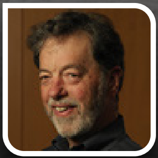
THE PARADOX OF PREDATORY PRICING

BY JOHN B. KIRKWOOD[1]



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The Paradox of Predatory Pricing

By John B. Kirkwood

Predatory pricing is an antitrust paradox. In concept, the conduct is plainly anticompetitive, yet no predatory pricing case has resulted in an injunction or treble damages for over a generation. This article addresses two ways of restructuring U.S. law to improve the situation. The first approach would eliminate the first *Brooke Group* requirement and allow plaintiffs to challenge above-cost pricing. The second approach would drop the other *Brooke Group* requirement and allow plaintiffs to challenge below-cost pricing without establishing probable recoupment. Plaintiffs would, however, have to show that the defendant had no justification for pricing below cost. The article concludes that the second approach is likely to be superior. It would facilitate challenges to true predatory pricing by eliminating the element of existing law that is most difficult to establish. It is less likely to deter desirable price cutting because it creates less uncertainty. It is easier to tell whether a price is below cost than whether a price cut is likely to lead to long-run monopoly power. While the second approach would not reach above-cost predation, it would reduce predatory pricing overall and enhance consumer welfare.

I. INTRODUCTION

Predatory pricing is an antitrust paradox. In concept, the conduct is plainly anticompetitive. A dominant firm cuts its price below its incremental costs, losing money on every additional sale, solely to injure a significant rival.[2] The rival, unable to withstand the assault,[3] exits the market or abandons its expansion plans, enabling the predator to raise its price to supracompetitive levels. This two-step maneuver – a price reduction followed by a larger or longer lasting price increase – enhances the dominant firm's profits and reduces the welfare of consumers.

U.S. courts, however, have made this harmful practice exceedingly difficult to challenge. The Supreme Court has insisted that a plaintiff establish both below-cost pricing and a reasonable likelihood of recoupment,[4] and few plaintiffs have been able to overcome these twin obstacles. Plaintiffs have lost every predatory pricing case (and every similar case) in the Supreme Court,[5] and study after study has found that plaintiffs' success rate in the lower courts is abysmal.[6] To be sure, recent evidence suggests that plaintiffs' prospects may have improved somewhat. A study of decisions since 2013 found that plaintiffs were victorious almost 30 percent of the time.[7] But the number of cases was small, and the victories occurred on motions to dismiss. To my knowledge, there is still no instance since Brooke Group in which a plaintiff successfully litigated a predatory pricing case to final judgment. In consequence, the paradox remains: predatory pricing is clearly anticompetitive, but it has not resulted in an injunction or treble damages for over a generation.[8]

The courts' hostility to predatory pricing claims rests on two principal grounds. First, predatory pricing cases tend to chill price competition. Because a predatory pricing case is an attack on price cutting, a mistaken finding of liability will punish the very behavior that antitrust seeks to encourage.[9] Second, some early studies indicated that true predation almost never occurs. In the Supreme Court's famous language, these studies suggested that "predatory pricing schemes are rarely tried, and even more rarely successful."[10] Both factors, if true, imply that courts ought to be hostile to predatory pricing cases. In essence, they discourage procompetitive behavior and seldom uncover real predation. Moreover, under the Court's current rules litigating a predatory pricing case is costly and complicated. Why incur these costs when the chance of a beneficial outcome is low?

This pessimistic conclusion, however, hinges on the accuracy of its underlying premises. If predatory pricing cases were simpler to litigate and less likely to chill desirable conduct, and if true predation were more common, courts should be more receptive to predatory pricing claims.

One premise – that true predation is almost nonexistent – has already been undercut. Numerous studies since *Brooke Group* have

2 In the pure case of predatory pricing, the price cut makes no economic sense except for its adverse effect on competition. See Gregory J. Werden, *Identifying Exclusionary Conduct Under Section 2: The "No Economic Sense" Test*, 73 Antitrust L.J. 413 (2006).

3 In the traditional "deep pocket" model of predation, the rival cannot survive the price war because it lacks the financial resources of the dominant firm. Modern economic theories of predation emphasize other factors that impede a rival's ability to withstand a predatory assault, such as higher costs, inadequate information, or lack of a track record.

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

5 See *Brooke Group*, 509 U.S. at 209; *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104 (1986); *Matsushita Elec. Indus Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986). See also *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc.*, 127 S. Ct. 1069 (2007) (rejecting liability in a predatory bidding case); *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328 (1990) (rejecting liability in a maximum resale price maintenance case).

6 See Christopher R. Leslie, *Predatory Pricing and Recoupment*, 113 Colum. L. Rev. 1695 (2013); Patrick Bolton, Joseph F Brodley & Michael H. Riordan, *Predatory Pricing: Strategic Theory and Legal Policy*, 88 Geo. L.J. 2239 (2000); James D. Hurwitz & William E. Kovacic, *Judicial Analysis of Predation: The Emerging Trends*, 35 Vand. L. Rev. 63 (1982).

7 See John B. Kirkwood, *Predation and Discrimination*, in Handbook on Abuse of Dominance and Monopolization , (Pinar Akman ed., forthcoming). This chapter also discusses European Union law on predatory pricing, which is more favorable to plaintiffs.

8 Perhaps the answer is that no firm engaged in predatory pricing during this period. But that seems doubtful, given the theory and evidence cited in this article. Moreover, one case – Spirit's action against Northwest Airlines – appeared to involve a compelling case of predation. Spirit had begun to offer service on two of Northwest's routes and Northwest responded with deep price cuts, causing Spirit to withdraw. After Spirit left, Northwest raised its prices *sevenfold*. While the district court, like so many courts before it, granted summary judgment for Northwest, Spirit persuaded the Sixth Circuit to allow the case to proceed. See *Spirit Airlines, Inc. v. Northwest Airlines, Inc.*, 431 F.3d 917 (6th Cir. 2005). Spirit's victory was pyrrhic, however, because Northwest declared bankruptcy and Spirit decided to withdraw its suit, without obtaining an injunction or damages. For an excellent discussion of Spirit's strong claim but its failure to achieve more, see Kenneth G. Elzinga & David E. Mills, *Predatory Pricing in the Airline Industry: Spirit Airlines v. Northwest Airlines (2005)*, in The Antitrust Revolution 354 (John E. Kwoka, Jr. & Lawrence J. White, eds., 2019). To be sure, a plaintiff could achieve a victory without a litigated judgment by extracting a substantial settlement from the defendant. But Elzinga & Mills provide no evidence that Spirit secured a substantial settlement. See id. Moreover, to my knowledge, no other predatory pricing plaintiff has done so since *Brooke Group.*

9 See *Brooke Group*, 509 U.S. at 223, 226.

10 *Id.* at 226 (quoting *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986)).

shown that predatory pricing is not only a viable strategy in many circumstances but it has occurred repeatedly.[11] The Tenth Circuit acknowledged this new literature, noting that it proves that "price predation is not only plausible, but profitable, especially in a multi-market context where predation can occur in one market and recoupment can occur rapidly in other markets."[12] Consequently, the court stated: "Although this court approaches the matter with caution, we do not do so with the incredulity that once prevailed."[13]

The Court's other premise – that predatory pricing cases unduly chill procompetitive price cuts – could be reduced by restructuring predatory pricing litigation so that it is less likely to deter desirable behavior and more likely to result in liability when true predation has occurred. Such restructuring could also reduce the cost and complexity of predatory pricing cases, making them less expensive and time consuming.

Some scholars have proposed to achieve these ends through a dramatic alteration of predatory pricing law. Economist Aaron Edlin, for example, would do away with the *Brooke Group* requirements altogether and substitute a limited ban on reactive price cuts. Specifically, a monopolist could not reduce its price in response to entry if the entrant is charging a price 20 percent or more below the monopolist's price.[14] This clever proposal creates an incentive for a monopolist to lower its pre-entry price, since a lower pre-entry price would give the monopolist greater latitude to respond to entry. But the proposal also eliminates both existing *Brooke Group* requirements. Such a radical reworking of existing law may be too much for Congress or the courts.

This essay explores a more moderate approach. It addresses the desirability of eliminating one of the *Brooke Group* requirements, either the below-cost test or the recoupment requirement. Either change would make it easier to combat true predatory pricing. The crucial question is whether the change would create an unacceptable risk of chilling procompetitive price cutting. Part I examines the wisdom of eliminating the below-cost requirement. This approach would allow a plaintiff to challenge above-cost as well as below-cost price cutting so long as the plaintiff establishes that the defendant was likely to recoup its profit sacrifice and impose long-term harm on consumers. Part II addresses the other alternative: eliminating the recoupment requirement. This option would allow a plaintiff to challenge a price cut if it proves that the defendant priced below its average variable cost and rebuts the defendant's asserted justifications for that pricing.

This essay concludes that the second approach – dropping the recoupment requirement – is superior. It would facilitate challenges to predatory pricing by eliminating the requirement that is most difficult to establish. And it is less likely to deter desirable price cutting because it provides firms with a reasonably bright line they can follow. They can reduce prices whenever they want so long as they do not price below average variable cost.

Eliminating the below-cost requirement would deprive them of this guardrail and leave them with only the recoupment requirement, which is less definite because it demands that they predict whether a price cut would result in *long run* harm to competition and consumers. Because predicting the long run is difficult, firms interested in playing it safe will be more inclined to avoid aggressive price cutting.

II. ELIMINATING THE BELOW-COST REQUIREMENT

The below-cost requirement is not necessary to distinguish predatory from procompetitive price cutting. A dominant firm need not price below its average variable costs – the usual cost standard – to drive out, discipline, or deter a rival. So long as the dominant firm has significant advantages over the rival, an above-cost price reduction can achieve a predatory effect. For example, a dominant firm may possess economies of scale that are unavailable to the rival, and as result, the dominant firm's average variable costs are substantially below those of the rival. In this situation, the dominant firm can drive the rival's price below its average variable cost without pricing below average variable cost itself. In other words, the dominant firm can impose losses on the rival without incurring comparable losses itself. Other advantages such as learning-by-doing economies, network effects, brand loyalty, and access to cheaper capital could have the same effect. In consequence, a price above average variable cost or even average total cost can be predatory. Numerous scholars agree.[15]

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11 For reviews of the new scholarship, see Leslie, supra note 6; Bolton, Brodley, & Riordan, *supra* note 6; Richard O. Zerbe Jr. & Michael T. Mumford, *Does Predatory Pricing Exist? Economic Theory and the Courts After* Brooke Group, 41 Antitrust Bull. 949 (1996); Jonathan B. Baker, *Predatory Pricing After* Brooke Group: *An Economic Perspective*, 62 Antitrust L.J. 585 (1994).

12 *United States v AMR Corp.*, 335 F.3d 1109, 1115 (10th Cir. 2003).

13 *Id.*

14 See Aaron S. Edlin, *Stopping Above-Cost Predatory Pricing*, 111 Yale. L.J. 941 (2002). The ban would apply for 12 to 18 months or until the incumbent no longer has monopoly power.

15 See, e.g. Herbert Hovenkamp, *The Harvard and Chicago Schools and the Dominant Firm*, in Where the Chicago School Overshot the Mark 132, 148-49 (Robert Pitofsky ed. 2008); Aaron S. Edin, *Stopping Above-Cost Predatory Pricing*, 111 Yale L.J. 941, 944 (2002); Bolton, Brodley & Riordan, *supra* note 6, at 2271; Jonathan Baker, *Predatory Pricing after* Brooke Group: *An Economic Analysis*, 62 Antitrust L.J. 585, 591 (1994); John B. Kirkwood, *Controlling Above-Cost Predation: An Alternative to* Weyerhaeuser *and* Brooke Group, 53 Antitrust Bull. 369, 382-86 (2008).

Abolishing the price-cost test would make sense in many ways. It would allow plaintiffs to challenge above-cost predation, and it would let them avoid the cost measurement issues that frequently plague predatory pricing litigation.[16] At the same time, plaintiffs would still have to establish a reasonable likelihood of recoupment, which is often difficult to do.[17] In consequence, this approach would still block most challenges to procompetitive price reductions.

Dropping the below-cost requirement, however, would deprive firms of a reasonably bright line for determining whether their pricing is legal or illegal, While that line is not sharp, given the cost measurement issues, it is still something that business executives can readily understand. It tells them that they can reduce price, even if it harms the competition, so long as they do not cut price below average variable cost. They must maintain a positive contribution margin.[18] If that line were removed, firms would be less uncertain about what they could do and would be more inclined to moderate or forego aggressive price reductions. It is not clear, of course, how much chilling would occur, since the recoupment requirement would remain in place. But there is reason to fear significant chilling.

III. ELIMINATING THE RECOUPMENT REQUIREMENT

The second approach would remove the recoupment requirement, as Christopher Leslie has recommended, and replace it with a less onerous approach. This requirement has frequently defeated predatory pricing claims. Indeed, Leslie found that the recoupment requirement was the single largest reason these claims failed.[19] In addition, the requirement is arguably unnecessary. As Scott Hemphill & Phillip Weiser point out, a "price below cost is, in effect, prima facie evidence that the firm thought it could recoup its predatory price cut."[20] Thus, a court could infer recoupment from both the existence of below-cost pricing and the absence of a non-predatory explanation for the behavior. Accordingly, the second approach would require the plaintiff to prove not only that the defendant priced below cost but also that its asserted justifications for that pricing were invalid.

As Hemphill & Weiser note, the principal procompetitive justifications for a price below cost are "when a firm introduces a product with temporary low prices, or sets a low price in anticipation of later scale economies."[21] If a defendant advances one or both reasons, the plaintiff's burden would be to show that the asserted justification is incorrect. The plaintiff might demonstrate, for example, that an introductory pricing explanation was inapt because there had been no significant improvement in the defendant's product, or the defendant had priced below cost far longer than necessary to introduce a new product. Likewise, the plaintiff might rebut a scale economy explanation by demonstrating that there was no reason to expect that a sharp increase in the defendant's market share would result in a substantial reduction in its costs. Whatever the purported justification, the plaintiff would have to establish that it was invalid.

This approach is likely to produce better results than the first option. By retaining the below-cost test, this approach would send clearer signals to business and encourage aggressive above-cost price cuts. It would protect procompetitive below-cost pricing by insulting it from challenge unless the plaintiff can rebut the defendant's asserted justifications. Most important, by abolishing the recoupment requirement, it would reduce the costs of challenging true predatory pricing.

IV. CONCLUSION

This article suggests that the law governing predatory pricing should be restructured to eliminate the recoupment requirement and replace it with a requirement that the plaintiff rebut the defendant's explanations for pricing below cost. This reform is likely to increase challenges to genuine predatory pricing while limiting a plaintiff's ability to attack procompetitive price cuts. Although it is not perfect – it would not reach above-cost predation – this reform is likely to enhance consumer welfare and mitigate the paradox of predatory pricing.

16 See, e.g. Hovenkamp, *supra* note 15, at 132 ("In some cases measuring [price-cost relations] is extraordinarily difficult, particularly if the defendant produces multiple products with common costs").

17 See Leslie, *supra* note 6, at 1740 (noting that as of 2013, summary judgment in the U.S. was most often granted for defendants because the plaintiff could not supply adequate evidence of recoupment).

18 In fact, as discussed below, a firm may sometimes be able to justify a negative contribution margin (a price below average variable cost). A contribution margin is the profit margin on an incremental sale, normally measured as price minus average variable cost.

19 See *supra* note 17.

20 C. Scott Hemphill & Philip J. Weiser, *Beyond* Brooke Group: *Bringing Reality to the Law of Predatory Pricing*, 127 Yale L.J. 2048, 2055 (2018).

21 *Id.* at 2055 n. 28.

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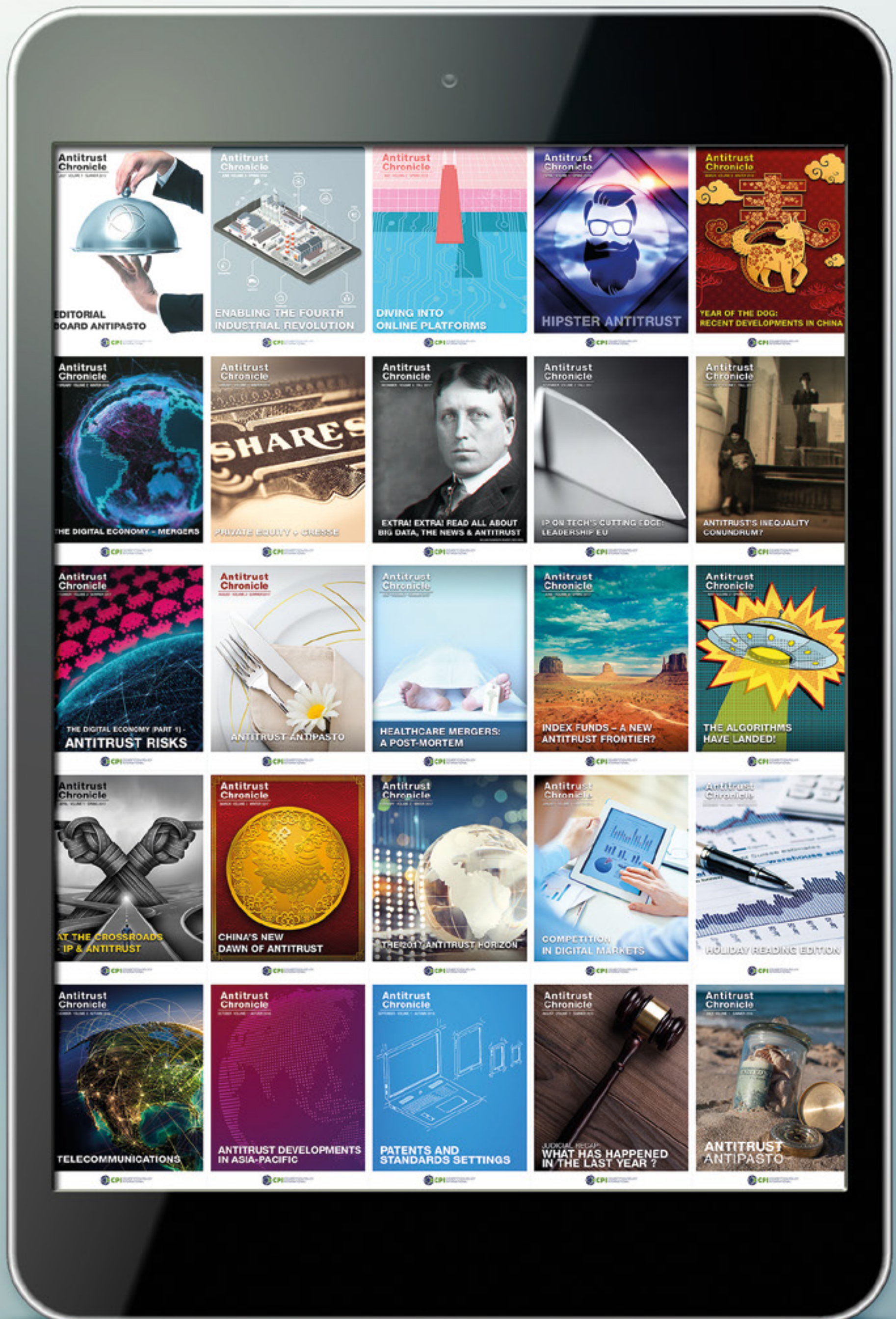

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