

NOTES

PREDATORY PRICING: THE RETREAT FROM THE AVC RULE AND THE SEARCH FOR A PRACTICAL ALTERNATIVE*

The antitrust concept of predatory pricing has been defined¹ as "behavior that involves a reduction of price in the short run so as to drive competing firms out of the market or to discourage entry of new firms in an effort to gain larger profits via higher prices in the long run than would have been earned if the price reduction had not occurred."² Despite this simple definition, courts historically have experienced difficulty in identifying predation due to lack of a widely accepted or clearly delineated legal standard.³ Early courts addressing predatory pricing turned to vague formulae that did not provide an objective standard by which to analyze the offense.⁴ Examples of this subjective analysis were evident where courts referred to "ruinous competition"⁵ or "predatory intent"⁶ when adjudicating liability. Several courts, when discussing predation, used the phrase "below-cost" pricing, but never defined it in unambiguous economic or accounting terminology.⁷ Furthermore, while "below-cost"

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¹ Although there is no universally accepted definition of predatory pricing, in order to introduce the concept and give the reader general boundaries for considering the topic, the definition suggested by a recent commentator will be accepted in this note. See Joskow & Klevorick, *A Framework For Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213, 219-20 (1979) [hereinafter cited as Joskow].

² *Id.*

³ See *Mt. Lebanon Motors, Inc. v. Chrysler Corp.*, 283 F. Supp. 453, 459-60 (W.D. Pa. 1968), *aff'd*, 417 F.2d 622 (3d Cir. 1969) (discussion of many factors that may be material in a predatory pricing case, including the size of the firms involved, and any advantage unrelated to competitive merits such as multi-territorial market or multi-line of commerce); Joskow, *supra* note 1, at 219 n.20.

⁴ See Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of The Sherman Act*, 88 HARV. L. REV. 697, 698 (1975) [hereinafter cited as Areeda].

⁵ *Porto Rican Am. Tobacco Co. v. American Tobacco Co.*, 30 F.2d 234, 236 (2d Cir. 1929), *cert. denied*, 279 U.S. 858 (1929) (Ruinous competition brought about by lowering prices was an illegal medium of eliminating weaker competition).

⁶ See *Forster Mfg. Co. v. FTC*, 335 F.2d 47, 52-53 (1st Cir. 1964), *cert. denied*, 380 U.S. 906 (1965) (Predatory intent evidenced where respondent, when discussing price cuts, stated "don't try to follow me. If you do, we will put you out of business.").

⁷ *Story Parchment Co. v. Paterson Co.*, 282 U.S. 555, 561 (1931) (Evidence indicated that respondents sold their goods "below the point of fair profit, and finally, below the cost of production."); *Greenville Publishing Co. v. Daily Reflector, Inc.*, 496 F.2d 391, 396-98 (4th Cir. 1974) (Contention that defendant deliberately sold advertisements in his paper below cost to drive plaintiff's paper out of town adequately described a violation of section 2 of the Sherman Act. Opposing accountant's views of "costs" presented an issue of fact to go to the trier of fact. Beyond that the ultimate question related to intent.); *National Dairy Prod. Corp. v. United States*, 350

pricing was considered severely anti-competitive,⁸ it was not deemed a requisite element in a finding of predation and by itself was not necessarily illegal.⁹ As a result of these imprecise standards, neither courts nor businesses had an objective guideline when attempting to distinguish between legal pricing conduct and illegal, anti-competitive pricing conduct. Consequently, as an antitrust tool to foster competitive practices, the predatory pricing violation was not as effective as it might have been.

The existence of predation can be used to prove attempted monopolization in violation of section 2 of the Sherman Act.¹⁰ It is in this context that charges of predatory pricing most often arise.¹¹ An attempt to monopolize claim under section 2 generally requires that the plaintiff show the relevant market, the defendant's specific intent to monopolize that market, and a dangerous probability of success.¹² The elements, however, are not entirely distinct. The requirement of a dangerous probability of success can be satisfied by direct proof of adequate market power to succeed, or can be inferred from proof of specific intent to monopolize.¹³ Specific intent to monopolize can be inferred from proof

F.2d 321, 327 (8th Cir. 1965), *vacated and remanded on other grounds*, 384 U.S. 883 (1966) (Evidence of predatory intent where National Dairy sold milk at "unreasonably low prices," which were "below National's cost," for a period of six weeks, even though there was no evidence it was done to hurt rivals.); *E. B. Muller Co. v. FTC*, 142 F.2d 511, 517 (6th Cir. 1944) (Statement by defendant that sales would "mean some loss to us" held to have weight on the question of intent to eliminate a competitor and on whether sales were actually "below cost."). *See also Utah Pie Co. v. Continental Baking Co.*, 386 U.S. 685 (1967), where the Court found the existence of predatory conduct, but enunciated no clear standard of predation. Among other factors, price was set at "less than its direct cost plus an allocation for overhead." *Id.* at 698. Whether this reference to below-cost pricing was meant as an economic or accounting definition was unclear, yet the Court did not further clarify this reference to cost.

⁸ *Ovitron Corp. v. General Motors Corp.*, 295 F. Supp. 373, 378 (S.D.N.Y. 1969) ("Pricing below cost is a severely anticompetitive tactic frequently engaged in by corporations with significant resources to drive weaker competitors from the field.").

⁹ *Greenville Publishing Co. v. Daily Reflector, Inc.*, 496 F.2d at 396. *See also Pacific Eng'r & Prod. Co. of Nevada v. Kerr-McGee Corp.*, 551 F.2d 790, 796 (10th Cir. 1977) (no reference to be drawn from sales below total cost).

¹⁰ 15 U.S.C. § 2 (1976). This section provides:

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding one million dollars if a corporation, or, if any other person, one hundred thousand dollars or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

Id.

¹¹ A charge of predation, and, therefore, a focus on predatory pricing, may also arise under the Clayton Act as amended by the Robinson-Patman Act in a primary-line price discrimination case. 15 U.S.C. §§ 12-27 (1976). *See, e.g., Moore v. Mead's Fine Bread Co.*, 348 U.S. 115, 120 (1954) (Local intrastate price cutting by an interstate baker that drove a local rival out of business violated the Robinson-Patman Act.). The predatory pricing issues are similar in the two contexts. Therefore, the analysis of predatory pricing in this note will refer to claims arising under either of these acts involving predation. *See, e.g., International Air Indus., Inc. v. American Excelsior Co.*, 517 F.2d 714, 720 n.10 (5th Cir. 1975) (Robinson-Patman Act case). *See Areeda, supra* note 4, at 726-28.

¹² *See United States v. Empire Gas Corp.*, 537 F.2d 296, 298-99 (8th Cir. 1976).

¹³ *California Computer Prods., Inc. v. International Business Machines Corp.*, 613 F.2d

of predatory conduct.¹⁴ Proof of predatory pricing, therefore, could be the key to proving two elements of a section 2 attempt to monopolize claim.¹⁵ Specific intent could be inferred from the predatory conduct, and this in turn could lead to an inference of a dangerous probability of success.¹⁶

The topic of predatory pricing has become the object of increased concern over the past five years in both academic literature¹⁷ and judicial decisions.¹⁸ This heightened level of interest in the topic, in economic and legal debate, can be traced directly to an article on the subject by Professors Phillip Areeda and Donald Turner.¹⁹ The article was the first attempt in legal literature to develop a per se legal standard designed to distinguish predatory conduct from competitive conduct based solely on cost-price analysis suggested by economic theory.²⁰ It proposed the Average Variable Cost (AVC) rule in an attempt to establish a legal test focusing on objective criteria to identify predation.²¹ This rule very simply defined conduct setting price at or above a firm's average variable cost of

727, 737 (9th Cir. 1979). See *Swift and Co. v. United States*, 196 U.S. 375, 396 (1905) (Intent is essential to an attempt to monopolize case and is necessary to produce a dangerous probability. The dangerous probability requirement can therefore be a consequence of intent.).

¹⁴ See *Marquis v. Chrysler Corp.*, 577 F.2d 624, 641 (9th Cir. 1978). See also *FTC v. Anheuser-Busch, Inc.*, 363 U.S. 536 (1960) (In a Robinson-Patman case, predatory price cutting may allow the inference of intent to create a primary-line injury to lessen competition or to create a monopoly, absent any showing of intent.).

¹⁵ Although three elements are generally required to prove an attempt to monopolize: (1) proof of a relevant market; (2) proof of specific intent; and (3) proof of a dangerous probability of success, in the Ninth Circuit the first of these elements may not be required, thus making the proof of predatory pricing even more crucial to proving a section 2 attempt to monopolize. See *Hallmark Indus. v. Reynolds Metal Co.*, 489 F.2d 8, 12-13 (9th Cir. 1973). Commentators also have questioned the need to prove relevant market. See, e.g., Note, *Attempt to Monopolize Under the Sherman Act: Defendant's Market Power as a Requisite to a Prima Facie Case*, 73 COLUM. L. REV. 1451 (1973); Note, *Prosecutions for Attempt to Monopolize: The Relevance of the Relevant Market*, 42 N.Y.U. L. REV. 110 (1967).

¹⁶ *Gough v. Rossmoor Corp.*, 585 F.2d 381, 390 (9th Cir. 1978) ("short-cut method" of establishing liability: proof of dangerous probability of success can be inferred from proof of specific intent, which in turn can be inferred from a proof of predatory or anticompetitive conduct which constitutes an unreasonable restraint of trade).

¹⁷ See Baumol, *Quasi-Permanence of Price Reductions: A Policy for Prevention of Predatory Pricing*, 89 YALE L.J. 1 (1979) [hereinafter cited as Baumol]; Joskow, *supra* note 1; McGee, *Predatory Pricing Revisited*, 23 J. OF L. & ECON. 289 (1980) [hereinafter cited as McGee]; Scherer, *Predatory Pricing and the Sherman Act: A Comment*, 89 HARV. L. REV. 869 (1976) [hereinafter cited as Scherer]; Williamson, *Predatory Pricing: A Strategic and Welfare Analysis*, 87 YALE L.J. 284 (1977) [hereinafter cited as Williamson].

¹⁸ See, e.g., *Chillicothe Sand & Gravel v. Martin Marietta Corp.*, 615 F.2d 427 (7th Cir. 1980) (discussed in text and notes at notes 239-55 *infra*); *California Computer Prods., Inc. v. International Business Machines Corp.*, 613 F.2d 727 (9th Cir. 1979) (discussed in text and notes at notes 204-16 *infra*); *Janich Bros. v. American Distilling Co.*, 570 F.2d 848 (9th Cir. 1977), *cert. denied*, 439 U.S. 829 (1978); *Hanson v. Shell Oil Co.*, 541 F.2d 1352 (9th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977); *International Air Indus., Inc. v. American Excelsior Co.*, 517 F.2d 714 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976); *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. 965 (N.D. Cal. 1979) (discussed in text and notes at notes 217-37 *infra*).

¹⁹ Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of The Sherman Act*, 88 HARV. L. REV. 697 (1975).

²⁰ See Joskow, *supra* note 1, at 213 & n.1.

²¹ See Areeda, *supra* note 4, at 699-700.

production as competitive and conduct setting price below this point as predatory.²² Areeda and Turner limited their examination of predation solely to this cost-based rule. They preferred this test because it provided an objective basis for the courts to analyze the offense.²³

Almost immediately after its proposal, the Areeda and Turner approach gained quick acceptance in several courts.²⁴ After repeated academic criticisms and counter-proposals,²⁵ however, courts more recently have indicated a reluctance to apply the rule in all cases.²⁶ In at least one instance a court has explicitly rejected the Areeda/Turner approach as incorrect when applied to most cases of alleged predatory pricing.²⁷ As a result of this retreat from the AVC rule, widespread disagreement now again exists over the correct test for a court to apply when examining allegations of predation.

It is the purpose of this note to examine the Areeda/Turner approach and its judicial treatment. This examination will show that recent courts are correct in expressing reluctance to adopt the AVC rule because it fails to consider several factors that are essential to making a reasoned finding of predatory pricing. Once these overlooked factors have been identified, through a review of the rule and a look at proposed theoretical alternatives, this note will present a test for predation that attempts to integrate all of the appropriate considerations. The note begins by defining various economic cost concepts underlying the AVC rule. These concepts are then incorporated into a discussion of the various cost-price relationships Areeda and Turner analyzed in their development of the rule. The second section contains an examination of problems with the AVC rule and its application in the courtroom. Included in this examination are recent cases indicating a judicial retreat from the AVC rule. The third section of this note consists of an analysis of two contrasting, theoretical alternatives to the Areeda/Turner approach. The final section is devoted to an enumeration of several characteristics that should be embodied in a valid legal standard of predatory pricing followed by a proposed two-step test for determining predation.

I. THE AVC RULE: WHAT IT IS AND HOW IT WORKS

The AVC rule²⁸ represented the first legal approach to predatory pricing based on an analysis of economic costs. Areeda and Turner attempted to establish a legal standard capable of clear and correct delineation of predatory conduct.²⁹ After examining the topic, they concluded that predatory pricing was

²² *Id.* at 733.

²³ *Id.* at 698, 699.

²⁴ See *Hanson v. Shell Oil Co.*, 541 F.2d at 1358; *International Air Indus., Inc. v. American Excelsior Co.*, 517 F.2d at 720 n.10.

²⁵ See note 17 *supra*.

²⁶ See *California Computer Prods., Inc. v. International Business Machines Corp.*, 613 F.2d at 743.

²⁷ See *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. at 995.

²⁸ Areeda, *supra* note 4, at 733.

²⁹ *Id.* at 698.

an infrequent occurrence.³⁰ Therefore, a major consideration in their formulation of the rule was to minimize the threat of litigation in order to avoid deterring legitimate, competitive pricing.³¹ As long as courts continued to apply "empty formulae" based on subjective or vague definitions of the offense, they reasoned that this threat would remain large.³² Since the likelihood of an actual violation was small, Areeda and Turner focused on establishing a requirement of specific and objective data as a way to minimize this threat.³³ The result was a test distinguishing between predatory and competitive conduct based solely on an analysis of the relationship between a firm's economic costs and its prices.³⁴

An explanation of the AVC rule requires an understanding of three key measures of economic cost employed by Areeda and Turner in formulating the rule. These economic measures were used to designate various levels of price considered by Areeda and Turner when analyzing predatory conduct. One of these measures, average variable cost, was utilized as the dividing line between predation and competition in the courtroom application of their standard.³⁵ The remaining two measures, marginal cost and average total cost, were utilized by them in the economic justification of the rule.³⁶

All three measures of cost utilized by Areeda and Turner reflect economic costs. A firm's economic costs can be divided into two categories: fixed and variable.³⁷ Fixed costs are costs facing a firm that do not vary with output and cannot change during the period of time under consideration.³⁸ These costs, sometimes referred to as overhead, would continue even if the firm produced no output at all.³⁹ Examples of fixed costs include the firm's cost of plant and equipment, management services, interest payment on bonded debt, property taxes, and depreciation.⁴⁰ Additionally, economic fixed costs also include the return on investment or normal profits necessary to attract equity capital to a firm, an amount not included in an accountant's definition of costs.⁴¹ These costs are included in the economic definition because they represent payments theoretically necessary to bid capital away from alternative uses.⁴² Therefore, they are considered a cost of doing business, similar to interest payments on debt capital. In determining any resource's economic cost, the marketplace payment that would be necessary to bid a resource away from an alternative use is included.⁴³

³⁰ *Id.*

³¹ *Id.* at 699.

³² *Id.*

³³ *See id.* at 698, 699.

³⁴ *Id.* at 699-700.

³⁵ *Id.* at 733.

³⁶ *Id.* at 704-16.

³⁷ *Id.* at 700. *See* E. MANSFIELD, *ECONOMICS: PRINCIPLES, PROBLEMS, DECISIONS* 121, 436 (1st ed. 1974) [hereinafter cited as MANSFIELD].

³⁸ *Id.*

³⁹ Areeda, *supra* note 4, at 700.

⁴⁰ *Id.* Depreciation is included to the extent that equipment is not consumed by using it in the production process. *Id.*

⁴¹ Areeda, *supra* note 4, at 700.

⁴² MANSFIELD, *supra* note 37, at 435. *See* Areeda, *supra* note 4, at 700.

⁴³ *See* MANSFIELD, *supra* note 37, at 435.

Economists refer to this as the opportunity cost concept.⁴⁴ The other type of economic costs, variable costs, are those costs that are linked directly to the level of output and can be changed during the time under consideration.⁴⁵ Examples of variable costs include the cost of materials used in production, direct labor, most indirect labor, fuel, and any other per unit fees such as licensure and royalties.⁴⁶

With the distinction between fixed and variable costs in mind, the three cost measures utilized by Areeda and Turner may be defined in the following manner. Average total cost (ATC) is the total cost of producing the product divided by the number of units produced.⁴⁷ Total cost is the sum of all fixed and variable costs that are required to operate the entire production process.⁴⁸ Average variable cost (AVC) is the sum of all variable costs incurred in producing the product divided by the number of units produced.⁴⁹ Marginal cost is the increase in total cost, or the incremental cost, resulting from production of the last unit of output.⁵⁰ Since variable costs are the only costs that change with different levels of output, marginal cost is solely a function of additional variable cost incurred due to production of the last unit of output.⁵¹ Areeda and Turner relied on these three measures of economic cost in their development of a legal standard of predation. In their comparison of a firm's price relative to cost, the examination of price set equal to these measures of cost proved to be either theoretically or practically useful in determining the existence of predatory pricing.

*A. Development of the Areeda/Turner AVC Rule:
Relationships Between Price and Economic Costs*

Areeda and Turner developed the AVC rule in an attempt to formulate a meaningful and workable test to determine the existence of predation.⁵² They began by attempting to discover the theoretical point at which price, in relation

⁴⁴ *Id.*

⁴⁵ See MANSFIELD, *supra* note 37 at 121. Determination of costs as fixed or variable is a function of time. Over a long enough time period, all inputs and, therefore, all costs are variable, because everything including plants and equipment could be purchased or sold. Thus, the period of time relevant to classify costs as variable or fixed is the short run. Short run is defined as the period of time in which the firm cannot replace, increase, or decrease its plant and equipment. Areeda, *supra* note 4, at 701.

⁴⁶ *Id.* at 700.

⁴⁷ MANSFIELD, *supra* note 37, at 439.

⁴⁸ *Id.* at 436-38.

⁴⁹ Areeda, *supra* note 4, at 700. See MANSFIELD, *supra* note 37, at 439.

⁵⁰ Areeda, *supra* note 4, at 700. See MANSFIELD, *supra* note 37, at 441.

⁵¹ Areeda, *supra* note 4, at 700. If variable costs were strictly proportional to output, marginal cost would equal AVC at all outputs. *Id.* at 700 n.13. In most situations, however, variable costs will not be strictly proportional to output and marginal cost will then be lower than AVC at some outputs and higher than AVC at other outputs. *Id.* For example, labor is a variable cost. Once it becomes necessary to employ a set workforce over time periods such as an hour or week, this workforce may be able to turn out additional output in that period without requiring any additional labor cost. In this situation the additional cost for the last unit of output would only be the cost for the added materials used, and marginal cost will be less than AVC.

⁵² *Id.* at 699.

to cost, became predatory.⁵³ Then, once they discovered this relationship, they sought a practical measure to approximate the theoretical point they had discovered. In explaining their theoretical point, Areeda and Turner initially considered three situations: where price was set equal to or above ATC; where price was set below ATC but equal to or above marginal cost; and where price was set below marginal cost.⁵⁴ Each of these situations is discussed below, followed by an examination of how Areeda and Turner converted their theoretical conclusions into a practical rule.

1. Price Greater Than or Equal to ATC

Where price was set equal to or above a firm's reasonably anticipated⁵⁵ average total cost, Areeda and Turner concluded that pricing conduct was non-predatory and therefore lawful.⁵⁶ They reasoned that administrative problems of distinguishing predatory pricing from competitive pricing at any point above ATC were too great,⁵⁷ and that attempts to draw this distinction above ATC would increase the likelihood of higher prices.⁵⁸ A firm that set price above the product's ATC would be making, by economic cost definition, at least normal profits on its investment.⁵⁹ Total revenues generated by the product covered total economic costs, placing the firm at or above its "breakeven" point.⁶⁰ So long as the firm was making normal or excess profits from the product, Areeda and Turner concluded illegal conduct should not be found.⁶¹ Although a firm may have been foregoing higher profits, it was not losing money on the product and was covering all costs associated with production.⁶² Areeda and Turner viewed pricing at or above ATC as competition on the merits, since only less efficient firms, those with higher costs, would be driven from the market.⁶³

In their discussion of prices at or above ATC, Areeda and Turner acknowledged two examples of pricing that might be predatory. First, a monopolist could set prices at or above ATC yet still be foregoing monopoly profits that could be achieved by pricing at a higher profit-maximization point.⁶⁴ This conduct, known as limit pricing, makes the market less attractive to new entrants than it otherwise would be if prices were higher,⁶⁵ and acts as a barrier to entry.

⁵³ See Areeda, *supra* note 4, at 701-03.

⁵⁴ See *id.* at 703-16.

⁵⁵ Reasonably anticipated costs are relevant throughout this discussion of the Areeda/Turner approach, since it is necessary to show not only the relation of prices to immediate costs but also to costs that the producer "reasonably anticipated he would attain within a reasonable period of time" at the time of the price reduction. *Id.* at 715.

⁵⁶ *Id.* at 732-33.

⁵⁷ *Id.* at 707-08.

⁵⁸ *Id.* at 708.

⁵⁹ *Id.* at 704.

⁶⁰ *Id.*

⁶¹ *Id.* at 704-05.

⁶² See *id.* at 704 & n.20.

⁶³ *Id.* at 706-07.

⁶⁴ *Id.* at 704-05.

⁶⁵ *Id.* at 705-06.

Second, a monopolist could make temporary reductions to ATC in order to discourage new competition.⁶⁶ In this instance, the monopolist normally may be pricing far above ATC, charging whatever the market will bear.⁶⁷ When a new entrant appears ready to enter the market, however, the monopolist will reduce its prices to ATC to discourage entry by the potential competitor.⁶⁸ This strategy would be employed where barriers to entry, such as start up costs, are high.⁶⁹ Due to the investment required, this new price level would not be high enough to allow the new entrant to justify the initial outlay or to cover expenses of its facilities at the lowered level of return.⁷⁰ The result would scare off potential competitors or force new entrants out of the market. Then, left alone in the market, the monopolist would raise prices to the previous level.⁷¹

While recognizing these situations, Areeda and Turner did not advocate combatting them.⁷² A rule prohibiting either of these practices, by requiring a higher price floor in certain situations, they argued, would be impossible to implement.⁷³ On one hand, they reasoned it would make no legal sense to propose a standard to forbid limit pricing, because this would compel a firm to invite entry by exploiting consumers.⁷⁴ On the other hand, a standard forbidding temporary reductions would be very difficult to administer due to the necessity of distinguishing between legitimate post-reduction increases and improper ones.⁷⁵ Although resumption of pre-reduction price levels would not be permitted, adjustments in the price to cope with changes in cost or demand would have to be allowed.⁷⁶ This would result in a continuous administrative supervision of pricing conduct, a burden Areeda and Turner concluded was not justified by the "speculative" benefit that such a rule might bring.⁷⁷

The difficulty in differentiating between these instances of predation and competitive pricing would be substantial where prices were set at or above ATC. As a result, Areeda and Turner designated pricing conduct that covers ATC as legitimately competitive. Their examination, therefore, goes no further in instances where the alleged predator's price generates at least normal profits.⁷⁸

2. Price Less Than ATC, but Greater Than or Equal to Marginal Cost

The second price-cost relationship analyzed by Areeda and Turner was where a firm set price below ATC, but equal to or above its reasonably

⁶⁶ *Id.* at 706.

⁶⁷ See MANSFIELD, *supra* note 37 at 484.

⁶⁸ Areeda, *supra* note 4, at 706.

⁶⁹ *Id.* These barriers consist of the large investment in facilities, personnel training, distribution development, or product promotion necessary to produce and sell the product. *Id.*

⁷⁰ *Id.*

⁷¹ See *id.*

⁷² *Id.* at 704-05.

⁷³ See *id.* at 706-09.

⁷⁴ *Id.* at 706 n.26.

⁷⁵ *Id.* at 707.

⁷⁶ *Id.* at 708.

⁷⁷ *Id.* at 709.

⁷⁸ *Id.*

anticipated marginal cost. At this level too, Areeda and Turner deemed the pricing conduct non-predatory and, therefore, lawful.⁷⁹ Their justification of this approach was primarily based on their view of efficiency. According to this view, pricing at a level equal to or above marginal cost eliminated or dissuaded from entry only less efficient firms, or equally efficient firms with less capital.⁸⁰ This outcome was regarded as competitively and socially optimal, because resources would be allocated to their most efficient use when a less efficient firm stopped production.⁸¹ Though acknowledging that in some cases an equally efficient firm with less capital might also be destroyed,⁸² Areeda and Turner allowed this situation to stand for administrative reasons.⁸³ These reasons included the difficulty of trying to determine and enforce a higher price floor, as well as the likelihood that a higher floor would allow not only equally efficient firms, but also less efficient firms, to survive.⁸⁴ On this basis Areeda and Turner concluded that prohibition of any price set at or above marginal price could not be justified on economic or administrative grounds.⁸⁵ As a result, they designated conduct setting prices that at least covered marginal cost as non-predatory. Indeed, they considered price set equal to marginal cost optimal, allowing no less-efficient firms to remain in the market.

3. Price Less Than Marginal Cost

The final price-cost relationship analyzed by Areeda and Turner was where a firm set price below reasonably anticipated marginal cost. This pricing conduct was deemed by them to be predatory and, therefore, unlawful.⁸⁶ Where price equaled or exceeded marginal cost, Areeda and Turner reasoned that firms would be destroyed or dissuaded from entry on the basis of efficiency and optimization of the social allocation of resources. Where, however, price fell below marginal cost these reasons were no longer the cause of the destruction and dissuasion.⁸⁷ When prices were below marginal cost, at least some units were sold at an out-of-pocket loss.⁸⁸ The revenue received for a unit would not cover the additional variable cost of producing the last unit of output. Thus, where price was set below marginal cost, aggregate losses increased as production rose.⁸⁹ Areeda and Turner concluded that by pricing at this level a firm

⁷⁹ *Id.* at 733.

⁸⁰ *See id.* at 709-11. Areeda and Turner equated the term "staying power" with capital reserves or the financial ability to absorb the losses incurred at selling below ATC. *Id.*

⁸¹ *Id.* at 711.

⁸² *Id.* at 710.

⁸³ *Id.* at 711.

⁸⁴ *Id.*

⁸⁵ *Id.* at 711-12.

⁸⁶ *Id.* at 733. The single exception to this rule would be where price, though below marginal cost, is at or above ATC. This only occurs where demand is straining capacity and the firm is producing at a level beyond minimum AVC. A situation like this was believed by Areeda and Turner to be unlikely to have any anti-competitive effects and, therefore, would not be deemed predatory so long as price was equal to or above ATC. *Id.* at 712-13.

⁸⁷ *Id.* at 712.

⁸⁸ *Id.*

⁸⁹ *Id.* The firm could eliminate these losses by reducing production, or ceasing production altogether. *Id.*

incurred private losses, wasted social resources, and "greatly increase[d] the possibility that rivalry will be extinguished or prevented for reasons unrelated to the efficiency of the monopolist."⁹⁰ Only firms with sufficient capital resources to sustain increased losses with every unit sold would remain in the market. Furthermore, these short run losses would only be incurred with the belief that rivals would not be able to continue production, thereby eliminating competition in the hope of future increased prices and profit that would more than offset immediate losses. As a result, Areeda and Turner designated conduct setting price below marginal cost as conclusive evidence of illegal predatory pricing.⁹¹

Marginal cost thus was determined to be the theoretical point below which price becomes predatory.⁹² Areeda and Turner noted that price equal to marginal cost produces an efficient allocation of resources under perfect competition.⁹³ Therefore, they considered that any decrease in price to the level of marginal cost or approaching this point would result in improved resource allocation.⁹⁴ Areeda and Turner concluded, however, that there could be no legitimate reason for pricing below this point.⁹⁵ For these reasons, conduct would not be considered predatory unless it resulted in pricing below marginal cost.

4. From Theory to Practice: AVC as a Surrogate for Marginal Cost

Although Areeda and Turner viewed marginal cost as the economically sound point at which to distinguish between competitive and predatory pricing conduct, they concluded that its use as a legal standard was impractical.⁹⁶ Marginal cost is not an accounting cost and, thus, cannot be determined from conventional business records.⁹⁷ Since marginal cost is strictly an economic concept, a rule relying on marginal cost determination could not be applied, as a practical matter, in the overwhelming majority of cases addressing predation. Areeda and Turner concluded, therefore, that the administrative impediment to using a marginal cost rule necessitated finding a surrogate to approximate marginal cost.⁹⁸

Areeda and Turner chose average variable cost as their surrogate for marginal cost.⁹⁹ They chose AVC primarily because a figure representing AVC could be determined from normal business records¹⁰⁰ and because they concluded that AVC approximated marginal cost in most instances.¹⁰¹ Areeda and

⁹⁰ *Id.*

⁹¹ *Id.* at 733.

⁹² *Id.* at 716.

⁹³ *Id.* at 702.

⁹⁴ *Id.* at 703.

⁹⁵ *See id.* at 712.

⁹⁶ *Id.* at 716.

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Areeda and Turner noted that the use of AVC would raise no difficulties when the two measures were "identical over the relevant range of output." *Id.* at 717 & n.42.

Turner acknowledged, however, that the two costs were not always the same.¹⁰² At low levels of production, variable cost per unit decreases as output increases, and as a result marginal cost is less than AVC.¹⁰³ Conversely, at high levels of production variable cost per unit increases as output nears capacity, and marginal cost is greater than AVC.¹⁰⁴ Only in the middle range of production levels, where AVC is at its minimum, are marginal cost and AVC closely comparable.

In addressing these differences, Areeda and Turner concluded that the AVC standard was the "correct test on principle" where AVC exceeded marginal cost because a firm pricing below AVC would incur fewer losses by ceasing production.¹⁰⁵ It would be unusual for a firm to have such a pricing policy absent a predatory intent. Where AVC is less than marginal cost, the deviation from a marginal cost standard originally was permitted by Areeda and Turner due to their belief that predatory pricing rarely occurred and that the likelihood of predation was even less when capacity was strained.¹⁰⁶ This likelihood was less because the loss of profits would be great due to the act of foregoing higher prices on the very large volume being sold, and new demand resulting from driving a rival out of business could not be met since production was already nearing capacity.¹⁰⁷ In this range of output, however, the deviation of AVC and marginal cost becomes progressively greater as production increases beyond the point of minimum AVC.¹⁰⁸ Therefore, AVC becomes a progressively less satisfactory surrogate for their theoretical division between predation and competition, marginal cost.¹⁰⁹ Areeda and Turner subsequently qualified their standard in this area, concluding that a defendant should only be permitted to rely on the AVC standard in this instance if some evidence was offered to indicate that AVC was not significantly below marginal cost.¹¹⁰

As a result of the substitution of AVC for marginal cost, the following standard emerged as the AVC rule, (1) a price set equal to or above reasonably anticipated average variable cost is non-predatory, and such pricing conduct is lawful, (2) a price set below reasonably anticipated average variable cost is predatory, and such pricing conduct is unlawful.¹¹¹ The AVC rule represented a

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.* The phenomenon of marginal cost rising above AVC can be demonstrated by examining one variable cost: direct labor. Plant capacity may be achieved only through the use of three shifts per day. In order to employ labor for the third shift, however, the firm would have to pay a shift differential. In this regard the direct labor cost of producing units in the third shift would be higher than that of the first shift. Thus, the marginal cost of the last unit produced in the third shift will be greater than the AVC of the product. This higher cost of producing the third shift units would then raise overall AVC, though not as high as the marginal cost.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 718.

¹⁰⁷ *Id.*

¹⁰⁸ Williamson, *supra* note 17, at 337 n.129.

¹⁰⁹ *Id.*

¹¹⁰ Areeda & Turner, *Williamson On Predatory Pricing*, 87 YALE L.J. 1337, 1338 (1978) [hereinafter cited as Areeda II].

¹¹¹ Areeda, *supra* note 4, at 733.

per se approach to predatory pricing.¹¹² Due to Areeda and Turner's conclusion that a standard relying on the existence of such factors as predatory intent provided little basis for analyzing the offense,¹¹³ their standard for determining predatory pricing relied entirely on an examination of the defendant's price-cost relationship.¹¹⁴

B. *Rationale for Adoption of the AVC Rule*

In a response to academic criticism, which began soon after publication of the original article,¹¹⁵ Areeda and Turner in a subsequent article stated four major reasons for adopting their approach.¹¹⁶ First, they noted that when considering any predatory pricing rules, the desire to encourage competitive pricing conduct must be recognized. Therefore, rules adopted for predatory pricing should seek to avoid frivolous suits that may have the effect of chilling legitimate competition through the threat of litigation.¹¹⁷ The requirement of showing price below AVC would deter suits where the objective data did not support such a showing. This rule would do away with vague formulations of the offense and delineate a clear cut standard of predation.¹¹⁸ Also, this would enable firms to base decisions upon a recognizable standard without the fear that competitive pricing would draw suits under section 2 of the Sherman Act.¹¹⁹

Second, a price set equal to AVC, a surrogate for short run marginal cost, would employ resources in the socially optimal manner, maximizing social welfare.¹²⁰ A price equal to marginal cost would be the result under perfect competition, so any downward change in price levels up to this point would be an improvement over normal monopoly pricing.¹²¹ The AVC rule encourages this type of downward change by defining only conduct that reduced prices below average variable cost as predatory.¹²²

Third, any rule that established a price floor above marginal or average variable cost would harm competition based on efficiency by preserving inefficient rivals or attracting inefficient entry.¹²³ Under the AVC rule, however, only

¹¹² A *per se* approach was defined by the Supreme Court in *Northern Pacific Ry. v. United States*, 356 U.S. 1 (1958), where the Court stated:

[T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use.

Id. at 5.

¹¹³ Areeda, *supra* note 4, at 699.

¹¹⁴ *See id.* at 699-700.

¹¹⁵ Williamson, *supra* note 17; *see also* Scherer, *supra* note 17; Scherer, *Some Last Words on Predatory Pricing*, 89 HARV. L. REV. 901 (1976); and Williamson, *Williamson on Predatory Pricing II*, 88 YALE L.J. 1183 (1979).

¹¹⁶ *See* Areeda II, *supra* note 110, at 1339.

¹¹⁷ *Id.*

¹¹⁸ *See* Areeda, *supra* note 4, at 698.

¹¹⁹ *See id.* at 699.

¹²⁰ *Id.*

¹²¹ Areeda, *supra* note 4, at 703.

¹²² *See id.* at 733.

¹²³ *See* Areeda II, *supra* note 110, at 1339.

equally or more efficient firms would remain if prices were reduced to the minimum legal level. Entry by all firms except those anticipating to be more efficient would be dissuaded.¹²⁴

Finally, Areeda and Turner noted that effective legal rules must concentrate on short run, observable consequences.¹²⁵ Areeda and Turner admitted equally efficient firms might be destroyed or dissuaded from entry under the AVC rule. This destruction would cause long run welfare costs potentially exceeding short run gains. They contended, however, that long run consequences were speculative or estimated.¹²⁶ Such immeasurable or indeterminate factors could not be adequately incorporated into an effective legal rule.¹²⁷

II. QUESTIONING THE AVC RULE

The AVC rule was applied in the courtroom not long after publication of the Areeda/Turner article.¹²⁸ In the subsequent four years almost every court addressing the issue of predatory pricing either applied or favorably commented on the AVC rule. These courts included the courts of appeals for the Fifth,¹²⁹ Ninth,¹³⁰ and Tenth¹³¹ circuits as well as numerous district courts, primarily in the Ninth Circuit.¹³² Courts applying the AVC rule relied heavily on the Areeda/Turner article to provide theoretical support, rather than attempting to provide their own analysis of the validity of the approach.¹³³ Nevertheless, almost as soon as courts first accepted the AVC rule, the identification of problems with the approach began. Even during the initial period of judicial acceptance, commentators expressed criticism about the manner in which Areeda and Turner applied economic theory.¹³⁴ Meanwhile, as courts continued

¹²⁴ Areeda, *supra* note 4, at 711.

¹²⁵ See Areeda II, *supra* note 110, at 1339.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *International Air Indus., Inc. v. American Excelsior Co.*, 517 F.2d 714 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976). See generally Comment: *An Appraisal of Marginal Cost and Predatory Pricing Under Section 2 of The Sherman Act*, 30 ALA. L. REV. 562 (1979).

¹²⁹ *International Air Indus., Inc. v. American Excelsior Co.*, 517 F.2d 714 (5th Cir. 1975).

¹³⁰ *Janich Bros. v. American Distilling Co.*, 570 F.2d 848 (9th Cir. 1977), *cert. denied*, 439 U.S. 829 (1978); *Hanson v. Shell Oil Co.*, 541 F.2d 1352 (9th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977).

¹³¹ *Pacific Eng'r & Prod. Co. of Nevada v. Kerr-McGee Corp.*, 551 F.2d 790 (10th Cir. 1977), *cert. denied*, 434 U.S. 879 (1977).

¹³² *Foremost Int'l Tours, Inc. v. Quantas Airways Ltd.*, 478 F. Supp. 589 (D. Hawaii 1979); *California Steel and Tube v. Kaiser Steel Corp.*, 469 F. Supp. 265 (C.D. Cal. 1979); *William Inglis & Sons Baking Co. v. ITT Continental Baking Co.*, 461 F. Supp. 410 (N.D. Cal. 1978); *ILC Peripherals v. International Business Machines Corp.*, 458 F. Supp. 423 (N.D. Cal. 1978); *Murphy Tugboat Co. v. Crowley*, 454 F. Supp. 847 (N.D. Cal. 1978); *Weber v. Wynne*, 431 F. Supp. 1048 (D. N.J. 1977). *Contra*, *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. 965 (N.D. Cal. 1979); *O. Hommel Co. v. Ferro Corp.*, 472 F. Supp. 793 (W.D. Pa. 1979).

¹³³ *E.G.*, *Janich Bros. v. American Distilling Co.*, 570 F.2d at 856-58; *International Air Indus., Inc. v. American Excelsior Co.*, 517 F.2d at 723-24.

¹³⁴ See Scherer, *supra* note 17; Williamson, *supra* note 17.

to accept the AVC rule, other problems with the approach became evident. Recently, several courts have retreated from the earlier across-the-board acceptance of the AVC rule.

A. Problems with the AVC Approach to Predatory Pricing

As the AVC rule and the implications of its application to actual business situations are examined, various problems arise. These problems can be grouped into four general categories: (1) problems stemming from the divergent policy considerations behind the Sherman Act and the AVC rule, (2) problems with ascertaining and using AVC, (3) theoretical criticisms of the concepts Areeda and Turner relied on to support their approach, and (4) judicial misconception and misapplication of the AVC rule and its consequences.

1. Divergent Policy Considerations

The AVC rule tends to undermine certain salutary features of federal antitrust policies. While the Sherman Act places primary emphasis on competition, the AVC rule only emphasizes economic efficiency. These considerations are not always consistent. On one hand, the AVC rule encourages pricing conduct that destroys or dissuades less efficient competition,¹³⁵ indicating that survival of inefficient firms is undesirable. On the other hand, courts have recognized that Congress, in enacting the Sherman Act, appreciated that firms with higher costs may well warrant protection in the interests of competition.¹³⁶ Federal antitrust policies place great emphasis on competition from as many sources as possible, including new entrants and smaller rivals.¹³⁷ New entrants and small producers, however, face higher costs than large or established firms.¹³⁸ The AVC rule allows the large or established firms to price below their breakeven point, ATC, and well below the corresponding breakeven point for the small or new firms. Thus, the AVC rule seriously threatens the ability of the new or smaller producer to survive.

Societal benefits from the AVC rule and the Sherman Act are different. The AVC rule, consistent with its emphasis on economic efficiency, aims for optimal resource allocation and the resulting low consumer price achieved where price is set equal to marginal cost.¹³⁹ But the Sherman Act, due to social and political considerations, instead emphasizes decentralization even at the expense of higher consumer prices that this might entail.¹⁴⁰ The social and political motivations behind the Sherman Act indicate a fear of excessive economic power concentration more than they do the desire for optimal resource allocation.¹⁴¹

The economic concepts underlying the AVC rule focus solely on cost data, excluding the intent factors relevant to federal antitrust policies. Areeda and

¹³⁵ See Areeda, *supra* note 4, at 711.

¹³⁶ See *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962).

¹³⁷ *Id.* See generally Sullivan, *Economics and More Humanistic Disciplines: What Are the Sources of Wisdom for Antitrust?*, 125 U. PA. L. REV. 1214 (1977) [hereinafter cited as Sullivan].

¹³⁸ R. CAVES, *AMERICAN INDUSTRY: STRUCTURE, CONDUCT, PERFORMANCE* 24-29 (2d ed. 1967) [hereinafter cited as CAVES].

¹³⁹ Areeda, *supra* note 4, at 711.

¹⁴⁰ See note 136 *supra*.

¹⁴¹ See generally Pitofsky, *The Political Content of Antitrust*, 127 U. PA. L. REV. 1051 (1979).

Turner ignore intent, concluding it provides an insufficient basis for analysis of predatory pricing.¹⁴² They rely exclusively on economic cost data to indicate the existence of predation.¹⁴³ While objective cost data may be all that is required to solve what is strictly an economic problem, predation is not strictly an economic problem. It is a violation of the Sherman Act. Predatory pricing involves a price reduction with the aim of driving competitors out of business, so as to enjoy larger profits in the long run.¹⁴⁴ Proof of predatory pricing may be used to infer the specific intent required as part of an attempt to monopolize case.¹⁴⁵ Thus, an examination of the intentions or reasons behind management's decision to make the price reduction is relevant in identifying predation. These reasons either may be legitimate and legal justifications based on the business situation at hand or they may not be, and evidence on intent well may help the court to make this determination.¹⁴⁶ It may be true that any decision to price below AVC is necessarily predatory, as fewer losses would ensue from completely halting production,¹⁴⁷ but this does not mean that a price reduction to some higher level that also entails losses might not also indicate predation. The Areeda/Turner approach, however, operates to nullify other evidence of intent where price is above AVC.¹⁴⁸

Due to its exclusion of evidence of intent, as well as lack of emphasis on social and political considerations of federal antitrust policy, the AVC rule is an inadequate basis for identifying a violation of the Sherman Act. The rule is too rigid an approach for legal identification of predation. For instance Areeda and Turner are willing to allow equally efficient competitors to be destroyed because of the administrative problems entailed in eliminating this risk.¹⁴⁹ The Sherman Act, however, makes no allowance for destruction of competition simply because of administrative difficulty.¹⁵⁰ While a cost-based cutoff may be helpful in focusing the court's attention on an objective test that provides some guidelines, the Areeda/Turner approach results in a standard devoid of the flexibility required to analyze predation as a violation of the Sherman Act.¹⁵¹

2. Problems in the Use of Average Variable Cost

The use of average variable cost as the point delineating legal pricing conduct ignores problems in determining AVC and in comparing firms with dif-

¹⁴² Areeda *supra* note 4, at 699.

¹⁴³ *Id.* at 699-700, 733.

¹⁴⁴ See text and notes at notes 1-2 *supra*.

¹⁴⁵ See note 14 *supra*.

¹⁴⁶ See *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. at 996.

¹⁴⁷ See MANSFIELD, *supra* note 37, at 456; Areeda *supra* note 4, at 702 n.17.

¹⁴⁸ See *Pacific Eng'r & Prod. Co. of Nevada v. Kerr-McGee Corp.*, 551 F.2d 790 (10th Cir. 1977). The district court had found the defendant guilty of violating section 2 of the Sherman Act and section 2(a) of the Robinson-Patman Act based on evidence of intent. *Id.* at 792-95. The court of appeals, however, applied the AVC rule and found price to be above AVC but below ATC. Based on this finding and factors indicating the industry was in decline, the court reversed, placing no weight on the other evidence of intent. See *id.* at 797, 799.

¹⁴⁹ Areeda, *supra* note 4, at 711.

¹⁵⁰ *Chillicothe Sand & Gravel v. Martin Marietta Corp.*, 615 F.2d at 432.

¹⁵¹ See generally Sullivan, *supra* note 137.

fering cost structures. This section will discuss realistic business situations where use of the AVC rule would result in an inaccurate analysis of predation resulting in similar firms receiving inconsistent legal treatment. First, figures expressing AVC can be imprecise, therefore, use of the AVC rule will not result in uniform legal treatment of similar firms. Any figure for AVC can be no more precise than the identification and allocation of variable costs. Neither the identification of costs as variable, nor their subsequent allocation among products is subject to uniform inter-firm treatment. Any resulting figure for AVC is affected by arbitrary management decisions. The determination of some costs as either variable or fixed is discretionary on the part of management.¹⁵² Further, even assuming uniform definitions of fixed and variable costs, a cost that is variable for one firm may be fixed for another. For example, a long-term contract with a supplier may obligate a firm to purchase a set amount of materials regardless of production level, while a rival may purchase the item more frequently only in the amount required for a specific production level. In the first instance the obligated amount is a fixed cost, while the second firm's cost varies with production. Thus, management decisions, to some extent, can influence what costs are fixed and what costs are variable to the particular firm. Should management foresee potential predatory pricing problems, these decisions could be made with the aim of developing very low AVC figures for particular products.

Second, two firms, incurring the same total costs, could have dissimilar AVC figures and, thus, be treated differently under the Areeda/Turner approach for the purpose of identifying predatory pricing. A firm that is highly automated may incur large fixed costs for equipment and low variable costs for labor. Its rival, facing the same level of total costs, may be labor intensive and, therefore, may incur larger variable costs for labor and smaller fixed costs. Under the AVC rule the former firm could price much lower than the latter firm, even though both face the same breakeven point. The AVC rule takes no account of varying cost structures facing the firms when it looks solely to AVC in determining predation. The firms described above could both price at the same level, yet one would be guilty of predation while the other would be innocent. Because of this problem and because of the management decisions that impact variable cost determination noted above, the use of AVC as the cutoff identifying predation raises serious problems.

3. Theoretical Economic Criticisms

The theoretical analysis Areeda and Turner used to support their rule is inaccurate in several respects. Their use of AVC as a surrogate for economic marginal cost raises problems, as does their reliance on marginal cost-pricing. Additionally, their attempts to characterize the concepts of welfare maximization and efficiency in short run cost terms is questionable.

First, while Areeda and Turner utilized economic costs in their theoretical search for the correct cutoff between competition and predation, they were forced to rely on an accounting cost in the practical application of their rule.

¹⁵² See R. ANTHONY & J. REECE, ACCOUNTING: TEXT AND CASES 504 (6th ed. 1979) [hereinafter cited as ANTHONY].

Even if economic theory supports the use of AVC, economic costs are not the same as accounting costs. On one hand, an economist's cost measures the marketplace value of an item, its current value in its most valuable alternative use.¹⁵³ On the other hand, an accountant's cost measures the historical out-of-pocket cost of an item, the expense incurred at the time the item was acquired.¹⁵⁴ These two conceptions of cost are different, especially where the value of an item increases, or inflation occurs, over the passage of time. In these situations, an economist's cost will be higher than an accountant's cost for the same item.¹⁵⁵ Thus, a theoretical justification based on economic measures of cost would support the use of a figure higher than the corresponding accounting measure of cost. For this reason it is inaccurate to rely on accounting costs to apply the AVC rule, which was justified on a theoretical economic analysis.

Second, theoretical support for the use of marginal cost as a cutoff does not support the substitution of AVC for marginal cost as the cutoff. As noted earlier, AVC is not the same as marginal cost.¹⁵⁶ AVC is equal to marginal cost at only one point, minimum AVC,¹⁵⁷ and Areeda and Turner conceded they knew of no *a priori* reason to expect a firm to operate at this point.¹⁵⁸ Marginal cost is not equal to AVC at any other level of output, and it equals or exceeds ATC at higher levels of output.¹⁵⁹ If, indeed, marginal cost is the correct theoretical cutoff, the substitution of another measure of cost that equals marginal cost at only one level of production and varies greatly at all other levels is not valid. The economic analysis supporting marginal cost could only justify the substitution of AVC for marginal cost at this one point where they are equal. Without some proof that a firm is operating at minimum AVC, the rationale Areeda and Turner provide for a marginal cost cutoff¹⁶⁰ is inapplicable to AVC.

Third, the concept of marginal cost-pricing, the theoretical basis for the Areeda/Turner approach, was derived from an unrealistic model of market

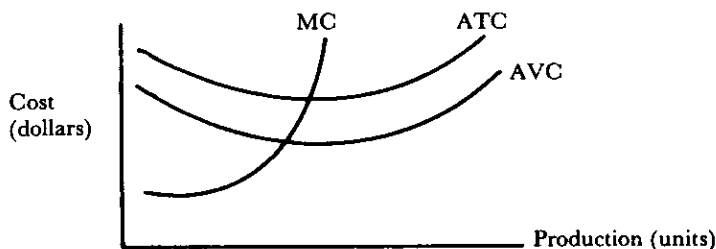
¹⁵³ MANSFIELD, *supra* note 37, at 435.

¹⁵⁴ ANTHONY, *supra* note 152, at 27-29.

¹⁵⁵ See *id.* An example of this would be materials purchased or contracted for at a set price much earlier than actual production and sale of the products. Also, a labor contract setting wage rates that was negotiated several years earlier without adequate raises included to keep pace with inflation would be an example of differing accounting and economic valuation.

¹⁵⁶ See text and accompanying notes at notes 102-04 *supra*.

¹⁵⁷ MANSFIELD, *supra* note 37, at 442. The approximate relationship of marginal cost (MC) to average total cost (ATC) is shown on the following chart. Marginal cost intersects both AVC and ATC at their minimums:



¹⁵⁸ Areeda, *supra* note 4, at 717.

¹⁵⁹ See Chart I, *supra* note 157.

¹⁶⁰ See Areeda, *supra* note 4, at 709-16.

conditions. The idea that marginal cost-pricing represented the optimal allocation of resources was developed from the determination of the optimal production level for a firm under perfectly competitive market conditions.¹⁶¹ The requirements of this model of perfect competition,¹⁶² however, do not exist in any real-life market.¹⁶³ Moreover, a claim of predatory pricing is likely only to arise in an industry that varies greatly from perfect competition. A perfectly competitive market is one where no producer has any influence over setting the price.¹⁶⁴ The firm in this situation faces a market price established for it and holds such a small share of the market that the firm cannot ever influence the price.¹⁶⁵ Predatory pricing, however, could never exist without power over prices, the underlying assumption being that a firm has in fact reduced the price. In fact it would seem that only a firm that has significant market power and financial reserves could even employ the tactic with any hope of success. This influence over price indicates a market which is far from perfectly competitive.¹⁶⁶ In regard to Areeda and Turner's use of a theory based on the model of perfect competition, economist Oliver E. Williamson commented, "[c]aution is warranted where the assumptions on which received doctrine is based are greatly at variance with the real world circumstances under examination."¹⁶⁷ While the perfectly competitive firm has no control over its prices,¹⁶⁸ any firm scrutinized in a predatory pricing case, by definition, has demonstrated control over its prices. Since the marginal cost-pricing concept is based on perfect competition and the assumptions underlying perfect competition are not satisfied in reality, the application of marginal cost-pricing analysis to predatory pricing is unwise.

Fourth, the AVC rule applies a short-run analysis to long-run welfare maximization concepts. Areeda and Turner stressed optimal resource allocation and marginal cost-pricing as a goal by which to judge a firm's pricing conduct.¹⁶⁹ Their aim was to maximize consumers' welfare by improving resource allocation and lowering price.¹⁷⁰ If the AVC rule is followed, however, the welfare loss in the form of monopoly power in the long run could well exceed any short-run gain to the consumer through lower prices.¹⁷¹ What may appear to maximize the welfare of consumers in the short run will not necessarily result in a course of action in the best interest of society in the long run. Further, Areeda and Turner emphasize pricing at marginal cost as the way to optimally allocate resources.¹⁷² Marginal cost-pricing, when stated in its long run equation, however, results in

¹⁶¹ MANSFIELD, *supra* note 37, at 455.

¹⁶² *Id.* at 476.

¹⁶³ *Id.* at 477.

¹⁶⁴ MANSFIELD, *supra* note 37, at 476.

¹⁶⁵ *Id.*

¹⁶⁶ Economists do not agree on a resource allocation model, or any overall model, for markets not portraying either the conditions of perfect competition or monopoly. *Id.* at 505.

¹⁶⁷ See Williamson, *supra* note 17, at 340.

¹⁶⁸ MANSFIELD, *supra* note 37, at 476.

¹⁶⁹ See Areeda, *supra* note 4, at 702-03, 711.

¹⁷⁰ *Id.* at 703.

¹⁷¹ See *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. at 993.

¹⁷² See Areeda, *supra* note 4, at 702-03, 711.

a price equal to both marginal cost and long-run ATC.¹⁷³ AVC is always lower than ATC, even in the long run. Thus, the welfare maximization argument stressing optimal resource allocation and marginal cost-pricing, when analyzed in its proper context, requires a price that covers long-run ATC. Application of the Areeda/Turner approach, allowing price to equal AVC, will not result in an optimal allocation of resources over the long run. It is this long run context, ignored by the AVC rule, that correctly addresses welfare maximization.¹⁷⁴

Finally, Areeda and Turner incorrectly viewed short-run costs as the sole indicator of efficiency. This view is detrimental to firms that have legitimate short-run cost differences. New entrants face higher costs than established firms,¹⁷⁵ and small producers face higher costs than larger producers.¹⁷⁶ The Areeda/Turner approach allows firms to price at AVC, but since AVC is below ATC this implies that a firm pricing at the legal minimum will not cover fixed costs with the revenue generated by sales of this product.¹⁷⁷ Established and larger firms are likely to have the capital to cover these costs, "staying power,"¹⁷⁸ thus enabling them to price below ATC. New entrants and smaller firms, however, are much less likely to possess this "staying power" and, therefore, less likely to be able to price below their breakeven point, ATC. As an additional handicap, fixed costs per unit are likely to be higher for new or smaller firms.¹⁷⁹ Since these firms cannot realistically price below ATC, the result of the AVC rule is to allow the established or larger firms, able to price below ATC, to accentuate their inherent cost advantage. If costs alone are examined to determine predation, the latter firms can legally lower prices to their AVC with the goal of driving new or smaller rivals out of the market. In this respect, the AVC rule ignores predation so long as price remains equal to or above AVC. By driving these rivals out of the market, the AVC rule does not give them the chance to increase efficiency and decrease costs, thereby denying them the chance to become more effective competition in the long run. Efficiency is not strictly a short run concept; it increases with experience¹⁸⁰ and with increased scale.¹⁸¹ This is particularly true of the new entrant whose experience and initial production levels are usually minimal. At low levels of cumulative production, costs decrease more quickly due to experience than they do at higher levels of cumulative production.¹⁸² In favoring established and larger producers, the AVC rule frustrates attempts by new and smaller producers to realize the benefit of increases in experience and production. This, therefore, decreases the likelihood that established firms will face efficient, effective competition in the long run.

¹⁷³ See P. SAMUELSON, *ECONOMICS* 470 (10th ed. 1976). Price = Marginal Cost = Long Run Average Cost.

¹⁷⁴ See Williamson, *supra* note 17, at 289.

¹⁷⁵ CAVES, *supra* note 138, at 24-28.

¹⁷⁶ *Id.* at 108.

¹⁷⁷ See Areeda, *supra* note 4, at 704.

¹⁷⁸ See *id.* at 709.

¹⁷⁹ See CAVES, *supra* note 138, at 26-27.

¹⁸⁰ See BOSTON CONSULTING GROUP, *THE EXPERIENCE CURVE III — WHY DOES IT WORK?* (1974).

¹⁸¹ CAVES, *supra* note 138, at 108.

¹⁸² See note 342 *infra*.

4. Judicial Misconceptions and Misapplication

Courts using the AVC rule have indicated both a misunderstanding of the concepts implicit in the rule and misapplication of the rule. The misunderstandings stem primarily from the incorrect view that subsidization of a particular product does not occur at prices above AVC and from an incomplete view of competition to be eliminated if a firm sets prices equal to AVC. Furthermore, in at least one instance the misapplication of the AVC rule occurred when rulings on peripheral issues became dispositive and the court expressed a desire to benefit consumers over competition.

One misconception that is manifest in some court opinions is that pricing above AVC means that the firm is not incurring a loss on the sale of its product.¹⁸³ Where price is less than ATC, however, losses will be incurred and subsidization will exist.¹⁸⁴ Since AVC is less than ATC, pricing at AVC implies that a firm is not covering its total costs and, therefore, is suffering a loss on its sales. *International Air Industries, Inc. v. American Excelsior Co.*¹⁸⁵ provides an example of a court that did not recognize these losses. The court in *International Air* adopted the AVC rule.¹⁸⁶ In so doing, the court noted that a firm pricing above AVC would increase net revenues in the short run and, therefore, would have no need to "subsidize" losses in the relevant market with profits from other markets.¹⁸⁷

This view of the AVC rule is incorrect. While revenues in this situation may cover variable expenses, if price is below ATC they would not cover all fixed expenses such as management salaries or rents. The latter expenses may not be susceptible to change in the short run, but they are an inevitable cost of production. If these expenses cannot be covered by revenues from sale of the product, subsidization from some other source will be required to cover these costs.

Another misconception held by courts is that only less efficient¹⁸⁸ or equally efficient¹⁸⁹ rivals could be driven out of the market. This incorrectly assumes that more efficient rivals are safe.¹⁹⁰ In fact, since any price below ATC necessitates some form of subsidization, more efficient firms with less financial staying power than the price cutter could be ruined. The more efficient firms will have, according to Areeda and Turner's view of efficiency, ATC below that

¹⁸³ See *International Air Indus., Inc. v. American Excelsior Co.*, 517 F.2d 714 (5th Cir. 1975); *Weber v. Wynne*, 431 F. Supp. 1048, 1060 (D.N.J. 1977). But see *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. at 992.

¹⁸⁴ See *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. at 992. See also Areeda, *supra* note 4, at 704 n.20.

¹⁸⁵ 517 F.2d 714 (5th Cir. 1975).

¹⁸⁶ *Id.* at 724.

¹⁸⁷ *Id.* at 725. In the related footnote the court observed that absence of such aid from other markets is a determinative factor in viewing predatory conduct and determining whether a statutory violation occurred. *Id.* at 725 n.32. See also *Borden Co. v. FTC*, 381 F.2d 175 (5th Cir. 1967).

¹⁸⁸ *California Computer Prods., Inc. v. International Business Machines Corp.*, 613 F.2d 727, 743 (9th Cir. 1979).

¹⁸⁹ *E.g.*, *International Air Indus., Inc. v. American Excelsior Co.* 517 F.2d at 723-24; *Weber v. Wynne*, 431 F. Supp. at 1060.

¹⁹⁰ See *International Air Indus., Inc. v. American Excelsior Co.*, 517 F.2d at 724. But see *Transamerica Computer Co. v. International Business Machines Corp.* 481 F. Supp. at 992.

of the price cutter, but if the more efficient firm's ATC is above the new price level, the more efficient firm will incur losses despite its greater efficiency. If it cannot endure these losses for long, the less efficient price cutter, through incurring larger losses, merely has to wait until the more efficient firm depletes its financial reserves and is driven from the market. Courts applying the AVC rule have not correctly understood this situation.

Misconceptions such as these indicate that the courts have difficulty applying or analyzing an economic approach such as the AVC rule.¹⁹¹ As a result, cases adopting the AVC rule have developed arguments in support of their application almost exclusively by quoting at length from Areeda and Turner.¹⁹² Until recently, no court developed any approach of its own based on a review and synthesis of case law and academic literature.¹⁹³

In addition to these misconceptions, at least one court purporting to apply the AVC rule has misapplied the standard. The court in *Foremost Tours, Inc. v. Qantas Airways*¹⁹⁴ avoided a finding of predation by stressing matters unrelated to the alleged predatory conduct. While acknowledging that subsidization was occurring, the court found the pricing conduct, which benefited consumers through lower prices, lawful.¹⁹⁵

¹⁹¹ Perhaps this problem arises because most judges are not economists and may have little or no economic background. See *United States v. Topco Assoc., Inc.*, 405 U.S. 596, 609 (1972) ("The fact is that courts are of limited utility in examining difficult economic problems.").

¹⁹² See note 133 *supra*.

¹⁹³ *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. 965 (N.D. Cal. 1979).

¹⁹⁴ 478 F. Supp. 589 (D. Hawaii 1979).

¹⁹⁵ In *Foremost Tours*, the court avoided finding prices below AVC based on non-economic issues: currency conversion rates and "de minimis" administrative costs. Plaintiff, a tour wholesaler, packaged, promoted, and sold Australian tours through retail travel agencies. *Id.* at 592. Defendant, an international air carrier, began to sell tours through one of its divisions. *Id.* Foremost filed suit claiming violation of sections 1 and 2 of the Sherman Act. *Id.* at 592-93. Among other allegations, predatory pricing was charged. *Id.* at 596.

First the plaintiff contended that it was necessary to convert United States dollars into Australian dollars to compare price with cost. *Id.* at 599. The court rejected this argument. *Id.* Such a conversion would have resulted in the showing of below-AVC pricing in the land tour operations, *id.*, but the court reasoned that since Qantas spent more in the United States purchasing aircraft and parts than it took in from sales, it could apply the conversion rate applicable to converting Australian dollars into United States dollars. *Id.* At this rate the price of the land tour was above its AVC. *Id.*

Second, plaintiff argued that Qantas had calculated the cost associated with the land operations incorrectly, omitting appropriate administrative expenses. *Id.* at 600. Plaintiff contended when cost was correctly calculated, Qantas had priced the land tours below its AVC. *Id.* The court conceded that strictly applying the AVC rule to the land tour operations, Qantas offered these operations at below AVC, including administrative expenses. *Id.* Nevertheless, the court observed that Qantas's primary business purpose in all its operations was to sell seats on its airplanes, which resulted in considerable profit. *Id.* at 601. Viewed in this context, and considering the *de minimis* significance of the expenses for the land tour operations compared to the large profits from the air transport operations, the court grouped the two operations together. See *id.* at 600-01. This combination resulted in a combined price above AVC. See *id.* at 601. Plaintiff argued that allowing this subsidization of the land tour operations by the air transport operations was contrary to the Sherman Act. *Id.* The court acknowledged that consideration of the combined operations would be detrimental to other tour operators but would result in lower prices beneficial to consumers, whereas consideration of the operations separately would protect tour operators to the detriment of consumers, due to higher prices. *Id.* The court justified its grouping of the opera-

Application of the AVC rule, and misconception of its consequences, in this manner indicates either a lack of desire to analyze the situation in terms of the rule, or the lack of background necessary to apply the correct analysis. In either event, this type of treatment is no more satisfactory a way of determining predation than was that which occurred prior to the introduction of any economic cost-based approach. If courts lack the background to either apply or refute technical economic analysis, they probably should not adopt such an approach as a legal rule.¹⁹⁶

In summary, many problems have been encountered in examining the AVC rule. While attracting criticism on theoretical economic grounds, other more practical criticisms of the approach also exist. Divergent policy considerations and problems, stemming from the use of average variable cost and judicial misunderstanding, combine with the theoretical criticisms to keep the AVC rule from being a viable legal standard for predatory pricing. Although initially the AVC rule was greeted favorably by the judiciary, recent cases indicate that the

tions on this benefit to consumers and allowed the resulting subsidization of Qantas's land tour operations. *See id.* at 601. Therefore, the court gave judgment for the defendant.

In the plaintiff's first argument, conversion rates, not price or cost, became the key issue. The identical price could be below AVC, and under the AVC rule illegal, when applying one conversion rate and above average variable cost when applying the other rate. This takes the focus off the crucial issue of the predatory nature of the pricing and puts it on the determination of which conversion rate to apply. The land tours, a service in Australia, were purchased in the United States. Yet, because of an unrelated matter, the purchase of aircraft and parts, the conversion rate applied was that for converting Australian dollars to United States dollars. In so doing the court avoided finding the defendant's pricing conduct illegal.

In the plaintiff's second argument the court avoided finding a violation of the AVC rule only by grouping two separate operations together for consideration. The plaintiff's expense allocation argument was based on the land tour operations alone. *See id.* at 600. Air transport is necessarily a separate operation to all tour operators except those which are part of an air carrier. Only air carriers can provide this service on their own, other tour operators, like Foremost, had to find a "sponsoring air carrier" to contract with for provision of air transport. *Id.* at 592. Simply because Qantas was able to provide both operations through separate divisions is not justification for considering the two operations together. When the court realized the land tour operations were priced below average cost, it looked elsewhere for this new classification. The outcome, a subsidization of the land tour operations, cannot be permitted merely because of the resulting lower prices, admittedly detrimental to tour operators other than Qantas. This justification could result in cases that would avoid a finding of predatory pricing, so long as the resultant price was beneficial to consumers.

This decision was an incorrect application of a legal rule to an alleged instance of predatory pricing. The focus was not placed on an analysis of the price or pricing conduct. Instead, it was first placed on the determination of which conversion rate to apply. This determination in turn set the price level relative to AVC. Whenever there is a fluctuation of the rate, this type of emphasis could well make the same price predatory at some points in time and not predatory shortly thereafter. This treatment avoids the crucial analysis of the price and the decision which set the price. In the second instance, the court was incorrect in ignoring the administrative costs as "de minimis" due to its comparison with profits from other markets. The court was wrong in ignoring these costs, which if considered would necessitate a different outcome, solely on the basis that the primary purpose of all Qantas's programs was to sell the profitable plane seats. *Id.* at 601. This amounted to outright subsidization of the land tours by the air travel division.

¹⁹⁶ This is especially true because of the court's responsibility for giving accurate instructions to a jury based on the resulting legal rule, or for explaining the rationale of the rule both to juries and in decisions.

judicial response to the AVC rule may be changing. Even courts that previously espoused the AVC rule now seem to be retreating from their earlier stand.¹⁹⁷

B. *Judicial Retreat from the AVC Rule and the Quest for a New Standard*

The AVC rule received almost instant judicial recognition and acceptance.¹⁹⁸ In the years immediately following its introduction, the only circuits to address the issue of predatory pricing employed the Areeda and Turner standard.¹⁹⁹ Meanwhile, academic criticism of the rule began to mount.²⁰⁰ In the face of this criticism, several courts,²⁰¹ the National Commission to Review Antitrust Laws,²⁰² and the Justice Department²⁰³ subsequently questioned the AVC rule and suggested that alternative approaches to determining predation be explored and developed.

The Ninth Circuit Court of Appeals in *California Computer Products, Inc. v. International Business Machines Corp.*²⁰⁴ first indicated a reluctance to apply the AVC rule in all cases.²⁰⁵ In this case the defendant, IBM, was alleged to have engaged in predatory pricing practices with regard to certain electronic data processing products.²⁰⁶ Specifically, these products were disk products, devices using magnetic disks to store information, and controllers used to communicate between these disks and the central processing unit (CPU).²⁰⁷ The plaintiff, CalComp, was a small computer products manufacturer that produced disk products compatible with IBM's CPUs.²⁰⁸ CalComp alleged violations of sections 1 and 2 of the Sherman Act because of IBM's introduction of new non-compatible CPUs, its reduction in disk product prices, and its change in marketing practices.²⁰⁹

On the issue of predatory price reductions, the court held that IBM's

¹⁹⁷ See text and notes at notes 204-38 *infra*.

¹⁹⁸ See note 128 *supra*.

¹⁹⁹ See notes 129-31 *supra*.

²⁰⁰ See, e.g., Scherer, *supra* note 17; Sullivan, *supra* note 137; Williamson, *supra* note 17.

²⁰¹ See text and notes at notes 204-55 *infra*.

²⁰² See note 256 *infra*.

²⁰³ See note 258 *infra*.

²⁰⁴ 613 F.2d 727 (9th Cir. 1979).

²⁰⁵ See *id.* at 743. Prior to *California Computer Products*, the Federal Trade Commission in *Borden, Inc.*, 92 F.T.C. 669 (1978), acknowledged the academic debate over the AVC rule. *Id.* at 800. In *Borden*, however, it was unnecessary to apply a new standard for predation since Borden's conduct was "exclusionary in intent and in effect." *Id.* at 804. A concurring opinion by Commissioner Pitofsky criticized the Areeda/Turner approach. *Id.* at 817-31. See also *O. Hommel Co. v. Ferro Corp.*, 472 F. Supp. 793 (W.D. Pa. 1979). In a decision rendered the same day as *California Computer Products*, the court in *O. Hommel Co.* specifically declined to adopt the AVC rule. *Id.* at 796. See generally *Outboard Marine Corp. v. Pezetel*, 461 F. Supp. 384, 400 (D. Del. 1978) (Dismissal of charges where no allegations were made that prices were below cost or that they were foregoing a profit. No mention was made of a necessity to show prices below AVC even though the debate between Areeda/Turner and Williamson was cited.).

²⁰⁶ *California Computer Prods., Inc. v. International Business Machines Corp.*, 613 F.2d at 731.

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ *Id.*

pricing conduct was legal since CalComp failed to show that the price reductions unnecessarily excluded or restricted competition.²¹⁰ It found IBM's conduct to have been a legitimate response to price competition from other producers like CalComp.²¹¹ The court noted that evidence presented by IBM indicated the post-reduction prices were still substantially profitable.²¹² Thus, the court reasoned that IBM's conduct was not predatory.²¹³ In this case the plaintiff not only failed to produce evidence of below AVC pricing, but also failed to counter the evidence introduced by IBM that even after the price reductions the products remained profitable.²¹⁴ Although the court thus was not faced with facts necessitating a reassessment of the AVC rule, the court observed that refinement of the AVC rule might be necessary as future predatory pricing cases arose.²¹⁵ Specifically, the court noted, "we do not foreclose the possibility that a monopolist who reduces prices to some point above marginal or average variable cost might still be held to have engaged in a predatory act because of other aspects of its conduct."²¹⁶

One district court in the Ninth Circuit has read this language as a cue to retreat further from acceptance of the AVC rule. Indeed, *Transamerica Computer Co. v. International Business Machines Corp.*²¹⁷ is the first case to abandon the AVC rule as the per se standard for identifying predation. In *Transamerica*, the plaintiff alleged that IBM monopolized or attempted to monopolize the computer peripheral equipment market in violation of section 2 of the Sherman Act.²¹⁸ In response to competition, IBM had reduced substantially the prices of its products and offered longer and better lease terms for its peripherals.²¹⁹

In deciding the case, the court repudiated the AVC rule for most cases alleging predation.²²⁰ The court took this action because it recognized several of the deficiencies in Areeda and Turner's approach that are described above.²²¹ The court noted that it was self-evident that a firm selling below average total

²¹⁰ *Id.* at 742.

²¹¹ *Id.*

²¹² *See id.* at 741-42, 743.

²¹³ *Id.* at 743.

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ *Id.* After *California Computer Products*, in March 1980, the Ninth Circuit in *Ernest W. Hahn, Inc. v. Coddling*, 615 F.2d 830, 845-46 (9th Cir. 1980), reversed a dismissal of complaints on the pleadings of a predatory pricing claim where allegations were made of price "below cost" without any mention of average variable cost. In so doing, the court indicated a willingness to consider costs other than average variable cost.

²¹⁷ 481 F. Supp. 965 (N.D. Cal. 1979).

²¹⁸ *Id.* at 971-72. Peripheral equipment is a category including disks, tapes, printers, and terminals that are connected to the central processing unit (CPU). This equipment performs the functions of storing data for later use, feeding data into the CPU, and accepting data from the CPU. *Id.* at 972.

²¹⁹ *Id.* at 973.

²²⁰ *See id.* at 995. The jury was unable to reach agreement on any of the issues. Accordingly, pursuant to a pre-trial stipulation, the case was then submitted to the court for a decision. *Id.* at 974.

²²¹ See text at notes 136, 137, 140, 141, 146, 171, 184 & 190 *supra*.

cost would incur a loss.²²² It reasoned that even a more efficient rival would incur a loss if its average total cost was below the price cutter's average total cost but above the price.²²³ In such a situation the more efficient firm would be able to survive only if it were able to withstand losses as long as the price cutter chose to inflict them.²²⁴ The court concluded that under such conditions competition based on efficiency would be replaced by competition based on wealth.²²⁵

The *Transamerica* court reasoned if pricing below average total cost was to be legal, firms able to sustain this price would eliminate competitors through temporary provision of more and lower priced goods.²²⁶ Instead, the court noted, Congress and the courts had placed their reliance on effective ongoing competition from many sources to accomplish proper resource allocation.²²⁷ After discussing this interpretation of the Sherman Act, the court stated:

Areeda and Turner have made a policy judgment. The economic analysis used to justify that judgment is incomplete, and the judgment itself stands contradicted by the economic, political, and social policies of the Sherman Act.

A conclusive presumption of the legality of an unprofitable low price, merely because it is above marginal cost, a cost which is all but incapable of proof, would truly be a "defendant's paradise." This court rejects it.²²⁸

Thus, the court abandoned the AVC rule as a contradiction of the policies inherent in the Sherman Act.

To replace the AVC rule, the *Transamerica* court presented its own economic cost-based approach to predatory pricing.²²⁹ Prices set at or above ATC would be conclusively presumed legal.²³⁰ Prices set below ATC would be illegal if they were unreasonable.²³¹ In formulating this approach the court acknowledged it would be too difficult to distinguish between competitive and anti-competitive price reductions where price remained above ATC since this determination inherently would rely heavily on proof of intent. Therefore, the court stated that the "minimal threat to competition by a free zone above average cost" was acceptable.²³² Where prices fell below ATC, however, the court concluded that a case by case "rule of reason" approach was necessary.²³³ The court listed

²²² 481 F. Supp. at 992.

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ *Id.* at 994.

²²⁷ *Id.*

²²⁸ *Id.* at 995 (footnote omitted).

²²⁹ *See id.* at 990. That the court utilized an economic approach is evident where it defined average cost as equal to that which covers costs and a normal return on investment.

²³⁰ *Id.* at 989.

²³¹ *Id.* at 991, 995.

²³² *Id.* at 991.

²³³ A rule of reason approach focuses on the challenged restraint or practice and its impact on competitive conditions. The Supreme Court in *Continental T.V., Inc. v. GTE Sylvania*, 433 U.S. 36 (1977), explained the rule of reason standard as follows: "Under this rule, the factfinder

several examples of situations in which prices set below ATC might be justified. The primary examples included cases involving: (1) excess capacity in the industry, (2) decreasing demand, or (3) liquidation of excess merchandise.²³⁴ Where price was below ATC, the court would allow evidence of intent to be considered in determining the reasonableness of the reduction.²³⁵ In this situation, evidence of intent could help clarify the nature of the pricing conduct by revealing whether the price cutter, in its own evaluation of the situation, thought it was "cutting losses or cutting throats."²³⁶ In applying its approach to IBM's conduct, the *Transamerica* court found that the post-reduction prices were above ATC and, therefore, legal.²³⁷

Both *Calcomp* and *Transamerica* represent a significant development in the law of predatory pricing. Since publication of the Areeda/Turner article, courts in the Ninth Circuit have heard more predatory pricing cases than all the other circuits combined.²³⁸ Because of the Ninth Circuit's leading role in this field, the views expressed in *CalComp* and *Transamerica* may well have an impact on future cases decided in other circuits.

More recently the Seventh Circuit Court of Appeals in *Chillicothe Sand & Gravel Co. v. Martin Marietta Corp.*²³⁹ discussed the controversy over the AVC rule.²⁴⁰ In this case, the plaintiff, Chillicothe Sand & Gravel (CS&G), was a small producer of road gravel while the defendant, Martin Marietta, was a large diversified company.²⁴¹ As a new entrant to the business,²⁴² CS&G began competing vigorously with Marietta for road gravel sales contracts.²⁴³ By pricing below Marietta, CS&G won customers away from the defendant.²⁴⁴ Marietta responded by cutting its prices.²⁴⁵ Thereafter, having lost most of its

weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition." *Id.* at 49. Earlier, in *Chicago Bd. of Trade v. United States*, 246 U.S. 231 (1918), when discussing the rule of reason standard, the Court noted that "[t]he true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or destroy competition." *Id.* at 238.

²³⁴ *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. at 996. In some circumstances, the court noted that promotional pricing, meeting competitors prices, and even occasional price wars could be included. *Id.*

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ See *id.* at 996-1002. In reaching this decision, the court reviewed various cost-accounting methods used by IBM to arrive at a full cost figure. See *id.* at 998-1001. The methods used were found to be generally accepted accounting principles, applied consistently, and, therefore, valid to establish cost. See *id.*

²³⁸ See notes 129-32 *supra*.

²³⁹ 615 F.2d 427 (7th Cir. 1980).

²⁴⁰ *Id.* at 431-32. The court cited *Transamerica's* divergence from the AVC rule. *Id.* at 431 n.6.

²⁴¹ *Id.* at 428-29.

²⁴² *Id.* at 429.

²⁴³ The court indicated that it was significant CS&G could become a vigorous competitor in the market after an outlay of only \$65,000. *Id.*

²⁴⁴ *Id.*

²⁴⁵ *Id.* CS&G then raised its prices and simultaneously entered the blacktopping business, placing itself in direct competition with firms that had been its best customers for road gravel. *Id.* at 429-30 n.2.

road gravel sales contracts to Marietta,²⁴⁶ CS&G sued alleging violations of section 2 of the Sherman Act.²⁴⁷ CS&G claimed Marietta's price reduction had been a predatory attempt to drive it out of business.²⁴⁸ The district court granted a directed verdict in favor of the defendant.²⁴⁹

On appeal, the court noted that while examination of AVC could prove useful in analyzing predation,²⁵⁰ it was "willing to consider the presence of other factors in [its] evaluation of whether or not CS&G has made out a prima facie case of monopolizing or attempt to monopolize."²⁵¹ The court found that Marietta's prices were generally above ATC.²⁵² The court then examined other evidence of predation in Marietta's conduct. It looked at Marietta's bidding practices, package pricing, disparagement of CS&G's product, and a statement that it "wouldn't appreciate" CS&G's entry into the market.²⁵³ Despite this examination of additional evidence, the court of appeals nevertheless concluded that CS&G failed to present sufficient evidence of predatory conduct,²⁵⁴ and it affirmed the directed verdict.²⁵⁵

The *Chillicothe Sand & Gravel* court's willingness to consider evidence ignored by the AVC rule, coupled with the earlier repudiation of the AVC approach in *Transamerica*, suggests a change in judicial attitude toward the Areeda and Turner approach to predatory pricing.

In addition to this judicial change, both the National Commission to Review Antitrust Laws and the Department of Justice, Antitrust Division, have been critical of the Areeda/Turner approach. The Commission concluded that the AVC rule was "too restrictive" in its exclusion of considerations such as intent and market power, especially when a dominant firm's conduct was challenged.²⁵⁶ Further, the Commission recommended the Sherman Act be amended to include a standard for predation that took intent and market power, as well as the price-cost relationship, into account.²⁵⁷ Shortly after *Chillicothe Sand & Gravel*, the Department of Justice, referring to the three decisions detailed above, indicated it too questioned whether a rigid cost rule, such as the AVC rule, could "truly reflect market place realities and provide for anticom-

²⁴⁶ *Id.* at 429-30 & n.3.

²⁴⁷ *Id.* at 429.

²⁴⁸ *Id.* at 431.

²⁴⁹ *Id.* at 428.

²⁵⁰ *Id.* at 432.

²⁵¹ *Id.* The court cited *Pacific Eng'r & Prod. Co. of Nevada v. Kerr-McGee Corp.*, 551 F.2d 790 (10th Cir. 1977), in which the court stated it did not intend to adopt a solely cost-based approach in the instant case. *Id.* at 797. The *Chillicothe Sand & Gravel* court, however, was the first court to explicitly reject an absolute cost rule by indicating an intent to consider other factors in evaluating the establishment of a prima facie case. 615 F.2d at 432.

²⁵² *Id.* The phrase "generally above" is used here because, although all the price figures presented in the decision were above AVC, in its opinion the court noted, "prices were very close to and, generally, above average total cost." *Id.*

²⁵³ *Id.* at 432-33.

²⁵⁴ *Id.* at 432.

²⁵⁵ *Id.* at 434.

²⁵⁶ NATIONAL COMMISSION FOR THE REVIEW OF ANTITRUST LAWS AND PROCEDURES, REPORT TO THE PRESIDENT AND THE ATTORNEY GENERAL 149 (Jan. 22, 1979).

²⁵⁷ *Id.* at 151, 166.

petitive behavior."²⁵⁸ It noted that conclusive use of a solely cost-based standard in predatory pricing cases was unwise, and added that the recent trend in these court decisions was a healthy development.²⁵⁹

This retreat from the AVC rule comes in the wake of extensive academic criticism of the Areeda/Turner approach in legal literature. In their discussion of the AVC rule, courts often have cited academic commentators who have disagreed with Areeda and Turner. In spite of this, for several years courts continued to apply the AVC rule. This is not due, however, to a lack of proposed alternatives to the AVC rule. Almost every academic commentator criticizing Areeda and Turner's approach on a theoretical basis has proposed his own theoretical alternative to serve as a legal standard.²⁶⁰

III. TWO THEORETICAL ALTERNATIVES TO THE AVC RULE

Since its initial appearance, Areeda and Turner's approach to predatory pricing has been the subject of constant, critical academic debate.²⁶¹ Though several theoretical alternatives to the AVC rule have surfaced from this ongoing debate, no court has yet attempted to apply any analysis suggested by the other commentators. The range of theoretical alternatives can be demonstrated effectively by examining two contrasting approaches. At one extreme, Professor Sullivan has proposed a predominately non-economic approach,²⁶² while at the other end of the spectrum Professors Joskow and Klevorick have proposed an economic approach that differs significantly from the AVC rule.²⁶³

A. A Traditional Non-Economic Approach

Though not proposing that economic or cost analysis should be irrelevant in predatory pricing cases, Professor Sullivan in response to Areeda and Turner argued that any strictly economic approach to predation is wrong.²⁶⁴ This position stemmed from his systemic view of antitrust law.²⁶⁵ As a legal system, Sullivan argued, antitrust regulation is grounded in values other than economic efficiency and has value sources other than economics.²⁶⁶ These value sources include concepts drawn from the disciplines of sociology, political science, and history.²⁶⁷ Although these alternative value sources may not fully answer questions raised in antitrust debates, Sullivan reasoned they would at least

²⁵⁸ Remarks of Ky P. Ewing, Jr., Deputy Assistant Attorney General, Antitrust Division, before the Fifth Annual Symposium on Antitrust Law, The Southwestern Legal Foundation, Dallas, Texas, on May 9, 1980. [1980] TRADE REG. REP. (CCH) ¶ 55,936.

²⁵⁹ *Id.* at 55,936, 55,937.

²⁶⁰ See, e.g., Baumol, *supra* note 17; Scherer, *supra* note 17; Williamson, *supra* note 17.

²⁶¹ See note 115 *supra* and Baumol, *supra* note 17.

²⁶² Sullivan, *supra* note 137.

²⁶³ Joskow, *supra* note 1.

²⁶⁴ Sullivan, *supra* note 137, at 1232, 1241.

²⁶⁵ See *id.* at 1232, 1241, 1242.

²⁶⁶ *Id.* at 1232.

²⁶⁷ See *id.* at 1232-41.

supply a "healthy skepticism" about the limited analysis drawn solely from economics.²⁶⁸

In a similar vein Sullivan also argued that traditional legal rules focusing on "human animus," or underlying intent, were more appropriate for a legal system than rules solely used to perform an economic evaluation.²⁶⁹ A firm seeking to exclude rivals by selling at unremunerative prices would leave traces.²⁷⁰ Sullivan contended that pretrial discovery procedures can uncover these traces, and that these traces would be easier to prove than the pricing conduct that Areeda and Turner would require to prove predation.²⁷¹ Under Sullivan's more traditional legal approach to predation either side would be free to present objective economic data such as that stressed by Areeda and Turner,²⁷² but in addition any evidence indicative of predatory intent also could be presented.²⁷³ This other, more subjective, evidence could include any traces uncovered in pretrial discovery providing an insight to the defendant management's perception about its market situation and the objectives it was trying to achieve by its pricing policy.²⁷⁴ The trier of fact then would review all of the evidence and would apply an intent based standard of predation with a major focus on these intra-firm perceptions.²⁷⁵

In Sullivan's view it is incorrect to replace a conventional formulation of predation that looks for evil intent with a test focusing solely on economic analysis.²⁷⁶ Complete reliance on economic analysis, he argued, overestimated the precision of the discipline of applied economics and underestimated the potential of other more humanistic disciplines in general, and of the trier of fact in particular, to discern predation.²⁷⁷ Where predation occurs, Sullivan argued, a predatory intent can be gleaned by the trier of fact when presented with all the available evidence.²⁷⁸

Sullivan's approach, however, is subject to the same criticisms Areeda and Turner have leveled against historical treatment of predatory pricing claims. While Sullivan correctly contends that standards such as the AVC rule are short-sighted in their total reliance on economic analysis, he fails to propose guidelines that delineate clearly what practices should constitute the offense of predatory pricing. Although Sullivan would not call evidence based on cost analysis irrelevant, he insists on a test primarily founded on intent. Theoretically, a plaintiff could prevail without any showing of objective cost data to substantiate its claim of predation. The emphasis placed on management perceptions and objectives in pricing policy correctly highlights an important issue ignored by

²⁶⁸ *Id.* at 1241.

²⁶⁹ *See id.* at 1229.

²⁷⁰ *Id.* at 1230.

²⁷¹ *Id.*

²⁷² *Id.* at 1232.

²⁷³ *Id.*

²⁷⁴ *Id.* at 1231.

²⁷⁵ *Id.* at 1231-32.

²⁷⁶ *Id.* at 1230.

²⁷⁷ *Id.*

²⁷⁸ *See id.* at 1231.

Areeda and Turner. Yet a firm that is uncertain whether a contemplated price adjustment might be deemed predatory has no concrete guideline under the Sullivan approach. Some degree of objective analysis is necessary to prevent a firm from being found guilty of predation solely based on intra-firm memoranda or over-zealous sales meetings that encourage employees to beat the competition and drive them out of the market. Sullivan's alternative to the AVC rule, like historical treatment of the issue, lacks this objective delineation of the boundaries of predatory pricing.

B. *A Two-Tier Economic Approach*

The proposal of Professors Joskow and Klevorick is fundamentally different from Professor Sullivan's approach. It is the most recent in the line of economic approaches that began with the Areeda and Turner article in 1975.²⁷⁹ Their proposal consisted of a two-tier analytical framework. The first tier entailed a structural analysis of the market, while the second tier examined pricing behavior.

In the first tier, this structural analysis required that the relevant market be placed on a continuum from monopoly markets to competitive markets.²⁸⁰ Joskow and Klevorick proposed to rely on "generally accepted definitions of monopoly power"²⁸¹ to accomplish this placement. In so doing, they identified three categories of structural characteristics to aid in the placement of markets on the continuum: (1) factors indicative of short-run monopoly power; (2) conditions of entry into the market; and (3) the dynamic effects of competitors or entrants on the costs of production and the quality of products offered to consumers.²⁸² Positioning a market on this continuum allowed the court to determine whether the market structure was such that "a dominant firm could engage in predatory pricing activity that would result in significant sacrifice in economic efficiency."²⁸³ Joskow and Klevorick considered markets approaching monopoly on the continuum to be most conducive to acts of predation.²⁸⁴ Predatory pricing is more attractive in industries with increased monopoly characteristics because the dominant firm will possess a greater ability to raise prices after destroying its rival than would a firm in a competitive market with no power to successfully raise prices.²⁸⁵ Thus, monopoly characteristics indicate a greater net profitability of predatory pricing conduct than do competitive characteristics.²⁸⁶ They further reasoned that because of the likelihood of success in a conducive atmosphere the costs of a failure to identify predatory pricing conduct would be highest in these markets.²⁸⁷ Therefore, a claim was to be pursued

²⁷⁹ See Baumol, Scherer, and Williamson, *supra* note 17. For a recent discussion of these and other economic proposals, see McGee, *supra* note 17.

²⁸⁰ See Joskow, *supra* note 1, at 226.

²⁸¹ *Id.* at 244.

²⁸² *Id.* at 224.

²⁸³ *Id.* at 246.

²⁸⁴ See Joskow, *supra* note 1, at 244.

²⁸⁵ See *id.* at 237.

²⁸⁶ See *id.* at 236.

²⁸⁷ See *id.* at 244-45.

beyond the first tier only where the existence of monopoly characteristics, either actual or potential, was pervasive enough to justify additional scrutiny.²⁸⁸ This would allow resources for antitrust enforcement to be targeted at those markets where the cost of failure to locate predation and the propensity to act predatorily are both high. Expenditure of resources here would produce the greatest social efficiency gains.²⁸⁹

The second tier of the test came into play when the first tier analysis determined that the market possessed structural characteristics demonstrating monopoly potential.²⁹⁰ This tier examined the defendant's pricing behavior and compared price to cost.²⁹¹ Both subjective and objective evidence was considered. Three price ranges were analyzed and the legality of prices within these ranges determined. First, prices found to be below AVC were determined to be predatory per se.²⁹² Second, prices found to be between AVC and ATC were determined to be predatory, unless they maximized short-run profits.²⁹³ Third, prices found to be above ATC were determined to be legal, unless a price reduction was reversed within an "unreasonable period of time."²⁹⁴ Evidence of intent, if introduced, would solely be used to address two issues: (1) whether the firm planned to increase prices once competition had been driven from the market, and (2) whether the pricing conduct was an effort to increase artificially the difficulty of entering the market.²⁹⁵ At this tier the burden of production would be on the defendant.²⁹⁶

Joskow and Klevorick justified the rule for each price range in the second tier of the test individually. For the first price range, prices below AVC, they found, as had Areeda and Turner, that a showing of prices within this range was sufficient to demonstrate predation.²⁹⁷ This conclusion, unlike Areeda and Turner's similar conclusion, however, was not based on microeconomic models or short run efficiency considerations.²⁹⁸ Rather, they reached this conclusion by looking to long run intent and consequences.²⁹⁹ They reasoned that a price cut to this level could have no purpose other than sacrifice of short run profits for long run monopoly gain.³⁰⁰

Joskow and Klevorick deemed prices set between AVC and ATC to be predatory unless the defendant could show that this strategy maximized short run profits.³⁰¹ They concluded that this defense would only be valid when

²⁸⁸ *Id.* at 245.

²⁸⁹ *Id.* at 262.

²⁹⁰ *See id.* at 249.

²⁹¹ *See id.* at 250-55.

²⁹² *Id.* at 252.

²⁹³ *Id.* at 253.

²⁹⁴ *Id.* at 255.

²⁹⁵ *Id.* at 261.

²⁹⁶ *Id.* at 259.

²⁹⁷ *Id.* at 252.

²⁹⁸ *Id.*

²⁹⁹ *Id.*

³⁰⁰ *Id.* at 251. They recognized one possible exception, where there is temporary excess capacity and shutting down would involve high cost to resume production. *Id.* at 252 n.77.

³⁰¹ *Id.* at 253.

substantial excess production capacity existed in the industry.³⁰² Generally, however, a price below ATC was deemed to be predatory because a firm pricing at this level could drive equally and even more efficient competitors, as well as less efficient competitors, from the market or deter their entry.³⁰³

Finally, in viewing prices set above ATC, Joskow and Klevorick concluded a price reduction to any point above ATC should be legal, unless it was rescinded within an unreasonable time.³⁰⁴ They reached this conclusion because prices above ATC were sustainable and, therefore, if they were maintained they were not usually short-run predatory attempts to cement monopoly power.³⁰⁵ If the price reduction was reversed within a short time, perhaps two years, however, predatory intent is suggested and the defendant would be required to show that the new price was justified by independent increases in cost or demand to avoid liability.³⁰⁶

The shifted burden of production was required because Joskow and Klevorick reasoned it would be difficult or impossible for the plaintiff or the court to ascertain the defendant's real costs.³⁰⁷ Any cost-based test would create a tremendous evidentiary burden on a plaintiff, and cost evidence obtained through discovery may be incomplete or difficult to understand.³⁰⁸ Therefore, the defendant should logically bear the burden of showing that the price cut was not predatory. This would include provision of cost studies, as well as detailed descriptions of the bases of cost studies and accounting techniques employed in developing cost estimates.³⁰⁹ The failure to maintain or produce this information would lead to the presumption that the price cut was predatory.³¹⁰

With regard to the second tier, Joskow and Klevorick only subjected a firm to scrutiny where the structural analysis indicated that there was a reasonable expectation that monopoly power had been or could be sustained through price reductions.³¹¹ Because of the showing of monopoly potential in the first tier, their proposed second-tier analysis was more rigorous than would be applied to all firms by Areeda and Turner.³¹² Thus, a firm's pricing conduct found acceptable to Areeda and Turner would not always be legal under this test.³¹³

³⁰² They noted that this condition might arise for three reasons: (1) the firm was in a declining industry; (2) an entrant entered at a sufficiently large scale of production that price equal to ATC left industry capacity underutilized; (3) the price-cutting firm followed a strategy of carrying excess capacity to deter entry. If one of the first two situations obtained, the price-cutting firm could use this defense to justify prices below ATC. If, however, the third reason accurately described the situation, this defense would not be available to the firm, and its below-ATC price would be illegal. *Id.*

³⁰³ *Id.*

³⁰⁴ *Id.* at 255.

³⁰⁵ *Id.*

³⁰⁶ *Id.*

³⁰⁷ *Id.*

³⁰⁸ *Id.*

³⁰⁹ *Id.* at 261.

³¹⁰ *Id.*

³¹¹ *See id.* at 249 & n.69.

³¹² *See id.* at 244.

³¹³ *See id.* at 252-55.

Joskow and Klevorick's proposal, while improving upon previous cost-based tests in its second tier, is an impractical test to apply in a courtroom. Although it may be theoretically valid, the first tier would necessitate detailed and complex industry analysis. In using terms like "generally accepted definitions of monopoly power,"³¹⁴ Joskow and Klevorick mislead the reader into concluding that a structural analysis of this type is a uniformly agreed on, relatively simple task.³¹⁵ As noted by a recent commentator, this proposal would make every predation case into what amounts to a major industry study followed by a section 2 Sherman Act case.³¹⁶

Beyond the fatal impracticality of this first-tier requirement, however, Joskow and Klevorick make three valid points in the second-tier explanation. First, shifting the focus from the short run economic efficiency emphasis of the AVC rule to long run intent and consequences is an improvement. As noted by Professor Sullivan, antitrust law is not grounded solely in economics,³¹⁷ and this approach takes this fact into account. Second, the choice of ATC as the crucial point in determining predation also is an improvement over Areeda and Turner's approach. The realization that equally efficient and even more efficient firms can be forced out of the market or dissuaded from entry at a price below ATC supports this choice. Finally, placing the burden of production on the defendant with regard to evidence necessary to establish a cost-price relationship is entirely logical since the defendant is likely to have sole control over such data.

The Sullivan and Joskow/Klevorick proposals for alternative approaches to predatory pricing stem from how the commentators view the AVC approach. Some of these problems may be non-economic — such as a lack of focus on intent — or economic — such as incorrect cost-price comparison point. These proposals, however, have problems themselves. The Sullivan approach, for example, because of its subjectivity, provides no objective guideline for a firm to follow in setting prices. Meanwhile, the Joskow/Klevorick approach is unsatisfactory because it is too complex to be practical. Nevertheless, courts, in the future, will have to account for factors that the AVC rule ignores by adopting a legal standard for predatory pricing that is practically applicable as well as theoretically valid.

IV. WANTED: A SUCCESSOR TO THE AVC RULE

Due to the deficiencies of the AVC rule, and the total inadequacy of any historical formulation of the offense, predatory pricing is a violation in search of a standard. Whether or not it is indeed a frequent occurrence, courts and businesses alike need a concrete legal standard for the offense to guide them in detecting or avoiding illegal conduct. An approach that built upon the requirement of objective data, which Areeda and Turner correctly pointed out as lacking in earlier analysis, while not ignoring other evidence relevant to

³¹⁴ See *id.* at 244.

³¹⁵ McGee, *supra* note 17, at 319.

³¹⁶ *Id.* at 320.

³¹⁷ Sullivan, *supra* note 137, at 1232.

predation should avoid the pitfalls of the AVC rule and clearly delineate the boundaries of the legal pricing conduct.

A. Factors Relevant to a Standard for Predatory Pricing

Examination of the AVC rule and proposed alternatives has produced a list of four major characteristics that should be embodied in a valid legal approach for identifying predatory pricing. Initially, a new approach should further the policies inherent in the Sherman Act, while also establishing an objective guideline for acceptable pricing conduct. Additionally it should be a practical approach capable of easy application to business and competitive realities. Further, it should attempt to foster both long-run competition and efficiency. Finally, any valid legal standard should be based on data and practices that the judiciary can understand and examine through traditional legal analysis.

First, like the Sherman Act, a standard for predation should recognize values other than economic efficiency.³¹⁸ Competition from new entrants and small producers should not be put at a disadvantage greater than their inherent cost disadvantage. Price reduction with the aim of driving these competitors out of business should be identified as predatory. In this respect, the reasons behind a price reduction are as relevant as the price level after the reduction in determining the predation. For this reason, a legal standard for the Sherman Act offense should consider managerial intentions and reasons for reducing its price rather than only examining the resulting price and its relationship to economic costs. While a flexible approach is therefore necessary, some sort of objective cutoff delineating which price reductions are suspect should be established. Firms need an objective guideline on which they can safely rely on in making pricing decisions. Without some cutoff point any price reduction would be open to a rival's charge of predation, even when the new price covered all costs of production and resulted in larger profits, both short-run and long-run, due to increased sales. Although it is theoretically possible to engage in predation by any reduction in price, practical realities dictate that prices set above some point be conclusively presumed legal.

Second, a standard for predation must be practical and examine actual business realities.³¹⁹ The standard should look to business practices, not economic theory for its rationale and application. While economic costs may conceptually be a superior way to recognize an item's value, only accounting costs are expressed in business records. Therefore, any practical standard should focus on accounting costs, not on economic costs, both in its theoretical analysis and in its practical application. Further, the analysis should not be premised on the theoretical model of perfect competition. For textbooks, this premise may be warranted, but for a legal examination of predation, the standard should reflect the realities of business in the less than perfectly competitive market. It is based on these real conditions that a manager will make the decision to reduce price.

³¹⁸ See text and notes at notes 135-51 *supra*.

³¹⁹ See text and notes at notes 152-55 & 161-68 *supra*.

Third, the standard should recognize both efficiency and competition as long-run concepts.³²⁰ New entrants and small producers should be encouraged to realize the efficiency gain and cost reductions available to them through increased cumulative production. This will increase effective competition in the long run. In order to remain in business over the long run all costs must be covered. With this long-run concept in mind, the standard should allow short-run deviations from this full-cost coverage only for legitimate and legal business purposes. Perhaps most firms charging below ATC will have a legitimate reason for this pricing, but this should be demonstrated, not presumed. Deviation for any other reason serves only to discourage competition from firms without equal financial staying power. While recognizing the inherent disadvantages of new and smaller producers, these disadvantages should not be accentuated by a rule stressing the short-run while ignoring long-run consequences.

Fourth, the standard should be capable of easy and correct application in the courtroom.³²¹ An analysis of predation should be based on traditional legal analysis. The standard should rely on an analysis of the firm's conduct that is capable of examination in court, not on theoretical economic analysis. The judiciary is comfortable with legal concepts while normally untrained in economic theory. Firms should be required to justify their conduct based on legitimate business realities, not on theoretical analysis. This coupled with the use of readily available business figures should result in a standard more suited for the legal examination of a Sherman Act offense. Therefore, a valid standard should be based on accounting costs rather than economic costs and take into account the discretion involved in formulating these costs. Beyond this, price reductions should be evaluated in light of the realities of the business place with ample flexibility to recognize what are legitimate justifications for reducing price and what are illegal attempts to destroy competition in the context of the Sherman Act. Only with these four factors in mind can the optimal predatory pricing test be devised.

B. *A Proposal: A Standard Based on Accounting Records and Managerial Practices*

The foregoing factors can be taken into account in the formulation of a two-step analysis for evaluating allegations of predatory pricing. As a first step, for ease of administration and to give businesses an objective guideline, the test would avail itself of an accounting, cost-based cutoff in establishing a presumption of predation. Firms setting prices above this level would receive no further scrutiny. Where price is set below this level, the court would proceed to the second step and examine the defendant's managerial practices.

Step one would involve a consideration of full costs. Under this step the court would designate any price set above the accountant's figure for ATC as legal.³²² A price shown to be below ATC would raise the presumption of

³²⁰ See text and notes at notes 169-82 *supra*.

³²¹ See text and notes at notes 185-96 *supra*.

³²² Other commentators proposing economic cost-based approaches have used ATC as the significant cutoff for identifying predatory pricing. Joskow, *supra* note 1, at 252-55;

predatory pricing conduct. Firms pricing below this point would face the second step of the test. Step two would involve an examination of the defendant's managerial practices to ascertain if legitimate business reasons exist for this pricing conduct. If a legitimate justification for this pricing is not shown, the defendant would be guilty of predation.

The first step of this approach examines accounting costs as opposed to economic costs, thereby avoiding the problems encountered by courts in applying an economic cost-based theory such as the AVC rule.³²³ ATC was chosen because it is the firm's breakeven point. At prices above this point, a sale of the product causes an addition to profits, not just a reduction in losses or a contribution toward fixed costs. Moreover, subsidization of the production process does not occur above this point, as no losses exist to be subsidized by revenue from a source other than sale of the product. Where the defendant continues to profit from the sale of the product, competition is on the basis of legitimate cost differences, fully covered by price, not on the basis of the amount of financial reserves a firm has available to subsidize sales. Therefore, it is reasonable to assume that this price is legitimately competitive rather than predatory.

To establish this cutoff, the court would accept the defendant's ATC as indicated in its business records. Although this figure is subject to some manipulation,³²⁴ it would be accepted for several reasons. First, so long as the apportionment methods are generally accepted accounting practices, there is no way a court could decide logically which of several accepted methods is "correct."³²⁵ Second, although indirect expenses still may be allocated among several products in various ways resulting in different ATC figures, far less variance is possible in determining ATC than in determining AVC. When computing ATC

Transamerica Computer Co. v. International Business Machines Corp., 481 F. Supp. at 995-96. The approach in this note, however, uses an accounting ATC figure. Economic ATC includes normal profits, or the returns necessary to attract the requisite capital to the business. This opportunity cost is not identified in business records, therefore the only readily available ATC figure found in business records is an accounting figure.

³²³ See text and notes at notes 152-68, *supra*.

³²⁴ Problems exist in allocating indirect fixed costs, such as management expenses or facilities overhead not directly traceable to any one product. Any accounting method must, somewhat arbitrarily, allocate these expenses in ascertaining the full cost of production. Although the costs must be consistently allocated to the products, the potential for manipulation, through allocating more of these indirect costs to one product and less to another, does exist. See ANTHONY, *supra* note 152, at 504-16. In single-product firms, the ATC is, of course, not subject to these allocation problems since all costs are traceable to the product. For multi-product firms, however, these allocation problems are present. See Joskow, *supra* note 1, at 252 n.79. Joskow and Klevorick followed Baumol in defining ATC for the multi-product firm as "average incremental cost" of the relevant product. *Id.* Baumol defines the "average incremental cost" of the product as the firm's total cost for all products minus what the firm's total cost would be without the product, divided by the number of units of the relevant product produced. Baumol, *supra* note 17, at 9 n.26. The author of this note does not, however, propose that the court enter into the complex calculations necessary to attain such a figure. Any resulting figure would also be of necessity imprecise and only speculative unless the firm actually did stop producing the product. Instead, the defendant's figure for ATC, easily obtainable, will be used. See note 326 *infra*.

³²⁵ See *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. at 998-1001.

arbitrary determinations of fixed or variable cost would not effect any figure for total costs. Therefore, the opportunity for manipulation is greatly reduced. As a result, accepting the defendant's accounting ATC figure, so long as its accounting practices have been consistently applied, is a relatively safe way of ascertaining the cost of production.³²⁶ Accounting ATC, unlike economic ATC, does not include a return on investment or profits necessary to attract equity capital.³²⁷ Thus, since accounting ATC is always higher than any measure of AVC, a standard using accounting ATC as a cutoff is harsher on price cutters than one using AVC, while at the same time, allowing lower prices and, therefore, being more lenient on price cutters than a standard using economic ATC.³²⁸

A price below ATC brings the second step of the proposal into play. Pricing below ATC would require a response from the defendant, and the burden of production shifts to the defendant to justify its pricing conduct.³²⁹ Under step two the court examines the managerial practices underlying the defendant's pricing conduct. The defendant could rebut the presumption of predation established in step one by demonstrating a legitimate business reason for such conduct. There are four reasons, any one of which, if established, would justify setting price below the firm's current ATC. The first justification is liquidation of excess inventory, obsolete merchandise, or an entire product line.³³⁰ These actions, if not taken repeatedly, would be legal.³³¹ The second justification is severe excess capacity in the industry.³³² The third justification is matching a competitor's price that was below the defendant's ATC.³³³ The fourth justifica-

³²⁶ This inclusion is justified because accounting practices are usually consistent throughout the life of a product, suggesting no intention on the part of the firm to protect any given product at any specific time and thereby avoid potential antitrust actions for predatory pricing. Consequently the burden rests on the defendant to show that the allocation method has been applied consistently. Absent such proof of consistency, or where a change has been made in allocation methods shortly before the price reduction resulting in a price above the average total cost using the new method and below average total cost using the old method, the court should proceed to step two to further scrutinize the defendant's pricing conduct. Generally speaking, it would be highly unlikely that a multi-product firm would change their allocation methods with antitrust avoidance in mind. First, it would be difficult for a firm to precisely determine the products to be protected with an artificially low accountant's cost. Second, it would be undesirable to burden the firm's remaining products with as artificially high price, above the actual cost of production. See note 324 *supra*.

³²⁷ See text and note at note 41 *supra*.

³²⁸ Where only accounting data exists, it is impractical to attempt to add to ATC a figure representing the normal return on investment necessary to attract capital, as any such computation is both complex and uncertain. See Joskow, *supra* note 1, at 252 n.80.

³²⁹ See *id.* at 261.

³³⁰ See Williamson, *supra* note 17, at 317-18; *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. at 996.

³³¹ See text and note at note 335 *infra*.

³³² See Joskow, *supra* note 1, at 253; *Transamerica Computer Co. v. International Business Machines Corp.*, 481 F. Supp. at 996.

³³³ This justification would only allow a firm, A, to match, not beat, competitor B's price which was below A's average total price. Once B moved its price up, A would have to follow, it could not remain at the lower (sub-ATC) price when B raised its price. Though this may well be detrimental to a third competitor, C, who could not match the low price, this situation is competition on the merits. The prohibition of such conduct would be detrimental both to competi-

tion is a planned increase in the defendant's production capacity that, when complete, will lower ATC. For this final justification to be legal, the below-ATC price must be (1) set in an effort to increase volume to meet new production capacity, and (2) reasonably expected to cover ATC when the new production capacity is added.

Liquidation, the first justification, is a legitimate, non-predatory reason for lowering prices below ATC. Predatory pricing requires short-run reduction of price to drive competition out of the product market in an effort to gain profits in the market via higher long-run prices.³³⁴ Managerial practices indicating liquidation of obsolete merchandise or of an entire product line are by definition non-predatory. In these situations the firm is either ridding itself of an obsolete product, or model, or removing itself entirely from production of the item. In either event, the firm is not absorbing short-run losses in the hope of larger market share and profits in the long run because it will not even be producing these products in the long run. Rather, it is selling obsolete or discontinued merchandise at a price designed to quickly and permanently liquidate all remaining inventory of the product. Short-run losses indeed may be sustained, but the long-run benefit consists solely of minimizing inventory or product write-off expenses, not of making profits from the product. Similarly, price cutting to liquidate excess inventory is legitimate and non-predatory, so long as this conduct is not a sham utilized on a regular basis to drive competitors out of the market.³³⁵

Severe excess capacity in the price-cutting firm due to declining demand or overexpansion of the industry, the second justification, is another legitimate, non-predatory reason for lowering price below ATC. A firm in a declining industry may incur excess capacity because of a decrease in demand for the product. This lowered demand can be satisfied by much less industry capacity, thereby forcing many existing firms out of the industry. Managerial practices indicating a desire to remain a producer in a declining industry is a legitimate reason for the pricing conduct. Where it is inevitable that some firms will be forced out of the industry, the conduct of cutting prices may be the only alternative open to a firm desiring to remain. Although competitors will be ruined, the motivation behind the conduct is self-preservation, not predation.³³⁶

tion and consumers. Of course, in the example above, if B moved its price below its average total cost without justification, B would be liable to suit by either A or C.

³³⁴ See text at note 2 *supra*.

³³⁵ There is no set time period to define "regularly" in this context. It is, however, suggested that if such liquidation of inventory through sub-ATC prices took place within 24 months after a previous liquidation it should be considered illegal, based on anti-competitive motives. Where a liquidation took place 48 months or more after any previous liquidation, it should, perhaps, be considered legal absent a showing of anti-competitive intent. Other situations would warrant a case-by-case examination where the intervening time fell within these two bounds. Another instance of illegal conduct, regardless of the intervening time, would be the situation where excess inventory is the result of planned over-production with the goal of building inventory to justify a sub-ATC liquidation aimed at destroying rivals.

³³⁶ To claim this justification, the defendant would initially have to show two objective facts before introducing subjective evidence that the pricing conduct was motivated by the desire to remain in the industry. The defendant would first have to show that the industry was declining and, second, that defendant itself had excess capacity in a main product line. Showing the first of

A similar situation of excess capacity causing legitimate price cuts may exist when a new entrant has entered the industry at a very large scale of production.³³⁷

Competitors pricing below defendant's ATC, the third justification, is also a legitimate, non-predatory reason for reducing price below this point. Managerial practices indicating that the desire to match a rival's price was the reason for the pricing conduct are legitimate and show competition on the merits. Pricing at this level may not be a viable long-run business strategy, but there should be no legal restriction on this conduct, so long as it only matches a rival's price.³³⁸ Regardless of the legality of the rival's price, this should be deemed legal and non-predatory as it enhances competition. Furthermore, if the rival's price is unjustifiably below its ATC the rival should be open to suit by matching firm and liable for any losses sustained on the resulting below ATC sales.³³⁹

Planned increase in production capacity lowering ATC, the fourth justi-

these facts, a declining industry, could be difficult if reliance was placed on trade journals or testimony of competitors. Both of these sources, to some extent, may be unreliable. Trade journals are only as accurate as the information provided to them and in any event may be slow in acknowledging that an industry was declining. Competitors may be unwilling to classify the industry as declining in this situation as such testimony would allow defendant to price below ATC, and it is likely, if this is a declining industry, that the competitors too are out to survive so their testimony may in fact be more self-serving than accurate. For these reasons, the author suggests that the court rely on Commerce Department figures for the industry and require a showing of declining sales for three consecutive years prior to the price cut as an objective showing of a declining industry. This may be attacked as arbitrary, but it is a neutral source providing a practical and objective basis for classification which would not require a complex in-court industry study.

Next, the defendant would have to show that it was affected by this decline by showing it had excess capacity. If it was operating without severe excess capacity prior to the price cut, there was no legitimate reason to cut prices to remain a viable producer as sufficient demand was existent at higher prices. Such a showing would require defendant to introduce sales and capacity figures for the three years preceding the price cut corresponding to the Commerce Department figures above. In these years, to rely on this justification, defendant cannot have substantially increased capacity thereby producing the excess. The excess must result from decreased demand — a factor not subject to the defendant's control — so sales must have declined. Additionally, the product must be a main product line of the defendant. If it did not account for a significant portion of defendant's sales dollars, perhaps 15%, the firm is not likely to be dependent on it and therefore has no legitimate business reason to incur losses on it as a necessity for survival. The potential for illegal subsidization of the product increases as the amount of overall sales represented by the product decreases, since the product is not relied on as a major source of defendant's business revenues.

³³⁷ In this situation the defendant would have to show that a new entrant to the industry within the three years prior to the price cut had sales equal to one of the largest firms in the industry prior to its entry. Then the defendant would have to show that *following* this entry the defendant experienced excess capacity. This showing would be the same as that required as the second objective fact in note 336 *supra*.

³³⁸ See note 333 *supra*.

³³⁹ It would not be acceptable to allow a firm to match only a rival's legal price. First, without a trial there would be no feasible way to ascertain if the rival's price was legally justified. Second, by the time the rival was tried and found guilty, or an injunction was granted, the original firm may be forced out of the market or even out of business. Damages at this point may come too late to be of any real value in retaining lost market share.

fication, is the final legitimate, non-predatory reason for reducing price below ATC. In order to rebut the presumption of predation using the fourth justification, the defendant must show managerial practices based on several factors. First, the defendant must introduce evidence of long-range plans indicating the intention of increasing production capacity. Second, evidence of action taken on these plans must be introduced.³⁴⁰ Third, after the passage of a period of time which would allow a firm to complete the contemplated increase in capacity,³⁴¹ production per period³⁴² must be higher, ATC must be lower, and price must cover ATC.³⁴³

This justification utilizes a long-run perspective and can be understood more readily by employing the concept of an experience curve.³⁴⁴ An experience curve demonstrates how an experienced producer can operate at costs lower than a new entrant, and why a large producer enjoys economies of scale relative

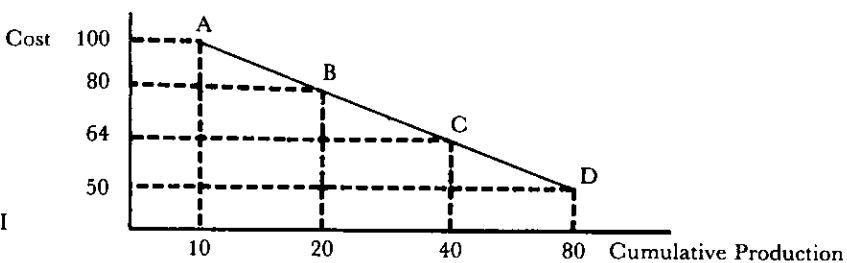
³⁴⁰ The plans must have been acted upon. Action would include out of pocket expenses normally expected to be required to implement the plans. In other words, the plans cannot be merely stated, or be in the official records without any action having been undertaken to complete them, if this justification is to be used.

³⁴¹ This time is the amount of time it would take a firm committed to carrying out such a plan to have completed the capacity expansion and bring the new production on line. This will necessarily have to be established through expert testimony, which could be offered by both parties to attempt to establish a time period, or at least give the trier of fact evidence on which it can determine a reasonable time, given the expansion planned and any other relevant factors.

³⁴² Sales per period indicates sales figures for a relevant period of time, e.g., a week, month, or year.

³⁴³ If a defendant shows action taken on the plans, but not dropping costs due to problems in bringing the new capacity on line, the court should allow time to correct the problem. If after the continuance, no further problems exist, but average total cost is still above price, the product is being subsidized by the firm and predatory conduct should be presumed.

³⁴⁴ The experience curve was a name applied to overall cost behavior by the Boston Consulting Group (BCG) in the late 1960's. It can best be understood if thought of graphically. Costs in dollars are plotted on the y-axis against cumulative production in units on the x-axis. This can be illustrated (using logarithmic coordinates) as follows:



The cost is measured in constant dollars over time, deflated to take inflation into account. The costs reflected are cash-flow figures obtained from cash-flow records prepared by a firm for use in business planning. This avoids decisions such as variable- or fixed-cost classifications and deferred-recognition-of-cash-expenditures problems, both inherent to accounting figures. Through the benefits of learning, specialization, investment, and scale of production, costs are shown to decline between 20 and 30 percent with every doubling of cumulative production. See Chart II *supra*. The experience curve, however, contradicts many basic assumptions of classical economics. For one thing, there is no minimal point or bottoming-out level for costs. Of course, as production

to a small producer.³⁴⁵ It takes into account what is known as the experience effect. This shows that cost decreases by a fixed percentage with each doubling of production.³⁴⁶ This effect is widely acknowledged in production economics and has been demonstrated in many industries.³⁴⁷ Cost is compared to cumulative production, with a representation of ATC that declines with increased production.³⁴⁸

Under the fourth justification, if no intention to increase production capacity in the form of long-range plans is shown, or if plans are shown but no action has been taken on them, then there is no valid reason for pricing at this level, and predation would be assumed. The time of the original price reduction could be labeled T_1 . The reasonable period of time to advance down the experience curve far enough to lower ATC to the level of price would be established by expert testimony. Thus, T_1 plus this reasonable period would equal a new point in time that could be labeled T_2 .³⁴⁹ By time T_2 defendant must show the requisite increase in cumulative production that would have been anticipated at time T_1 in order to lower ATC so that price covers full cost.³⁵⁰ This increase in produc-

grows it will take increasingly long to achieve the benefits accruing from a doubling of production.

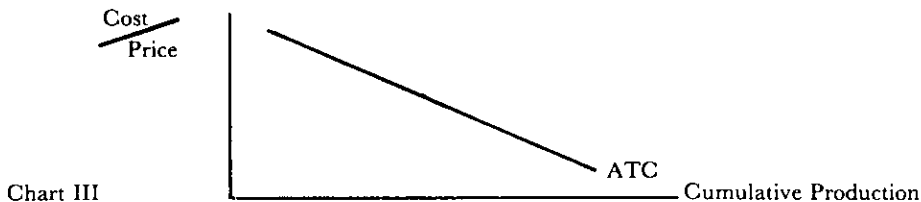
The curve also shows why all competitors cannot have similar cost functions. A firm can cut costs by working down its experience curve through increased capacity and volume sales. As this occurs, costs decrease so prices can be reduced while still covering current or reasonably foreseeable total costs. Competition is increased in an effort to proceed down the curve, by cutting the firm's costs while providing consumers with the benefit of lower price. If pricing conduct is a legitimate effort to proceed down the curve and to cover total costs that are shortly achievable through increased capacity and cumulative production, it should be allowed. See CONLEY, *EXPERIENCE CURVES AS A PLANNING TOOL* (1970); BOSTON CONSULTING GROUP, *PERSPECTIVES ON EXPERIENCE* (1972); BOSTON CONSULTING GROUP, *THE EXPERIENCE CURVE I-IV* (1973-74).

³⁴⁵ The experience curve is related to the learning curve effect. BOSTON CONSULTING GROUP, *THE EXPERIENCE CURVE II — HISTORY* (1973-74). The learning effect is an established principle that shows the direct labor hours and, therefore, costs, required to perform a task decrease by approximately 15 percent for each doubling of performance. See ANTHONY, *supra* note 152, at 642-44.

³⁴⁶ This is so when measured in constant, inflation-adjusted dollars.

³⁴⁷ E.g., high technology (Texas Instruments), steam turbine generators (Westinghouse, GE, Allis-Chalmers), integrated circuits (total industry), and polyvinylchloride (industry data), among others. BOSTON CONSULTING GROUP, *THE EXPERIENCE CURVE I-V* (1973-74).

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³⁴⁹ For example, if T_1 was January 1981 and the reasonable period is found by the trier of fact, based on expert testimony, to be 18 months, T_2 would be July 1982.

³⁵⁰ By reviewing past predatory pricing cases, any reasonable period less than 3 or 4 years should present no problem for the courts, as it takes that long to get to trial so the relevant figures should be part of historical data.

tion and resulting progression down the experience curve would be shown either by increased sales or inventory buildup.³⁵¹

If the fourth justification is relied on, the defendant must show that it progressed down, or is progressing down, its experience curve. If this is shown, the price reduction will be deemed to cover reasonably foreseeable ATC. In this situation, absent other evidence or direct proof of predatory intent, the pricing conduct would be deemed non-predatory and, thus, legal.

Managerial practices that could not be shown to justify the below ATC price level based on any of these four legitimate non-predatory reasons would indicate predation. Additionally, where the defendant establishes one of these justifications to rebut the presumption of predation, the plaintiff may, of course, introduce evidence to overcome the rebuttal. This would include introduction of any direct evidence of predatory intent.³⁵² If the defendant's presentation of managerial practices cannot establish one of the four justifications for its pricing conduct, or if the trier of fact determines that the plaintiff successfully overcame the defendant's efforts to show a legitimate business reason, the defendant would be found in violation of the antitrust statutes prohibiting predatory pricing. Defendant would then be liable for any damages to competitors resulting from its illegal pricing conduct.

C. *Rationale Behind Proposal*

The establishment of a cost-based cutoff in step one is justified by administrative convenience. Step one allows a "free-zone" above ATC where pricing conduct will not be analyzed. The first reason for this "free-zone" is the difficulty in attempting to separate predatory price reductions from legitimate, competitive price reductions where the post-reduction price still yields an accounting profit.³⁵³ This separation would for all practical purposes be impossible, and considering the existence of profits at this level coupled with the detriment to consumers by forcing these prices and profits even higher, would be a very dubious goal to seek. A second, and perhaps equally compelling reason for the cutoff, is to set an objective guideline that businesses can apply confidently in their pricing decisions. This objectivity is lacking under a traditional intent-based standard. Finally, at a price equal to or above ATC the production process is not being subsidized, instead its costs are fully covered, so the likelihood that the price is set for reasons other than that of making a current profit is minimal.

³⁵¹ This inventory buildup may not be legally liquidated at any price below the new ATC.

³⁵² Direct evidence of predatory intent behind the price reduction may be introduced. It is unlikely, however, that such clear "tracks" frequently will be available to overcome these justifications. See Joskow, *supra* note 1, at 259; Sullivan, *supra* note 137 at 1230-31.

³⁵³ Similar to other proposals, this cost-based approach finds the free-zone argument persuasive although the actual cutoff point employed is different. This difference stems from this proposal's use of accounting cost rather than economic cost (which includes "normal profit" or opportunity cost) in determining the cutoff point. See Areeda, *supra* note 4, at 704-09; Transamerica Computer Co. v. International Business Machines Corp., 481 F. Supp. at 989-91. The average total cost is the breakeven point, where out-of-pocket expenses for the necessary inputs, fixed and variable, equal gross revenues generated by the product. The argument in favor of a specific point for a cutoff is the same as the argument against a solely intent-based approach; businesses must be able to assess the legality of their plans against an objective standard.

Step two allows the analysis of the defendant's managerial practices, the intentions behind the pricing conduct. This provides for more flexibility than a solely cost-based approach. Therefore, other policy considerations of the Sherman Act and any business justifications that may exist for a manager to sell products below their full cost of production may be considered. The shifted burden of production at this step should facilitate the presentation of intrafirm perceptions of the reason for the price reduction,³⁵⁴ such as long-range plans, memoranda, and pricing strategy goals. A manager will not price below ATC without some strategic reason. An examination of managerial practices will not only take into account economic or accounting principles suggesting a price level. Instead, managerial practices leading to a price reduction are business judgments based on several factors: production economics, management accounting,³⁵⁵ as well as the firm's long-range goal or strategy.³⁵⁶ It is this combination of factors that an examination of managerial practices will consider. Step two would be flexible enough to allow the trier of fact to ascertain whether the firm's reasons for the price cut are legitimate, legal business justifications or predatory.

If the below-ATC prices are to be found legal, the defendant's presentation of managerial practices must demonstrate that any subsidization is justified by legitimate, legal business goals. If this cannot be shown, the defendant's conduct setting prices at a level not covering the full costs of production will be deemed predatory. The strategies of (1) liquidating excess or obsolete inventory, (2) attempting to become one of the producers who remain in a declining industry, (3) matching a rival's price, or (4) building volume to sustain increased production and lower ATC are all legitimate and legal goals. The antitrust laws are aimed to protect competition, not competitors. Therefore, it is immaterial that adherence to any of these strategies may be detrimental to a competitor, so long as it is not injurious to competition. If there is a legitimate, non-predatory justification for the defendant's conduct it should be legal. But any subsidization not justified by these legitimate business goals results in competition on the basis of financial reserves alone, and should not be legal.

In summary, this proposal meets the four criteria of a valid legal approach to predatory pricing. First, this test looks beyond economics to other values inherent in the Sherman Act. When price does not cover the full cost of production, the reasons and intentions behind pricing conduct are examined. Competition based on the size of a firm's financial reserves available to subsidize sales and drive a less wealthy producer out of business is not legalized. Similarly, the inherent cost advantage of established or larger firms is not allowed to be accentuated, and protection of competition from new or small firms, therefore, is increased. Second, this test utilizes actual business realities, not theoretical models. Accounting costs that are readily available are used in the test. Rather

³⁵⁴ Sullivan, *supra* note 137, at 1232.

³⁵⁵ See ANTHONY, *supra* note 152, at 457-77.

³⁵⁶ Both welfare and intent factors are included in the purview of managerial practices. The intent of the firm in deciding to cut prices is definitely relevant. Managerial practices result in action undertaken to further or achieve the firm's long-run goals. When the situation is assessed in these terms, the court can evaluate the welfare (long-run) implications of the pricing strategy than it could if only short-term consequences are focused upon.

than comparing reality to a non-existent industry that is perfectly competitive, actual pricing strategy and the practical business reasons behind it are examined. Third, in requiring price to cover full cost, except in several short run situations facing the firm, the test recognizes both efficiency and competition as long-run concepts. While pricing below ATC in the short run is recognized as legitimate in several situations, this test takes into account that a firm must cover full costs to remain in the industry in the long run. Additionally, the experience curve allows variations for cost decreases achieved over time. Finally, the test is capable of easy and correct application in a courtroom. Accounting ATC, sales, inventory, and cumulative production figures are readily available. If used, the experience curve must be introduced by the defendant.³⁵⁷ Further, the examination of managerial practices and any evidence of predatory intent takes the form of a traditional legal rule focusing on human conduct and the reasons behind the action. Such a test recognizes the values inherent in the antitrust laws and allows judges and juries to address the issue of predatory pricing with a familiar type of legal analysis that examines a firm's conduct in the context of practical business realities.

CONCLUSION

The controversial Areeda and Turner AVC rule is not an acceptable approach to predatory pricing. While it served the purpose of focusing attention on a more rational view of the offense, it excluded or misinterpreted important factors to be considered when determining predation. Academic critics have continually attacked the AVC rule. More recently, the courts too have begun to question the AVC rule and have indicated a desire to refine it, reject it, or make it only one of several factors considered relevant. In this academic and judicial retreat from the AVC rule, necessary attributes of future approaches have become evident. Predatory pricing is not solely an economic or cost-based phenomenon. It cannot be viewed only in economic terms, isolated from the managerial practices underlying the price reduction. These managerial practices must be examined, and if they do not indicate a strategy conforming to legally justifiable goals, the firm should be found guilty of predation.

CHARLES PURINTON SHIMER

³⁵⁷ Progression down the experience curve can be verified by looking at the firm's costs. If the defendant claims the slope of the curve is steep, in order to show the legality of the price reduction, the firm will bear the burden of showing much lower average total costs in a short period.

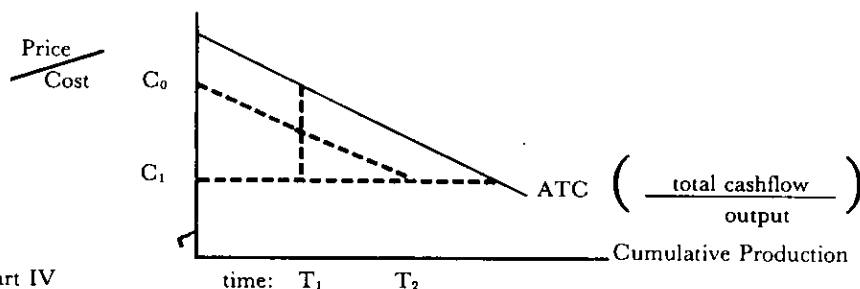


Chart IV