of scale. By the same token, however, legal rules that forbid mergers designed to exploit economies of scale can have no durable impact on levels of concentration. We are also more sensitive today to the importance of mergers as a method for displacing less efficient corporate managements, a social value distinct from economies of scale and impaired by rules broadly forbidding horizontal mergers.<sup>119</sup>

These revisions in our thinking about mergers call for conservative rules

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114. In *United States v. Marine Bancorporation*, 418 U.S. 602, 631 (1974), the Court described its *General Dynamics* decision as holding that market share statistics establish a rebuttable presumption of illegality.

115. See *United States v. Philadelphia National Bank*, 374 U.S. 321, 363 n.38, 364-65 n.41 (1963).

116. See, e.g., G. Stigler, *supra* note 75, at 59; Demsetz, *Two Systems of Belief About Monopoly*, in *INDUSTRIAL CONCENTRATION: THE NEW LEARNING* 164 (H. Goldschmid, H. Mann & J. Weston eds. 1974); Kessel, *A Study of the Effects of Competition in the Tax-Exempt Bond Market*, 79 J. POL. ECON. 706, 723 (1971).

117. See discussion of these factors in R. Posner, *supra* note 2, at 116-35.

118. See Demsetz, *supra* note 116; McGee, *Efficiency and Economics of Scale*, in *INDUSTRIAL CONCENTRATION: THE NEW LEARNING*, *supra* note 116, at 55.

119. To be sure, even a complete ban on horizontal mergers would not eliminate the possibility of corporate takeovers by the merger route, assuming that broad scope was allowed for vertical or at least conglomerate mergers. But often a firm in the same market will have a much better idea of whether another firm's management is failing to maximize the value of the assets under its control, and managerial complementarities will often be greater between firms in the same market than between firms in different markets.



of liability. There is little basis in current thinking for intervening in markets in which the four largest firms have a combined market share of less than 60 percent.<sup>120</sup> But mergers that carry a market across that threshold, and those that significantly increase concentration in a market that has already crossed it, should be presumptively illegal; and the grounds for rebutting the presumption should be limited to factors that establish some specific competitive incapacity of the acquiring or acquired firm (as in *General Dynamics*) that robs the market-share statistics in the particular case of their ordinary significance. Rebuttal based on ease of entry, economies of scale, or managerial efficiencies should not be allowed, because these factors, although clearly relevant to a correct evaluation of the competitive significance of a merger, are intractable subjects for litigation. With a less encompassing prohibition of horizontal mergers, we will have less need to worry about the adverse consequences of ignoring most of the efficiency justifications of challenged mergers.

### B. *Potential Competition*

1. *Penn-Olin*. The idea that eliminating a potential competitor might be the basis of an antitrust violation is an old one—it appears briefly in *Columbia Steel*—but its modern development begins with *United States v. Penn-Olin Chem. Co.*<sup>121</sup> In that case the Government challenged as violative of section 7 of the Clayton Act a joint venture between Pennsalt and Olin Mathieson to build a sodium-chlorate plant to serve the Southeastern United States, a growing market served by only two firms. Both joint venturers were chemical companies. Prior to the joint venture, Pennsalt had manufactured sodium chlorate, but its market was in the West; Olin had not. Each firm had considered, and according to the district court neither had completely rejected,<sup>122</sup> the possibility of building its own plant in the Southeast, before deciding on the joint venture.

The district court assumed that if but for the joint venture both Pennsalt and Olin would have built plants in the Southeast, the joint venture would have violated section 7 by reducing the number of competing firms from four to three; it found, however, that it was highly unlikely that both would have built plants.<sup>123</sup> It made no finding as to the probability that but for the joint venture one would have built a plant “while the other continued to ponder,”<sup>124</sup> since

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120. Kessel's study of underwriting costs found that an increase beyond eight in the number of bids submitted did not reduce those costs substantially, Kessel, *supra* note 116, at 723; and an industry where the four largest firms have less than 60 percent of the market is likely to contain at least eight significant competitors. As I have argued elsewhere, but will not repeat here, it would be better to define the legal standard in terms of the Herfindahl concentration index rather than the four-firm concentration ratio. See R. POSNER, *supra* note 2, at 423.

121. 378 U.S. 158 (1964).

122. 217 F. Supp. 110, 128-29 (D. Del. 1963).

123. *Id.* at 130.

124. 378 U.S. at 173.

it could see no significant competitive difference between that situation and the joint venture.

The Supreme Court did not disturb the district court's finding that both firms would not have built plants. But it reversed and remanded for a finding as to whether if the joint venture had been blocked and only one of the firms had built a plant, the other "would have remained a significant potential competitor"<sup>125</sup> whose threat to enter the market would have constrained the pricing decisions of the firms in the market. The following "standard" was proposed to guide the district court on remand:

We note generally the following criteria which the trial court might take into account in assessing the probability of a substantial lessening of competition: the number and power of the competitors in the relevant market; the background of their growth; the power of the joint venturers; the relationship of their lines of commerce; the competition existing between them and the power of each in dealing with the competitors of the other; the setting in which the joint venture was created; the reasons and necessities for its existence; the joint venture's line of commerce and the relationship thereof to that of its parents; the adaptability of its line of commerce to noncompetitive practices; the potential power of the joint venture in the relevant market; an appraisal of what the competition in the relevant market would have been if one of the joint venturers had entered it alone instead of through Penn-Olin; the effect, in the event of this occurrence, of the other joint venturer's potential competition; and such other factors as might indicate potential risk to competition in the relevant market.<sup>126</sup>

No one who reads this laundry list can believe that the Court had a clear understanding either of the problem of potential competition or of the practical limitations of judicial fact-finding.

To understand the role of potential competition in the scheme of section 7, it is useful—as always in the antitrust field—to return to fundamentals. The purpose of section 7, viewed economically (the only view taken in *Penn-Olin*), is to prevent the emergence of conditions that substantially increase the probability of effective collusion. There are two basic conditions of such collusion. The first (and the one to which potential competition is mainly relevant) is that the elasticity of demand for the output of the colluding firms be substantially less than infinite. The second is that the costs of collusion be relatively low. The elasticity of demand measures the responsiveness of the quantity demanded of a product to changes in its price. The more elastic (responsive) demand is, the closer is the profit-maximizing monopoly price to the competitive price.<sup>127</sup> Elasticity is thus a complete summary measure of the

125. *Id.* at 175-76.

126. *Id.* at 176-77.

127. A simple mathematical demonstration of this point may be useful in introducing

monopoly power of a group of colluding sellers, and anything that increases the elasticity of demand without reducing the costs of collusion reduces monopoly power.<sup>128</sup> The existence of potential competitors increases the elas-

some lawyers to the mysteries—and the power—of mathematical formulations of economic propositions.

The monopolist seeks to maximize his profits,  $Pr$ , which are simply the difference between total sales revenues and total costs. Thus

$$Pr = P(Q) \cdot Q - CQ, \quad (1)$$

where  $P(Q)$  (hereafter simply  $P$ ) is the price of the product expressed as a function of the quantity sold ( $Q$ ), and  $C$  is the (marginal) cost of producing one unit (for simplicity, constant costs are assumed and fixed costs are ignored).

What quantity should the monopolist produce in order to maximize his profits? The answer is obtained by differentiating  $Pr$  with respect to  $Q$ , our choice variable, and setting the result equal to zero (we assume the second-order condition for a maximum is satisfied, as it will be if the demand curve cuts the marginal-cost curve from above), which yields

$$\frac{dPr}{dQ} = \frac{dP}{dQ} Q + P - C \stackrel{!}{=} 0, \quad (2)$$

where  $dP/dQ$  denotes the effect on  $P$  of an infinitesimal change in  $Q$ .

The elasticity of demand ( $E$ ), expressed for simplicity as a positive number (strictly speaking it is negative, since an increase in price results in a decrease in quantity), is given by

$$E = - \frac{dQ}{dP} \cdot \frac{P}{Q}. \quad (3)$$

Substituting (3) into (2) and simplifying, we obtain

$$P \left( 1 - \frac{1}{E} \right) = C. \quad (4)$$

We can relabel  $P$  as  $P_m$ , since it is the profit-maximizing monopoly price, and, using  $P_c$  to denote the competitive price, rewrite (4) as

$$P_c = P_m \left( 1 - \frac{1}{E} \right), \quad (5)$$

since in a competitive market, price is equal to marginal cost ( $C$ ). By a simple manipulation, equation (5) is transformed into

$$\frac{P_m}{P_c} = \frac{E}{E-1}. \quad (6)$$

(I am indebted to my colleague William M. Landes for pointing out the utility of this expression.) It is plain from equation (6) that the ratio of the monopoly to the competitive price is an inverse function of the elasticity of demand, and of the elasticity of demand alone. As  $E$  approaches infinity, the monopoly price approaches equality with the competitive price and hence the incentive to collude disappears.

Two qualifications to the foregoing analysis should be made. First,  $E$  refers to the elasticity of demand at the profit-maximizing monopoly price. The elasticity of demand at the lower, competitive price may be different, and quite possibly lower; the lower it is the greater the incentive to collude. Second, that  $E$  be less than infinity at the monopoly price is a necessary rather than a sufficient condition for collusion to be attempted. If it is less than infinity, there are potential benefits from collusion, but these benefits may not exceed the costs of collusion (including any punishment costs). The significance of concentration in an economic analysis of competition and monopoly is that it reduces the costs of collusion.

128. Thus, the ease of entry into the retail grocery market involved in the *Von's* case must have substantially increased the elasticity of demand facing the firms in that market.

ticity of the demand curve facing the existing sellers in the market by providing a source of supply to which consumers will be able to turn if prices rise above competitive levels.

Did the joint venture challenged in *Penn-Olin* reduce the elasticity of demand for sodium chlorate in the southeastern market? The Court's (implicit) view is that it probably did because but for the joint venture either Pennsalt or Olin Mathieson would have built a plant in the Southeast and the other would have continued to pose a threat of doing so. But the Court seems wrong in this, especially since it accepted the district court's finding that both firms would not have entered the market on their own.<sup>129</sup>

Before the joint venture, there were only two firms in the southeastern sodium-chlorate market.<sup>130</sup> The conditions for effective collusion were probably propitious, therefore, except for the possibility that an increase in price would lead to a fairly early collapse in the demand for these firms' output as new firms, attracted by the supracompetitive profits generated by collusive pricing, entered the market. We do not know the extent to which the existing firms' pricing was in fact constrained by the existence of potential competition, but it is conceivable that the prospect of new entry so reduced the expected gains from collusive pricing—so increased the elasticity of demand for the existing firms' product in the medium to long run<sup>131</sup>—as to discourage those firms from attempting to collude.<sup>132</sup> If so, the elimination of potential competition would clearly have fostered collusion. But the joint venture did not simply eliminate a potential competitor in the southeastern market; it also added a new competitor in that market, which must have reduced the probability and effectiveness of collusion by increasing the number of firms (from two to three) whose pricing would have to be coordinated. The Court discounted the pro-competitive effect of the joint venture by remarking that if the joint-venture route had been barred, one of the joint venturers would probably have entered the Southeast on its own. But even if the district court had found that it was

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129. On remand, moreover, the district court found that *neither* firm would have entered the market by itself, and on this ground once again dismissed the complaint. 246 F. Supp. 917 (D. Del. 1965), *affirmed by an equally divided Court*, 389 U.S. 308 (1967).

130. I ignore, as did the Court, the very slight sales that Pennsalt had made in the Southeast.

131. A sharp rise in the price charged by the existing firms would not have evoked a corresponding increase in the quantity supplied in the short run, because other firms could not enter the market instantaneously. But the existing firms were presumably interested in maximizing not their profits in the immediate future, but the discounted present value of their entire stream of future earnings, which requires that they act in reference to the elasticity of the demand for their product over a substantial time period rather than just in the immediate future.

132. This is *not* the argument that colluding firms will set a price equal to the cost of any new entrant in order to forestall entry, a foolish policy, since if the long-run marginal costs of the new entrant are no higher than those of the existing firms, the effect of such a policy will be to forgo all monopoly profits. The rational strategy of the colluding sellers is to set a price higher than the cost of the new entrant, since as long as new entry is not instantaneous this policy will enable some monopoly profits to be obtained. See note 64 *supra*.

overwhelmingly probable that one (but not both) of the joint venturers would have entered the market on its own, the Court would have erred seriously in discounting the joint venture's procompetitive effect to zero. Entry by means of the joint venture was, we know *ex post*, a certainty. A court can try to estimate the likelihood that in the absence of the joint venture at least one of the firms would have entered on its own, but it cannot be certain that this would have happened. The fact that the firms adopted the joint venture method of entry suggests, at the very least, that entry by this method was more attractive to the firms, and therefore probably occurred earlier than it would have occurred by another method.

Another doubtful feature of the Court's analysis is the suggestion that once one firm had entered the market (assuming now that the joint venture had been blocked), the remaining firm would have continued to pose a threat of new entry which would operate as a constraint on pricing in the southeastern market. This possibility is in fact small, given the district court's finding, which the Supreme Court accepted, that both firms would not have entered the market on their own. The likelihood of collusive pricing in that market was presumably greater when there were only two firms—that is, before the hypothesized entry of either Pennsalt or Olin—than it was afterward, when there were three. At the earlier stage, therefore, the ratio of market price to cost was likely to be greater, and hence entry more attractive, than after a third firm (Penn-Olin) appeared in the market. But if both firms would not have entered the southeastern market when there were only two firms in that market, as the district court found and the Supreme Court agreed—if, in other words, the joint venturers believed that the market could support only three sellers—there is no reason to expect that after one of them had entered the remaining firm would still have considered entering on its own.<sup>133</sup>

If we know that either Pennsalt or Olin would have entered the southeastern market (call the actual entrant "*E*") and that the other firm (call it "*O*") would not have entered, in what sense can *O* be considered a substantial factor in that market? It is assumed that *O* would not enter if *E* did. *E* did enter; therefore, as just explained, it is even less likely now than before that *O* will enter. *O* will surely not enter unless the ratio of price to cost in the southeastern market is higher after *E* enters than before, but it is more likely to be lower since collusion is now more difficult for the firms in the market. The firms in the southeastern market know all this, presumably, and will

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133. A more extreme example may help to clarify this point. Suppose that a market contains only one firm; there are 20 firms that could enter it; and we know, somehow, that only 10—we do not know which 10—will do so. Ten firms do enter the market and prices fall. What basis is there for thinking that the remaining firms are likely to consider entry? When prices were higher, and entry therefore more attractive, we know that they would not have entered, and as the result of the entry of their 10 fellows entry is now less attractive.

therefore drastically discount the significance of *O*'s remaining a potential competitor.

I have thus far discussed the *Penn-Olin* decision as if the only four firms in the world were the two selling sodium chlorate in the Southeast plus Pennsalt and Olin Mathieson, two firms mulling entry into that market by one method or another. Even on that assumption, which is radically favorable to the Court's analysis of the case, the analysis seems highly questionable, as we have seen. But the assumption is in fact the most questionable feature of the decision. Suppose that after the joint venture Penn-Olin colludes with the existing firms in the Southeast. Pennsalt and Olin Mathieson are no longer potential competitors, but what of the remaining chemical firms in the country? Will they not be attracted to the southeastern sodium-chlorate market by the monopoly profits being generated there? The Court's laundry list of factors to be considered by the district court on remand omits the effect on the strength of potential competition of eliminating one potential competitor. Yet economic theory suggests that charging monopoly prices in a market will create attractive opportunities for a significant number of firms whose long-run costs of operating in the market will not be substantially higher than those of the firms already in it. The possibility that the ranks of potential competitors might be so depleted that a reduction in their number by one would be perceived by the firms in the market as the elimination of a significant constraint on collusive pricing behavior seems sufficiently remote to require that it be proved. This critical point eluded the Court in *Penn-Olin*.

To recapitulate, the existence of potential competition may constrain collusive pricing in a market by increasing the perceived elasticity of demand facing the sellers in the market. And so in principle the elimination of potential competition could have anticompetitive consequences. But it is a tremendous jump from this perception to the conclusion that eliminating a potential competitor is likely to have an effect on the market. The number of potential competitors is a function of the ratio of price to cost in the market in question, and every increase in price above cost should make entry attractive to some number of firms by providing them with an opportunity to obtain monopoly profits. At prices substantially above cost—the sorts of prices with which the antitrust laws are properly concerned—the number of potential competitors will normally be very large. But even if Pennsalt and Olin Mathieson were indeed the only potential competitors in the southeastern sodium-chlorate market, the Court's decision was probably wrong. The fact that these firms chose to enter by means of a joint venture rather than individually, coupled with the district court's finding (accepted by the Supreme Court) that both firms would not have entered individually,<sup>134</sup> provides substantial evidence that

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134. As to whether such a finding is meaningful, see text accompanying note 145 *infra*.

the procompetitive effect of the joint venture in injecting a third firm into the southeastern market outweighed its anticompetitive effect (a very tenuous one, as we have seen) in removing the potential competition of the firm that would not have entered individually once the other firm did so.

2. Procter & Gamble and Falstaff. The potential competition doctrine was next applied in *Federal Trade Commission v. Procter & Gamble Co.*,<sup>135</sup> a case that involved the acquisition by Procter of the Clorox Company. Clorox produces roughly half of all of the household liquid bleach sold in this country. The illegality of the merger was placed on two grounds, which are not easy to reconcile with each other. The first is that the merger entrenched still further Clorox's position of dominance in the liquid-bleach industry; the second, that it eliminated Procter as a potential competitor of Clorox.

The first ground strongly implies that Procter had both the ability and desire to underprice the existing producers of household liquid bleach—including Clorox.<sup>136</sup> If this is true, however, there seems little point in forbidding the acquisition. Procter, given its capability and disposition, will simply enter the market internally and proceed to destroy its feeble competitors. The end result of the acquisition and of forbidding the acquisition will be the same, a monopoly position for Procter & Gamble.

The ideal situation from the Court's point of view, apparently, would have been for Procter never in fact to enter the bleach market, but always to be thought by Clorox about to enter. The Court's analysis of Procter's great strengths (an incorrect analysis, as we shall see<sup>137</sup>) makes this an unlikely outcome. If Procter is so much more effective than any existing producer of liquid bleach, including Clorox, it can be expected to enter internally and quickly obtain a dominant position by that route.

To isolate the potential competition issue in the case, let us for the moment disregard the first ground of decision and assume that Procter had no decisive cost or other competitive advantage over Clorox or other bleach producers.<sup>138</sup> The question is then whether Procter's situation prior to the merger as a potential competitor of Clorox is likely to have affected Clorox's

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135. 386 U.S. 568 (1967).

136. The Court believed, incorrectly as it happens, *see* Peterman, *The Clorox Case and the Television Rate Structures*, 11 J. LAW & ECON. 321, 389, 396 (1968), that Procter could buy advertising time on television much more cheaply than Clorox—and of course Procter had a much deeper pocket than Clorox. *See* 386 U.S. at 575, 579 n.3.

137. *See* text accompanying notes 140-41 *infra*.

138. I have assumed in this discussion that internal expansion by Procter & Gamble into the household liquid bleach market would not have run afoul of any other provision of the antitrust laws—a reasonable assumption if Procter's predicted rapid growth in that market would have been due solely to its superior efficiency. But the Court seems to have thought that Procter's great power derived from, or would be exercised by means of, improper practices. *See* note 136 *supra*. This implies that Procter's achievement of a dominant position following internal entry might have violated section 2 of the Sherman Act, 15 U.S.C. § 2 (1970). If so, however, and assuming that Procter was deterred or could be prevented from violating the law, one wonders why the Court thought Procter a formidable potential competitor.

pricing decisions. Probably not. If Clorox charged a monopoly price, entry into the liquid bleach market would become attractive to a great many firms. Monopoly profits are not that widely available in the economy, and no patents, raw material scarcities, heavy capital requirements, or large economies of scale impede entry into the liquid bleach market. Even expertise in the marketing of consumer goods is not required, since liquid bleach can be sold through large retail chains that affix their own brand name to the bleach and assume complete responsibility for its promotion and marketing.<sup>139</sup> Indeed, it is difficult to imagine an easier market to enter than household liquid bleach—unless it is shoe retailing or retail groceries. This would appear to be a clear case in which the number of potential competitors is legion and the elimination of a single one can have no effect on the behavior of the firms in the market.

The Court emphasized Procter & Gamble's great reputation and success as a producer of consumer goods similar to liquid bleach, partly to support the first ground of the decision but also to support the second ground by distinguishing Procter from the faceless horde of potential competitors. The point, however, proves too much. To identify Procter & Gamble as a uniquely effective producer of the class of products that includes liquid bleach is to establish the futility of preventing it from acquiring Clorox—a firm in no position to compete on equal terms with the Procter & Gamble of the Court's imagination.

In fact, however, it is unlikely that Procter & Gamble, whatever its general commercial prowess, had any unique advantages as a potential producer of liquid bleach. This is suggested by the very high price that it paid for Clorox.<sup>140</sup> If Procter was thinking seriously of entering the bleach market on its own, and once in the market would have wiped the floor with Clorox as the Court apparently believed, it should have been able to buy Clorox quite cheaply, for Clorox's prospects as an independent firm would have been dim. We can, I think, go even further, and infer that unless there were special complementarities between Procter's and Clorox's managements or operations

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139. The Court seems to have thought that because a retailer's house-brand bleach sells at a lower price than Clorox, such brands do not provide effective competition for Clorox. This is incorrect. So far as appears, the difference in price between national-brand and house-brand bleach is fully explained by the higher cost of advertising and promotion incurred by the manufacturer when he sells under his own brand name. The existence of the price difference need not connote monopoly power. The price of Clorox bleach may well be held to the competitive level (where price equals marginal cost) by the lower-priced house-brand bleaches, since any attempt by Clorox to enlarge the price difference by increasing its price might cause such massive substitution in favor of the house brands as to make the higher price unprofitable.

140. Procter & Gamble bought Clorox in exchange for P&G stock having a market value of more than \$30 million. In the year prior to the merger, Clorox had had net income of \$2.6 million. The purchase price indicates that Procter thought Clorox's earnings would continue to increase whether or not Procter entered the market. If Procter could have convinced Clorox's stockholders that the alternative to selling to Procter was to watch Procter enter the liquid bleach market internally (or by purchase of one of Clorox's competitors) and take away much, perhaps all, of Clorox's business, it could have bought the company at a much lower price.



Procter was probably less likely than one or more other firms to have entered the liquid bleach market by internal growth rather than merger. It is unlikely that the highest bidder for Clorox would be a firm that thought itself well able to enter the market internally. A firm would not be willing to pay a high price for Clorox if it could indeed readily enter the market, and thereby reduce Clorox's profitability, should Clorox refuse to sell out to it on attractive terms. The highest bidder for Clorox would probably be a firm that had no other way of entering the liquid bleach market. Such a firm would not be able to chisel down the purchase price by implicitly threatening to enter the market internally should negotiations fail. Since Clorox was unable to get a better offer from anyone other than Procter, presumably Procter was such a firm. If so, it was not in the forefront of potential competitors and the merger should not have been forbidden on the ground that it substantially impaired the strength of potential competition in the household liquid bleach market.<sup>141</sup>

In *Penn-Olin* the Court had remanded for an assessment of *O*'s significance as a potential competitor, notwithstanding the finding that *O* would not enter the relevant market on its own. The question whether a firm that will not in fact enter a market on its own can still be regarded as a potential competitor in that market was again before the Court in *United States v. Falstaff Brewing Corp.*<sup>142</sup> Falstaff acquired Narragansett, a leading seller of beer in New England, where Falstaff had not previously done business. The district court, "relying heavily on testimony of Falstaff officers, concluded that the company had no intent to enter the New England market except through acquisition and that it therefore could not be considered a potential competitor in that market."<sup>143</sup> The Supreme Court held that the district court's conclusion did not follow from its premise: even if it were certain that Falstaff would not have entered the market except via the challenged merger,<sup>144</sup> Falstaff might have posed a threat of entry that would have constrained the pricing of the firms in the market.

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141. This analysis of course assumes that other firms rate the prospect of Procter & Gamble's entry lower than Procter & Gamble itself; otherwise, the prospect of Procter's entry would depress the purchase price that any firm would pay for Clorox. Presumably, however, there is a range of estimates of the likelihood and consequences of Procter's entry, and the firm whose estimate was at the low point of the range would be the highest bidder for Clorox.

An alternative possibility as to why Procter & Gamble was the highest bidder is that there were managerial or other complementarities between Procter and Clorox that made Clorox's assets more productive in Procter's hands than in anyone else's. If so, however, the merger increased efficiency and should presumably be allowed.

The short of it is that there is no theory under which Procter's purchase of Clorox identifies Procter as a most likely potential entrant whose elimination by the merger should be actionable under section 7.

142. 410 U.S. 526 (1973).

143. *Id.* at 532.

144. Another alternative would be to enter the market by purchasing a very small firm as a base from which to expand and become a major factor in the market. I would treat this sort of "toe-hold" acquisition as the equivalent in antitrust analysis of internal expansion, since it does not involve the elimination of a significant competitive factor.

At first blush this result seems to depend on a difference between what Falstaff knew (and the courts now know) about its own intentions and what the brewers selling in the Northeast thought about its intentions—a difference that vanishes once the testimony of Falstaff's officers comes to the attention of the brewers in the Northeast. But I think the Court was correct (although for the wrong reasons),<sup>145</sup> in *Falstaff* though not in *Penn-Olin*, in refusing to give controlling weight to evidence, however convincing, that the acquiring firm had no intention of entering the relevant market on its own. Intentions alter with circumstances. Suppose that the brewers in the Northeast have decided that if they colluded on price, entry would occur so rapidly as to make their collusion unprofitable, and as a result they charge the competitive price for beer. A Falstaff may have no interest in building a brewery in the Northeast at a price that would yield only the competitive rate of return. But it does not follow that Falstaff is not a significant potential competitor of the brewers in the Northeast. The fact that a somewhat higher price in the Northeast would cause it to change its mind may be one of the reasons why the higher price is not charged. The difference between the *Falstaff* and *Penn-Olin* cases is that in the former the merger did not alter the structure of the relevant market except insofar as it eliminated one potential competitor, while in the latter the joint venture made a highly monopolistic market somewhat less so and the potential competitor eliminated, given its assumed inability or unwillingness to enter the market when the market had been a duopoly, was a firm unlikely to be a significant factor in the thinking of the firms in the market.

The Court did not reach the hard question in *Falstaff*, which is whether eliminating Falstaff as a potential competitor was likely to make a significant difference in the thinking of the firms in the market. The Court seems, however, to have alluded to the issue in noting that Falstaff was one of only three brewers among the nation's 10 largest that were not selling in New England. But why cut off the class of most likely potential competitors at number 10? Narragansett was not one of the nation's 10 largest brewers yet it had 20 percent of the New England market. If a monopoly price were to be charged in New England, that market would become intensely attractive to any number of brewers not already selling there. There is no reason to think that Falstaff

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145. The Court was interested in drawing the logical distinction between Falstaff's *knowledge* of its own intentions and its competitors' *perceptions* of those intentions. There is a distinction, but it is a fragile reed on which to build antitrust doctrine. It seems unlikely that firms considering collusion would long be deterred by mistaken perceptions of the intentions of firms outside of the market. And if they did persistently exaggerate the likelihood of one firm's entry into the market, would they not generally magnify the strength of all potential competitors, in which event eliminating a single potential competitor would have little significance for their behavior? Incidentally, on remand the district court found that Falstaff was not perceived as a likely entrant, and again dismissed the complaint. *United States v. Falstaff Brewing Corp.*, 383 F. Supp. 1020 (D.R.I. 1974).

would enter sooner or on a larger scale than others. Indeed, as in *Procter & Gamble*, the fact that Falstaff chose to enter the New England market by purchasing the leading firm in the market, presumably at the best price which that firm could command for its assets, is some evidence that Falstaff would not have been the first brewer to enter the market on its own if the price of beer in New England had risen above the competitive level.

The potential competition doctrine is unsatisfactory, although the problem is less one of deep confusion as to fundamental policies, as has afflicted the Court in the restricted distribution and horizontal merger areas, than one of inability to develop objective and workable standards. In dealing with potential competition the Court has based policy squarely on the economic view of section 7; and concern with potential competition is in principle a reasonable corollary of the concern with collusive pricing that underlies the economic theory of section 7. The Court has not applied the concept of potential competition very well, but that is almost a detail. The root problem is the impossibility of developing simple, workable rules of illegality in this area; and without such rules the enforcement of the antitrust laws tends to degenerate into a costly exercise in judicial whim. There is no judicially workable method of ranking, even crudely, the potential competitors in a market for the purpose of identifying a set of most likely or most feared entrants.<sup>146</sup> And even if one could identify such a set through the methods of litigation, one would not know how to evaluate the elimination of one member of the set, whenever the set contained more than one member. There is no body of theory, let alone any empirical evidence, that tells us that if the number of equally potential competitors in a market falls from, say, four to three, the pricing decisions of the firms in the market will be affected.

3. *A Plea for Abandonment of the Potential Competition Doctrine.* The doctrine of potential competition was developed by the Court, and the Court can abandon it, and should do so. In theory, as I have suggested, the elimination of a potential competitor could affect the pricing in a market by reducing the elasticity of demand as perceived by the firms that are already in the market, assuming that conditions are otherwise favorable to collusion. But there is no way of translating this theoretical insight into an objective standard of illegality. As a first approximation, the elimination of an individual potential competitor can be expected to have no competitive significance at all, since there are presumably a number of other equally potential competitors, in the sense of firms that could enter the market at a cost no higher than that of the eliminated firm and would do so if the market price were

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146. Asking the firms in the market to testify about their perceptions regarding potential competition seems a peculiarly futile mode of inquiry. They can hardly be expected to testify that they refrained from colluding because of fear that firm *A* or *B* or . . . *Z* would have entered the market.

appreciably higher than the competitive level, that is, than costs. There may of course be cases in which this presumption could be rebutted if only we knew how to measure the entry costs of different firms or to establish reliably the perceptions of the firms in the market. But we can do neither of these things, so that if the government is required to prove that in fact the elimination of a given potential competitor altered the structure of competition in the market it will always fail. The alternative to requiring proof on these questions is to adopt presumptions based on theoretical or commonsensical probabilities. The Government, of course, prefers this approach, but the only presumption it has thus far been able to devise is that the fact of acquiring a firm shows that the acquirer was more likely than other firms to have entered (or have been perceived as likely to enter) the market by internal expansion (or what amounts to the same thing, by a "toehold" acquisition). We have seen that this presumption is, if anything, contrary to the probabilities. A more sensible presumption would be that the acquiring firm was *less* inclined than at least some other firms to enter the market by internal expansion. If this contrary presumption were accepted, the chances of the Government's prevailing in a potential competition suit would fall very nearly to zero. But this is not such a distressing prospect. After years of trying, neither the Government nor any other proponent of the potential competition doctrine has provided either theoretical or empirical basis for believing that the elimination of a specific potential competitor has ever affected the price level of a market.

The reader may be troubled by the implications of this analysis for the problem of defining the "market" in which to calculate market-share statistics in an ordinary horizontal merger case. After all, the definition of market is also an exercise in the appraisal of potential competition. We ask whether a firm that at present has no sales of Product X, or in Region Y, should nonetheless be included in that product or geographical market because it is potentially able to sell there. What makes this sort of inquiry manageable, however, is the existence in the market-definition context of simple, if very crude, proxies for the underlying quantities. We ask whether two products are virtually indistinguishable in production or consumption, and if they are we classify them in the same product market. We ask whether two firms that sell the identical product but in different regions would have to incur substantial transportation costs in order to ship into each other's regions, and if not we collapse the regions into a single geographical market. These are awfully rough, but serviceable and not completely arbitrary, methods of identifying a group of potential competitors whose ability to enter a market is so great that they are competitively equivalent to the firms already in the market.<sup>147</sup> No similar proxies are available for determining which if any

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147. See *United States v. El Paso Natural Gas Co.*, 376 U.S. 651 (1964), which I read as holding simply that two firms do not have to be selling to the same customer

members of a group of more remote potential competitors have such good prospects for entry that they influence price levels in the market. On the basis of present knowledge, it would seem best simply to ignore potential competitors who cannot be regarded as equivalent to the firms already in the market.

Perhaps, given the relative unimportance of transportation costs in the beer industry, it would have been appropriate to classify the beer industry as a single national market. In that event, Falstaff and Narragansett would have been actual competitors and their merger a horizontal one to be tested under whatever rule of thumb is used for deciding the legality of such mergers. So viewed, the merger would be competitively insignificant. The combined market share of Falstaff and Narragansett is very small when the relevant market is the entire nation, because there is a large number of substantial brewers. We have seen, however, that there is no objective basis on which to single out Falstaff among them as especially important in the thinking of the New England brewers. If Falstaff can fairly be deemed a part of the New England market before it bought Narragansett, so should the rest of the nation's brewers.

### III. CONCLUSION

Restricted distribution, horizontal mergers and potential competition do not, of course, comprise the whole of antitrust doctrine but they comprise a substantial part of it, especially of that part that has been developed since the early cartel and monopolization cases, which is to say since 1911. The analysis in the preceding parts of this Article provides, therefore, an appropriate basis for appraising the Court's modern contributions to antitrust doctrine. Our findings would be unchanged if we also examined the tying, exclusive dealing, price discrimination and other sorts of decisions that make up the remainder of the modern antitrust law. The conclusion seems inescapable that the Justices have done an unsatisfactory job in the antitrust field. I do not mean an unsatisfactory job as economists, although that is also true, but an unsatisfactory job as judges. The Court has failed to relate its antitrust rules to the purposes of the statutes that it is interpreting and the rules are in many cases inconsistent with those purposes and with each other; its antitrust jurisprudence has been mechanical rather than purposive. And it has repeatedly demonstrated insensitivity to the practical limitations of the judicial

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at the same time in order to be in competition for the customer's business—especially where the product in question is bought infrequently.

Observe that if we could measure the elasticity of demand facing a group of sellers, it would be unnecessary to ask whether the group constituted an economically realistic market. The effect of other sellers on the group's ability to collude would be automatically registered, together with all other relevant factors which our ignorance compels us to exclude from antitrust analysis. Cf. note 127 *supra*.

process, which require rules to guide decision rather than invitations to roam at large through masses of factual materials thrown up by the defense bar.

Although it seems important to draw attention to the deficient performance of the Court in antitrust, I confess to being rather at a loss when it comes to suggesting how the situation might be improved. The problem is not simply the intellectual limitations that the Justices share with the rest of humanity. Justice Hughes, who wrote the opinion in *Dr. Miles*,<sup>148</sup> was certainly an intelligent man and a distinguished Justice, and Justice Fortas, the author of the *Schwinn* opinion, is not only a competent and highly successful lawyer, and a former member of the Yale Law School faculty, but before joining the Court had been an antitrust specialist!<sup>149</sup> Justice White, another distinguished Yale Law School graduate and a conscientious and hard-working Justice with a lively interest in the antitrust field, is the author of several antitrust opinions that invite severe criticism.<sup>150</sup>

I conjecture that four factors have been significant in the Court's failure to create a coherent and rational body of antitrust doctrine. First, some Justices (although a minority) have viewed the antitrust field as an opportunity to vent their emotional or ideological hostility toward Big Business, which they have done without pausing to ask (perhaps without caring) whether they were actually helping small business.

Second, antitrust may be too difficult a body of law to be consigned to nonspecialists for its development and application. The Court rarely hears more than two or three antitrust cases a year and this provides too little exposure to the field to enable those Justices who were not experts when they were appointed to the Court to obtain an adequate grasp of the field.

Third, the Court has not been helped as much as one might have thought by the briefs and arguments of counsel, especially defense counsel. Whereas the lawyers for the Justice Department have been ingenious in proposing new theories of liability, the defense bar has been on the whole timid and unimaginative in proposing alternative theories of business behavior and standards of liability.<sup>151</sup> The typical defense posture in a case is to accept the theoretical basis of the Government's position but try to show that the defendant did not in fact commit the act complained of. As a result, the Government's constant pressure to expand the grounds of antitrust liability has met little resistance

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148. Not to mention the Court's opinion in *Appalachian Coals, Inc. v. United States*, 288 U.S. 344 (1933), discussed in R. POSNER *supra* note 2, at 74-75.

149. He also wrote the Court's opinion in *United States v. Sealy, Inc.*, 388 U.S. 350 (1967).

150. Besides *Albrecht v. Herald Co.*, 390 U.S. 145 (1968), he has written the Court's opinions in *United States v. Continental Can Co.*, 378 U.S. 441 (1964); *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*, 392 U.S. 481 (1968). The latter two opinions are discussed critically in R. POSNER, *supra* note 2, at 483-88 and 147-49, respectively.

151. For an example, see John L. Peterman's discussion of the defense of the *Brown Shoe* case, in *The Brown Shoe Case*, J. LAW & ECON. (forthcoming).

from the defense bar. There are of course important exceptions but it is the central tendency that I am trying to describe.

There is a reason for the asymmetry of the Government and the defense bar in this respect. The Government is not constrained by a client relationship to maximize its prospects for victory in the particular case, but can maximize its long-run prospects by subordinating efforts to win the particular case to efforts to establish new doctrine which may help it in later cases. It is very difficult for the defense bar to adopt a similarly far-sighted strategy. The client cares, primarily at any rate, about the outcome of the immediate case rather than about the future shape of antitrust doctrine. Responsibility to the client makes it very difficult for defense counsel to define his task as the improvement of antitrust doctrine rather than, or even as well as, the exoneration of his client. If, for example, the lawyer thinks he can persuade the district court that his client did not in fact engage in reciprocal buying, he may prefer not to argue also that whether the client did or did not engage in reciprocal buying is irrelevant because reciprocal buying is not anticompetitive. Such an argument may antagonize the judge or, even if the judge is convinced by the argument, a decision predicated on principle makes it more likely that the Government will persuade the Supreme Court to hear an appeal and ultimately reverse than would a decision based on factual grounds.

Fourth, some of the responsibility for the Court's poor performance in the antitrust area may be due to the Expediting Act,<sup>152</sup> which (until very recently<sup>153</sup>) provided for direct appeal from district court to Supreme Court in antitrust cases brought by the Department of Justice for equitable relief. I am not suggesting that the Court writes a better opinion on average in a private or Federal Trade Commission antitrust case, where there is intermediate appellate review; but since most of the important antitrust cases have been Justice Department equity cases, the Expediting Act has eliminated what would otherwise have been a substantial body of non-Supreme Court appellate decisions in the antitrust field and has reduced the number of circuit judges who are experienced in antitrust matters (which has had bad effects on the private and FTC cases that come before the circuit courts). The Court has, in short, had less help from the circuit judges in the antitrust field than in others. And it has needed—and continues to need—all of the help that it can get in this field. With the recent amendment of the Expediting Act,<sup>154</sup> there is perhaps some ground for hope for the future.

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152. 32 Stat. 823, *as amended*, 15 U.S.C. § 28 (1974).

153. *See* note 154 *infra*.

154. The Antitrust Procedures and Penalties Act, Pub. L. No. 93-52, § 4, *amending* 15 U.S.C. § 28 (1974), which President Ford had at this writing just signed into law, substitutes appeal to the circuit court for direct appeal to the Supreme Court from district court judgments in government antitrust cases. If either party seeks direct appeal and the district judge concurs, however, the Supreme Court may in its discretion hear the case on direct appeal from the district court.