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***A Geographic Market Power Test for Sherman Act Jurisdiction***

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# *A Geographic Market Power Test for Sherman Act Jurisdiction*

**D. Bruce Johnsen & Moin A. Yahya**

*Abstract*

This paper develops a clear and substantively reasoned test for Sherman Act jurisdiction based on the interstate exercise of market power. According to this test, to establish jurisdiction under the Act the plaintiff must allege that, if successful, the defendants' conduct is reasonably likely to raise prices "in more states than one." Local trade restraints that cannot plausibly be alleged to raise prices outside the home state therefore lie beyond the reach of the Sherman Act. The geographic market power test resolves a number of troubling anomalies in the case law on Sherman Act jurisdiction. It also takes seriously the Act's acknowledged goal of promoting consumer welfare and preserves the states' role as laboratories for political competition in our federal system of dual sovereignty.

# *A Geographic Market Power Test for Sherman Act Jurisdiction*

**D. Bruce Johnsen & Moin A. Yahya**

*"Determining the 'market' for a product or service, meaning the scope of other products or services against which it must compete, is of course necessary for many purposes of antitrust analysis."*[1]

## INTRODUCTION

This paper addresses the proper jurisdictional scope of the Sherman Antitrust Act (1890). The language of the Sherman Act explicitly prohibits restraints of trade or commerce "*among the several states*."[2] Yet during the past 30 years the U.S. Supreme Court has routinely upheld applications of the Sherman Act to restraints that are strictly intrastate by any economically sensible standard. Most recently, in *Summit Health, Ltd. v. Pinhas* (1991)[3] a narrow majority of the Court reaffirmed a jurisdictional test — the so-called "infected activities" test — that extends the Sherman Act's reach to even the most local restraints. This is a troubling development. It is clearly contrary to Congress's original intent in passing the Act, it fails to take seriously the Act's acknowledged goal of promoting consumer welfare, and it undermines the important role of the states as laboratories for political competition in our federal system of dual sovereignty.

Joined by three others, Justice Scalia wrote a forceful dissent challenging the majority's holding in *Summit*. Among other things, he argued that the infected activities test is needlessly vague and expansive and that it fails to resolve the threshold economic issues of market definition and market power that should be necessary to establish statutory jurisdiction. In his words, the question "is not whether Congress *could* reach the activity before us here if it wanted to, but whether it *has done so* via the Sherman Act. That enactment does not prohibit all conspiracies . . . that have sufficient constitutional 'nexus' to interstate commerce to be

[1] Summit Health, Ltd. v. Pinhas, 500 U.S. 322, 336 (1991) (Justice Scalia dissenting).
[2] Section 1 of the Sherman Act, 26 Stat. 209 (1890), reads as follows: "Every contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade or commerce among the several states, or with foreign nations is hereby declared to be illegal . . ." Section 2 of the Act reads as follows: "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. . ."

regulated. It prohibits only those conspiracies that are 'in restraint of trade or commerce among the several States'."[4]

This paper relies on practical antitrust economics to develop a clear and substantively reasoned test for Sherman Act jurisdiction that correctly considers the statutory issues of market definition and market power. We call this the "geographic market power" test. It roughly tracks established antitrust practice under the *1992 Horizontal Merger Guidelines*.[5] According to this test, to establish Sherman Act jurisdiction a plaintiff must plead with particularity that, if successful, the defendants' conduct is reasonably likely to raise prices "in more states than one."[6] This requires the plaintiff to identify the defendants' product and geographic antitrust markets. It also requires the plaintiff to allege that the defendants' share of the geographic antitrust market is sufficiently large that their restraint would be reasonably likely to achieve an effective exercise of market power that would substantially raise prices in multiple states. In the spirit of Justice Scalia's *Summit* dissent, local trade restraints that cannot plausibly be alleged to raise prices outside the home state lie beyond the reach of the Sherman Act.

Product and geographic antitrust market definitions, market shares, and interstate price effects are seldom capable of exact evidentiary proof. Yet, in a large number of cases currently entertained under *Summit* the likelihood of interstate price effects is so small that they can be presumed as a matter of law to be purely intrastate and the plaintiff screened out of federal court at the jurisdictional stage. The geographic market power test imposes an economically justified tradeoff on plaintiffs when pleading the facts necessary to establish Sherman Act jurisdiction. The wider the product and geographic antitrust market alleged, the more likley an effective exercise of market power in that market would result in interstate price effects. The wider the market, however, the smaller the defendants' market share and the less likely their alleged restraint would achieve an effective exercise of market power. Equally important, our test requires the plaintiff to make specific allegations regarding market definition and market shares that the defendant can attempt to rebut at the jurisdictional stage. Foreseeing dismissal on the pleadings, plaintiffs who are victims of purely local restraints will be forced to seek redress under state law.

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[3] 500 U.S. 322 (1991).
[4] 500 U.S. 322, 334 (1991).
[5] *1991 Horizontal Merger Guidelines* issued by the United States Justice Department Antitrust Division and the Federal Trade Commission, 57 Fed. Reg. 41552, § 1.1 (Sep. 10,1992) [hereinafter *Merger Guidelines*].

Our geographic market power test resolves a number of anomalies in the antitrust case law, most importantly that *Summit* places virtually no limit on Sherman Act jurisdiction in spite of the Act's clear statement that it applies only to restraints of trade *among the several states*. In *Hamms v. AAMCO* (1994),[7] for example, Judge Posner of the Seventh Circuit Court of Appeals noted in reviewing a post-*Summit* challenge to Sherman Act jurisdiction that if two children operating competing lemonade stands agreed to fix prices there is no clear principle preventing them from being subject to the jurisdiction of the Act, even though "the effect on the national economy would be slight."[8] This is an absurd state of affairs. There must be some reasoned basis for bounding federal jurisdiction if the Act's prohibition of trade restraints "among the several states" is to have any discernable meaning in light of its acknowledged goal of promoting consumer welfare. The geographic market power test bounds Sherman Act jurisdiction in a substantively reasoned way.

A second anomaly arising under *Summit* is that leaving Sherman Act jurisdiction unbounded undermines the states' important role as laboratories for political competition in our federal system of dual sovereignty. Political competition is best understood in the framework of competitive federalism, which has experienced growing appreciation among scholars and jurists as a basis for federal regulation.[9] According to this framework, state regulation is justified when

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[6] *Gibbons v. Ogden* 22 U.S. 1, 241-42 (1824).
[7] 33 F.3d 774 (1994).
[8] 33 F.3d 774, 780-81 (1994) [Posner cites Areeda & Hovenkamp. Check to see what they say].
[9] Charles M. Tiebout, *A Pure theory of Local Expenditures*, 60 J. POL. ECON. 416 (1956); James M. Buchanan & Charles J. Goetz, *Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model*, 1 J. PUB. ECON. 25 (1972); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); William A. Fischel, *Fiscal and Environmental Considerations in the Location of Firms in Suburban Communities, in Fiscal Zoning and Land Use Controls* (Edwin S. Mills & Wallace E. Oates eds., 1975); Ralph K. Winter, *State Law, Shareholder Protections, and the Theory of the Corporation*, 6 J. LEG. STUD. 251 (1977); Carol M. Rose, *Planning and Dealing: Piecemeal Land Controls as a Problem of Local Legitimacy*, 71 CAL. L. REV. 837 (1983); Frank Easterbrook, *Antitrust and the Economics of Federalism*, 26 J. OF LAW AND ECON. 23 (1983); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON & ORG. 225 (1985); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); Wallace E. Oates & Robert M. Schwab, *Economic Competition Among Jurisdictions: Efficiency Enhancing or Distorition Inducing?*, 35 J. PUB. ECON. 333 (1988); Thomas R. Dye, AMERICAN FEDERALISM: COMPEITITION AMONG GOVERNMENTS (1990); Daphne A. Kenyon & John Kincaid, COMPETITION AMONG STATES ANDLOCAL GOVERNMENTS: EFFICIENCY AND EQUITY IN AMERICAN FEDERALISM (1991); Richard L. Revez*, Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U.L. REV. 1210 (1992); Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Fedrelism and Economic Development*, 11 J.L. ECON. & ORG. 1 (1995); Roberta Romano, *State Competition for Corporate Charters*, in THE NEW FEDERALISM: CAN STATES BE TRUSTED? (John Ferejohn & Barry R. Weingast eds. 1997), at 129. *See* Gregory v. Ashcroft, 501 U.S. 452 (1991); New York v. United States, 505 U.S. 144 (1992); U.S. v. Lopez, 514 U.S. 549 (1995); U.S. v. Morrison, 529 U.S. 598 (2000); Solid Waste Agency of N. Cook County v. U.S. Army Corps of Eng'rs, 531 U.S. 159 (2001).

competition between private parties in the state's internal economic markets fails to allocate resources efficiently owing to an economic spillover that would require one party to bear the costs of some economic activity while allowing other parties to enjoy the benefits. But states will fail adequately to regulate their internal economic markets if regulatory spillovers require citizens of the regulating state to bear the costs of regulation while allowing the citizens of other states to enjoy the benefits.[10] In the face of interstate spillovers, individual states will misallocate political resources by engaging in too little regulation of their internal economic markets. As with state regulation of internal economic markets, federal regulation of economic markets is justified when competition between states leads to this kind of political market failure.

The market failure at issue under the Sherman Act is the exercise of market power, manifested in reduced output and increased prices that can spill over to neighboring states. If the price effects resulting from market power are strictly local and confined to a single state, that state's regulators have adequate incentive to address the problem, and according to competitive federalism there is no justification for federal regulation. Only when the price effects of market power are felt outside the state is federal intervention under the Sherman Act justified. The economic circumstances facing the citizens of the several states vary tremendously and can surely benefit from regulatory policies tailored specifically to those circumstances. Political competition in the general field of antitrust policy is no less important than in other areas of regulation. The geographic market power test for Sherman Act jurisdiction thus identifies a substantively reasoned balance between state and federal antitrust enforcement within the framework of competitive federalism. This framework recognizes the importance of both economic and political competition as drivers of efficient resource allocation.

The remainder of this paper builds the normative case in favor of the geographic market power test. Section I reviews the relevant case law. It begins with a brief look at a selection the case law on general Commerce Clause jurisdiction and then turns specifically to the case law on Sherman Act jurisdiction. Section II describes the simple economics of market power and illustrates the practical approach antitrust regulators have developed under the *Merger Guidelines* to define the relevant product and geographic markets and assess the likely effect of horizontal mergers on market power. Section III describes the geographic market power test in

[10] Alternatively, the spillover might impose the costs of regulation on other states while allowing citizens of the regulating states to enjoy all or most of the benefits.

operation. It adapts the *Merger Guidelines'* approach to assess the likely geographic scope of the price effects resulting from trade restraints that engender market power. It then outlines the particular facts plaintiffs must allege to establish Sherman Act jurisdiction. Section IV provides a normative justification for the geographic market power test based on the framework of competitive federalism. We argue the test is broadly consistent with general Commerce Clause case law, with the statutory intent behind the Sherman Act, and with the only economically plausible interpretation of the Act itself. What is more, it promises to resolve the current turmoil over Sherman Act jurisdiction in the federal circuits and to hasten the rate at which the judiciary's understanding of novel business arrangements advances. Section V provides a few concluding remarks. Several recent decisions limiting general federal commerce power suggest the Court is inclined to embrace the framework of competitive federalism, and that it may be sympathetic to the geographic market power test for Sherman Act jurisdiction.

## I. THE CASE LAW

*". . . admittedly, our case law [on substantial effects] has not been clear."*[11]

### A. A Brief History of Federal Commerce Clause Jurisdiction[12]

The starting point for any review of the case law on Commerce Clause[13] jurisdiction is Chief Justice Marshal's famous opinion in *Gibbons v. Ogden* (1824).[14] In prescribing the limits of federal authority over interstate commerce, Marshal's observed that "[c]ommerce among the States, cannot stop at the external boundary line of each State, but may be introduced into the

[11] Rehnquist in Lopez, at 559.
[12] For interesting recent discussions of the proper limits of the federal commerce power see Nelson Lund, *Federalism in the 21st Century: Historical Perspective: Federalism and Civil Liberties*, 45 KAN. L. REV. 1045 (1997); Ronald D. Rotunda, *The New States' Rights, The New Federalism, the New Commerce Clause, and the Proposed New Abdication*, 25 OKLAHOMA CITY UNIVERSITY LAW REVIEW 869 (2000); Maxwell L. Stearns, *A Rational Choice Analysis of the Dormant Commerce Clause* (unpublished working paper, George Mason University School of Law).
[13] Art. I, § 8, cl. 3, grants Congress the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."
[14] 22 U.S. 1 (1824).

interior." He went on to elaborate on the jurisdictional limits of federal commerce power in the following passage:

> Comprehensive as the word "among" is, it may very properly be restricted to that commerce which concerns more States than one. . . . The enumeration presupposes something not enumerated; and that something . . . must be the exclusively internal commerce of a State[, which does] not affect other States, and with which it is not necessary to interfere, for the purpose of executing some of the general powers of the government.[15]

In practice, Marshal's distinction between completely internal commerce and commerce that affects other states has proven difficult to apply with any kind of precision because he declined to provide a functional blueprint for identifying the nature of the commercial "effects" necessary to support federal jurisdiction. The Court eventually articulated a more specific blueprint in *Cooley v. Board of Wardens* (1851), where Justice Curtis reasoned that "the power to regulate commerce embraces a vast field, containing . . . exceedingly various subjects, quite unlike in their nature; some imperatively demanding a single uniform rule . . . and some, like the subject now in question, as imperatively demanding that diversity, which alone can meet [local] necessities."[16]

The ensuing case law, much of it addressing dormant commerce powers, led the Court to a narrower and more formalistic view of federal commerce jurisdiction, while at the same time developing the concept of exclusive "state police powers" under the Tenth Amendment.[17] The Court's increasing formalism gradually gave weight to the now discarded notion — characterized as "dual federalism" — that state and federal powers repose in separate geographic "spheres of sovereignty."[18] In *Wabash, St. Louis & Pacific Ry. Co. v. Illinois* (1886),[19] most notably, the Court found that a state statute prohibiting discrimination in railroad rates "for any distance within the State" would not have conflicted with the federal commerce power if its application had been confined to shipments occurring completely within the state. The Court

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[15] *Gibbons* at 194-95.
[16] 53 U.S. 299, 319 (1851).
[17] Edward S. Corwin, *The Passing of Dual Federalism*, 36 VA. L. REV. 1, 15 (1950).
[18] Andrew I. Gavil, *Recnstructing the Jurisdictional Foundation of Antitrust Federalism*, 61 Geo. Wash. L. Rev. 658 (1993), at n. 90. See Bruce Little, *Note: A Case of Judicial Backsliding: Artificial Restraints on the Commerce Power Reach of the Sherman Act*, 1985 U. ILL. L. REV. 163, around n. 20 (interstate commerce seen to involve the flow of goods across state lines).
[19] 118 U.S. 557 (1886).

struck down the statute in the case at hand, however, because it proscribed discrimination against shipments originating in Illinois but bound for other states.

Perhaps the Court's most formalistic statement of dual sovereignty came in *Kidd v. Pearson* (1888).[20] In upholding a state statute allowing the importation and sale of intoxicating liquors within the state but prohibiting their in-state manufacture, even for export, the Court stated that "[i]f it be held that [commerce] includes the regulation of all such manufactures as are intended to be the subject of commercial transactions in the future, it is impossible to deny that it would [include] every branch of human industry. . . . It would follow as an inevitable result that the duty would devolve on Congress to regulate all of these delicate, multiform, and vital interests — interests which in their nature are and must be, local in all the details of their successful management."[21] Such a scheme, the Court insisted, would be impracticable.

The Court eventually returned to a more functional approach to resolve the balance of dual sovereignty, dramatically expanding federal commerce jurisdiction in the face of FDR's prolific New Deal legislation. Much of the Commerce Clause case law at the time focused on whether the effect of the activity on interstate commerce was "direct" or "indirect."[22] In *Wickard v. Filburn* (1942),[23] the Court the direct-indirect effects distinction, pressing the outer limits of the functional approach. The Agricultural Adjustment Act (1938) imposed a national quota on the "marketing" of wheat, and the Secretary of Agriculture's marketing orders in turn allotted the national quota to individual farms, including Filburn's. When Filburn produced what the Court conceded was a "trivial" amount of wheat in excess of his allotment purely for use and consumption on the farm, the Secretary assessed him a marketing penalty.[24] Filburn claimed the marketing quotas were beyond the reach of federal commerce jurisdiction because they applied to strictly local "production and consumption" whose effects on interstate commerce, if any, were merely "indirect."[25] Justice Jackson flatly rejected Filburn's claim, finding that Congress can regulate even local production for farm use that is trivial by itself if, cumulatively across many local producers, "it exerts a substantial economic effect on interstate commerce" by

[20] 128 U.S. 1 (1888).
[21] 128 U.S. 1, 20-21 (1888).
[22] *See, e.g.*, U.S. v. E.C. Knight (1895); A.L.A. Schechter Poultry Corp. v. U.S., 295 U.S. 495 (1935); Carter v. Carter Coal Co., 298 U.S. 238 (1936); and NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937).
[23] 317 U.S. 111 (1942).
[24] It is worth noting that the Congress specifically anticipated the problem posed by the cumulative effects of nonmarket production by including wheat grown and used for home consumption in the Act's definition of the national marketing quota, 317 U.S. 111, 118-119 (1937).

displacing market transactions that would otherwise occur.[26] This has since come to be known as the "substantial effects" test for federal commerce jurisdiction.[27]

The ensuing 60 years of case law, including that concerned with Sherman Act jurisdiction, dramatically expanded the scope of federal commerce power while failing to identify any principled limitation on the substantial effects test.[28] In large part, the expansion derived from the compelling social objective in a series of civil rights cases most clearly evident in *Katzenbach v. McClung* (1964),[29] *Heart of Atlanta Motel, Inc. v. United States* (1964),[30] and *Daniel v. Paul* (1969).[31] In these cases the Court relied on both horizontal and vertical aggregation to show that the defendants' apparently local activities were in the stream of interstate commerce, while relying on a nebulous but-for approach to impute the necessary substantial effect. The Court's reasoning went something like this. Even if a particular instance of racial discrimination in a local restaurant's food sales does not, by itself, substantially affect interstate commerce, that restaurant's vertically-related inputs, say, its raw food supplies, arrived at the restaurant via the stream of commerce. Ergo, the food supplies of all restaurants engaged in racial discrimination, when aggregated horizontally, comprise a substantial portion of interstate commerce. If such restaurants were magically to vanish — that is, but-for their existence — the economic effect on the quantum or character of interstate commerce would surely be substantial in some way.[32]

B. A Brief History of Sherman Act Jurisdiction

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[25] 317 U.S. 111, 119 (1942).
[26] 317 U.S. 111, 125 (1942).
[27] Lopez, 514 U.S. 549, 584 (1995).
[28] According to some, the Court's expansion of federal powers threatened to shrink the scope of exclusive state police powers to the vanishing point. Even Justice Douglas, dissenting in *Maryland v. Wirtz* (1968), felt compelled to warn that according to the majority's approach "[a]ll activities affecting commerce, even in the minutest degree . . . may be regulated and controlled by Congress." Maryland v. Wirtz, 392 U.S. 183, 204 (1968) (Douglas, J., dissenting). Douglas was no stranger to the majority in rulings that expanded federal powers.
[29] 379 U.S. 294 (1964).
[30] 379 U.S. 241, 248 (1964).
[31] 395 U.S. 298 (1969).
[32] Congress's finding that the totality of racial discrimination in restaurants directly and adversely affects interstate commerce precluded as irrelevant any factual inquiry into the nexus between racial discrimination in a particular local restaurant and interstate commerce. Insert citation.

The Court first addressed the limits of Sherman Act jurisdiction in *U.S. v. E.C. Knight Co*. (1895),[33] where the U.S. attorney challenged a proposed a horizontal combination between five sugar manufacturers that would have allowed it to "control" roughly 98% of domestic sugar refining capacity. Relying heavily on *Kidd's* formalism, Chief Justice Fuller reasoned that "the power to control the manufacture of a given thing involves in a certain sense the control of its disposition . . . and although the exercise of that power may result in bringing the operation of commerce into play, it . . . affects it only incidentally and indirectly."[34] "[I]t does not follow," he concluded, "that an attempt to monopolize . . . manufacture [is] an attempt . . . to monopolize commerce, even though, in order to dispose of the product, the instrumentality of commerce [is] necessarily invoked." [35] Ten years later, in *Swift & Co. v. U.S.* (1905),[36] the Court summarily dismissed *E.C. Knight's* formalistic view of federal commerce power in favor of a more functional approach, concluding that "commerce among the States is not a technical legal conception, but a practical one, drawn from the course of business."[37] The Court lay to rest any doubt about the status of *E.C. Knight* in its landmark decision in *Standard Oil Co. of New Jersey v. U.S.* (1911), where it expressly rejected as "unsound" the formalistic distinction between commerce and manufacture.[38]

Thereafter, the case law on Sherman Act jurisdiction followed the expansive path of the case law on general Commerce Clause jurisdiction. By 1945, the Court had repeatedly affirmed that "Congress, in passing the Sherman Act, left no area of its constitutional power unoccupied."[39] Three years after its expansive decision in *Wickard v. Filburn*, the Court decided *Mandeville Island Farms v. American Crystal Sugar Co.* (1948),[40] specifically relying on *Wickard's* horizontal aggregation principle to establish Sherman Act jurisdiction over an agreement among local sugar beet refiners. The complaint alleged that the defendant, one of three refiners located in northern California, conspired with the other two to revise the standard form contract they used to buy beets from nearby growers. Prior to the revision, growers' receipts were based on a formula combining a percentage of the buyer's net returns from sugar

[33] 156 U.S. 1 (1895).
[34] 156 U.S. 1, 12 (1895).
[35] 156 U.S. 1, 17 (1895).
[36] 196 U.S. 375 (1905).
[37] 196 U.S. 375, 398 (1905).
[38] 221 U.S. 1, 69 (1911).
[39] United States v. Frankfort Distilleries, Inc., 324 U.S. 293, 298 (1945) (quoting Apex Hosiery Co. v. Leader, 310 U.S. 469, 495 (1940)).

sales and the measured sugar content of the grower's beets for the period covered by the contract.[41] The revised contracts specified, instead, that the grower's receipts were based on the average net return of all three refiners combined.

The plaintiffs, a group of growers that had agreed to the revised contract, later brought an action under the Sherman Act alleging the respondent's actions illegally fixed the price of sugar beets and thereby restrained interstate commerce in sugar.[42] Yet, the District Court judge inferred just the opposite from the face of the contracts contained in the complaint, according to which the price of sugar in interstate commerce determined the price of beets. To expedite an appeal on the question of federal jurisdiction, he allowed the plaintiffs to amend their complaint to eliminate the allegation that the defendant's restraint "affected the price of sugar in interstate commerce," in essence replacing it with the charge that the restraint of trade in beets, by itself, affected interstate commerce.[43]

Writing for the Supreme Court, Justice Rutledge found that the three refiners were the only practical market for the petitioners' beets owing to high transport costs and barriers to entry by competing refiners. As a result, the conspirators controlled the quantity of sugar manufactured and sold in interstate commerce from northern California.[44] In response to the defendant's claim that the three refiners were powerless to affect the national price of sugar, Rutledge found "[t]he idea that stabilization of prices paid for the only raw material consumed in an industry has no influence toward reducing competition in the distribution of the finished product, in an integrated industry such as this, is impossible to accept."[45] Drawing on *Wickard's* horizontal aggregation principle, he concluded that "Congress' power to keep the interstate market free of goods produced under conditions inimical to the general welfare . . . may be exercised in individual cases without showing any specific effect upon interstate commerce . . . .

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[40] 334 U.S. 219 (1948).
[41] The contracts also specified that the growers would buy all seed from the refiner, cultivate beets only on specifically designated land, and sell exclusively to the refiner, and that the refiner had a right to supervise the planting, cultivation, irrigation, and harvesting of the beets, including "the right to ascertain quality through growing and harvesting seasons by sampling and polarizing." [at 222-223]. The contracts therefore consisted of a multilateral sharing arrangement between each refiner and the growers with whom it had entered into contracts, with each grower's relative share being adjusted according to sugar content. The sugar content of the growers' beets, the price of refined sugar net of the refiner's selling costs, and the growers' production costs determined their profits. The refiners' production costs and the price of refined sugar net of selling costs determined their profits.
[42] 334 U.S. 219, 226 n. 6 (1948).
[43] 334 U.S. 219, 247 (1948).
[44] 334 U.S. 219, 240-41 (1948).
[45] 334 U.S. 219, 241 (1948).

[I]t is enough that the individual activity when multiplied into a general practice . . . contains a threat to the interstate economy that requires preventive regulation."[46]

In *U.S. v. Oregon State Medical Society* (1952)[47] the Court took a more limited approach to federal commerce power. There, the government brought a civil action to enjoin various medical associations and doctors that had formed together to provide affordable prepaid medical plans to subscribing patients entirely within the state of Oregon. Because the plans drew providing doctors from patients' local community, and because the doctors associated themselves exclusively with either the state or the county medical society's plan, the government claimed the arrangements amounted to territorial allocations in restraint of interstate commerce under Sections 1 and 2 of the Sherman Act. Justice Jackson rejected the government's claim, noting there was no evidence of an attempt by the defendants to withhold medical service and the only interstate commerce involved related to a few "sporadic" and "incidental" payments to "out-of-state doctors" for patients who happened to be temporarily away from their local service areas in Oregon. This was insufficient to show a restraint of trade in interstate commerce. Instead, he found that the government would have had to show that interstate commerce was adversely affected *specifically* by the "allocation of territories by doctor-sponsored plans, [but as] far as any evidence brought to our attention discloses, the activities of the latter are wholly intrastate."[48] In the antitrust setting, Justice Jackson apparently eschewed application of the horizontal aggregation principle he had announced in *Wickard*. This surely would have allowed him to find a substantial effect on interstate commerce if he had chosen to follow Justice Rutledge's reasoning in *Mandeville*.

By 1975, the vertical aggregation principle on which the Court relied in the civil rights cases began to creep into its decisions on Sherman Act jurisdiction. In *Goldfarb v. Virginia* (1975),[49] the Court considered a challenge to the Fairfax County Bar Association's (FCBA's) minimum fee schedule. When the plaintiffs were unable to find an attorney willing to perform an examination for their residential real closing for a reduced fee, they filed a class action suit claiming that the FCBA's minimum fee schedule violated Sections 1 and 2 of the Sherman Act. Writing for a unanimous Court, Chief Justice Burger reasoned that as a practical matter title

[46] 334 U.S. 219, 236 (1948).
[47] 343 U.S. 326 (1952).
[48] 343 U.S. 326, 338-39 (1952).
[49] 421 U.S. 773 (1975).

examinations are indispensable to the financing of real estate transactions because lenders require them as a condition for making a loan. Since a substantial volume of real estate loans originated outside the state, and "given the substantial volume of commerce involved and the inseparability of [title examinations] from the interstate aspects of real estate transactions," he concluded that "interstate commerce has been sufficiently affected,"[50] regardless of whether the fee schedule could be shown to reduce the number of title examinations or increase fees. Thus, according to Burger's assessment, but-for the availability of all title examinations aggregated horizontally the market for a vertically-related input in the stream of commerce — real estate financing — would surely suffer a substantial economic effect sufficient to support federal jurisdiction.[51]

In spite of the Court's back-door acceptance of horizontal aggregation in *Mandeville* and vertical aggregation in *Goldfarb*, most circuits continued to require Sherman Act plaintiff's to establish jurisdiction in either of two ways. The plaintiff could claim that the allegedly unlawful conduct itself took place "in commerce" or that the allegedly unlawful conduct had a "substantial effect" on interstate commerce even though it took place intrastate.[52] In *McLain v. Real Estate Bd. of New Orleans*, however, the Court found Sherman Act jurisdiction where the defendants' broader business activities, aggregated vertically, were in commerce even though the allegedly unlawful conduct was not.[53]

The plaintiff class of real estate buyers in *McLain* claimed that real estate brokers in the Greater New Orleans area had engaged in a massive conspiracy to fix commission rates, split fees, and suppress useful market information. The only connection between the conspiracy and interstate commerce shown by the plaintiffs was that brokers routinely, though gratuitously, advised buyers on how to obtain title insurance and financing, often from sources outside Louisiana. The District Court found that the defendants' brokerage activity occurred entirely in Louisiana and that the plaintiffs failed to allege, as required by *Goldfarb*, that the provision of insurance and financing constituted a large volume of interstate commerce inseparable from

[50] 421 U.S. 773, 785 (1975).
[51] Burger went on to note that "there may be legal services that have no nexus with interstate commerce and thus are beyond the reach of the Sherman Act," but he gave no indication how a party might make such a factual showing within the parameters set by the remainder of his opinion. 421 U.S. 773, 786 (1975). The Court reached much the same result a year later in *Hospital Bldg. Co. v. Rex Hospital Trustees*, where it looked to the plaintiff's vertically-related activities to find sufficient its allegations of a substantial effect on interstate commerce from the defendant's allegedly exclusionary restraints. 425 U.S. 738 (1976).
[52] Insert citations.

brokerage services. Accordingly, it dismissed the complaint for lack of federal jurisdiction, and the Court of Appeals affirmed.[54]

Chief Justice Burger reversed the lower courts, finding they had misinterpreted *Goldfarb*. That case, he asserted, addressed the "in commerce" test rather than the "substantial effects" test. To establish that the defendants' activities were in the stream of commerce, it was necessary to show that they were an "integral part of an interstate transaction." Such a showing is unnecessary where, as in the case at hand, the alleged basis for federal jurisdiction is the substantial effects test, which is "in no way restricted to those challenged activities that have an integral relationship to an activity in interstate commerce."[55] As Burger described the substantial effects test:

> To establish the jurisdictional element of a Sherman Act violation it would be sufficient for petitioners to demonstrate a substantial effect on interstate commerce generated by respondents' [broader] brokerage activity. Petitioners need not make the more particularized showing of an effect on interstate commerce caused by the alleged conspiracy to fix commission rates, or by those other aspects of respondents' activity that are alleged to be unlawful. . . . If establishing jurisdiction required a showing that the unlawful conduct itself had an effect on interstate commerce, jurisdiction would be defeated by a demonstration that the alleged restraint failed to have its intended anticompetitive effect. This is not the rule of our cases.[56]

Given the uncontroverted testimony from local lenders that an appreciable amount of their residential real estate loans occurred in interstate commerce, Burger concluded that "there remains only the requirement that respondents' activities which allegedly have been infected by a price-fixing conspiracy be shown 'as a matter of practical economics' to have a not insubstantial effect on the interstate commerce involved."[57] The infected activities version of the substantial effects test apparently requires the plaintiff to allege only that the defendants' unlawful conduct stands to have a "not insubstantial effect" on interstate commerce because, being interstate, the defendants' broader vertically-related business activities — such as title insurance and real estate financing — can be presumed to have a substantial economic effect on

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[53] McLain v. Real Estate Bd. of New Orleans, 444 U.S. 232 (1980).
[54] The District Court dismissed the complaint for failure to state a claim under FRCP 12(b)(6), while the Court of Appeals affirmed the District Court's ruling for failure of subject matter jurisdiction under FRCP 12(b)(1).
[55] 444 U.S. 232, 244 (1980).
[56] 444 U.S. 232, 243.

interstate commerce when aggregated horizontally across all defendants. That is, but-for the defendants' allegedly unlawful conduct the economic effect on the quantum or character of interstate commerce would be substantial, and this, according to Burger, was enough to carry the plaintiffs' jurisdictional burden.

Finally, in *Summit Health v. Pinhas* (1991),[58] the Court established its most expansive version of the substantial effects test, finding that a Sherman Act defendant's entire line of business can be infected by an economically trivial local restraint. The plaintiff in that case was a licensed and very skilled eye surgeon who refused to hire the services of a physician's assistant as required by the defendants' hospital policy. In response, the defendants — including the hospital at which the plaintiff held staff privileges, its parent corporation, and several of the plaintiff's fellow doctors who served on the hospital's peer review board — initiated peer review proceedings resulting in severe restrictions on the plaintiff's practice and an impending group boycott of his services by the defendants and other hospitals throughout the Los Angeles area. The plaintiff filed a complaint in federal court alleging, among other things, that the defendants had conspired to drive him out of the Los Angeles market by boycotting his services in an effort to increase their market share. To establish federal jurisdiction under the Sherman Act, the plaintiff alleged that the defendant corporate parent's hospitals served nonresident patients, received reimbursements from out-of-state insurers and the federal government, purchased supplies from the stream of commerce, and distributed peer review reports across state lines. In response to the defendants' contention that the plaintiff's complaint failed to describe an adequate nexus between the alleged group boycott and interstate commerce, the District Court dismissed the complaint. The Court of Appeals reversed, finding that "'as a matter of practical economics' the hospital's 'peer review process in general' obviously affected interstate commerce."[59]

Writing for a narrow majority, Justice Stevens's found that the petitioner was unquestionably engaged in interstate commerce even though its primary activity involved the provision of general health care services in a local market.[60] Echoing the Court of Appeals, Stevens reasoned that, "[a]s 'a matter of practical economics,' the effect of such a conspiracy on

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[57] 444 U.S. 232, 246 (quoting . Hospital Bldg. Co. v. Rex Hospital Trustees, 425 U.S. 738, 745 (1976).
[58] 500 U.S. 322, 326 (1991).
[59] 500 U.S. 322, 328 (1991).
[60] Justices Rehnquist, White, Marshal, and Blackmun concurred in the opinion.

the hospital's 'purchases of out-of-state medicines and supplies as well as its revenues from out-of-state insurance companies,' would establish the necessary interstate nexus."[61] In response to the petitioners' claim that a boycott of a single surgeon was insufficient to establish jurisdiction, Stevens argued, first, that the mere existence of an illegal agreement violates the Act regardless of its actual effects, and, second, that if successful the conspiracy would surely have reduced the supply of eye surgery in the Los Angeles market. Quoting *McLean*, he found that the respondent "need not make the more particularized showing of an effect on interstate commerce caused by the alleged conspiracy to fix commission rates, or by those other aspects of respondents' activity that are alleged to be unlawful."[62] What is more, according to Stevens, "[t]he competitive significance of respondent's exclusion from the market must be measured, not just by a particularized evaluation of his own practice, but rather, by a general evaluation of the impact of the restraint on other participants and potential participants in the market from which he has been excluded."[63]

In dissenting, Justice Scalia argued that the Act's language, "in restraint of trade or commerce among the several states,"[64] does indeed require the Court to examine the nature and likely effect of the restraint in each particular case. In Scalia's view, *McLain's* "infected activity" test was the result of the Court's confusion over the law; the Court could easily have found jurisdiction in *McLain* given the massive conspiracy being alleged, but instead it resorted to the infected activities test under the mistaken belief that "focusing upon the effects of the restraint itself would require plaintiffs to prove their case at the jurisdictional stage. That belief was in error because the prior approach had simply assumed, rather than required proof of, the success of the conspiracy."[65] As a result, Scalia lamented, the Court missed an opportunity to clear up the confusion in the circuits following *McLain* and had in fact made things worse. To establish Sherman Act jurisdiction in this case, he observed:

> [The Court] looks *neither* to the effect on commerce of the restraint, *nor* to the effect on commerce of the defendants' infected activity, but rather, it seems, to the effect on commerce of the activity from which the plaintiff has been excluded. As I understand the Court's opinion, the test of Sherman Act jurisdiction is

[61] 500 U.S. 322, 329.
[62] 500 U.S. 322, 331 (1991).
[63] 500 U.S. 322, 332 (1991).
[64] 500 U.S. 322, 333-34.
[65] 500 U.S. 322, 335 (1991).

> whether the entire line of commerce from which Dr. Pinhas has been excluded affects interstate commerce. Since excluding him from eye surgery at Midway Hospital effectively excluded him from the entire Los Angeles market for eye surgery . . . the jurisdictional question is simply whether that market affects interstate commerce, which of course it does. This analysis tells us nothing about the substantiality of the impact on interstate commerce generated by the particular conduct at issue here.
>
> Determining the "market" for a product or service, meaning the scope of other products or services against which it must compete, is of course necessary for many purposes of antitrust analysis. But today's opinion does not identify a relevant "market" in *that* sense. It declares Los Angeles to be the pertinent "market" only because that is the entire scope of Dr. Pinhas' exclusion from practice. If the scope of his exclusion had been national, it would have declared the entire United States to be the "market," though it is quite unlikely that all eye surgeons in the United States are in competition. I cannot understand why "market" in the Court's peculiar sense has any bearing upon this restraint's impact on interstate commerce, and hence upon Sherman Act jurisdiction. The Court does not even attempt to provide an explanation.[66]

Thus, the Court took vertical and horizontal aggregation to the extreme; but-for the entire Los Angeles market for eye surgery, the effect on the quantum or character of interstate commerce would be substantial, and the plaintiff's complaint was therefore sufficient to establish federal jurisdiction. Scalia emphasized the absurdity of the Court's but-for approach in pointedly observing that if "the alleged conspirators in the present case had decided to effectuate the ultimate exclusion of Dr. Pinhas, *i.e.*, to have him killed, it would be absurd to think that the *world market* in eye surgery would thereby be affected."[67] The Court's inference that competition in the Los Angeles market could have been affected by the exclusion of a single surgeon from the Los Angeles market therefore ignores the "'practical economics' of the matter."[68]

## II. PRACTICAL ANTITRUST ECONOMICS

*"Congress designed the Sherman Act as a 'consumer welfare prescription.'"*[69]

[66] 500 U.S. 322, 336-37 (1991).
[67] 500 U.S. 322, 338 (1991).
[68] 500 U.S. 322, 338 (1991).
[69] Reiter v. Sonotone Corp., 442 U.S. 330, 343 (1979).

Early on in the development of Sherman Act case law the Court groped for a clear standard by which to evaluate trade restraints. Candidates included the preservation of "small dealers and worthy men," the maintenance of reasonable prices, the maintenance of large numbers of competitors, the fragmentation of markets, and the suppression of "great aggregations of capital."[70] The result was a confused and often pernicious body of antitrust precedents. Antitrust scholars and jurists now largely agree that the exclusive goal of the Sherman Act and other antitrust laws is to promote "consumer welfare," as most forcefully advanced by Robert Bork.[71] According to the consumer welfare standard, business arrangements that create market power invariably generate "allocative inefficiency" reflected in reduced output and higher prices to consumers. But they may also generate offsetting "productive efficiency" by lowering production costs, which tends to increase output and lower prices. Consumer welfare is best served by prohibiting business arrangements whose probable net effect is to reduce output and raise prices; that is, to restrain trade.[72]

Based on the consumer welfare standard, Bork rationalized the use of a per se rule against "naked" horizontal restraints of trade such as price fixing, proposed a market share test for horizontal mergers, and persuasively argued that all vertical restraints should be subject to a full evidentiary inquiry under the rule of reason. As a result, the case law has become clearer and more predictable, with the adoption of an output test to distinguish per se restraints from those best addressed under a full reasonableness inquiry, a full reasonableness inquiry for vertical division of territories and vertical maximum retail prices, and a virtual presumption that predatory pricing is economically irrational. Horizontal merger policy has evolved toward a

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[70] Robert H. Bork, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF (Basic Books, New York: 1978), at 22-25, 50-66.

[71] Bork, *supra* note ?.

[72] The "consumer welfare" standard is regarded by some as a euphemism for business arrangements whose *probable* effect is to reduce allocative efficiency. *See, e.g.*, Easterbrook, at 24. Strictly speaking, promoting consumer welfare cannot be the exclusive goal of antitrust. This is best demonstrated by courts' resort to the *per se* rule against horizontal pricing restraints. The per se rule is justified on the grounds that such restraints are so unlikely to benefit consumers that they can be conclusively presumed to be unreasonable as a matter or law, even though there might be some rare cases in which consumers benefit from such restraints (see Thurgood Marshal in U.S. v. Northern Securities?). But this reasoning indicates that the per se rule sacrifices some small prospect of gain to consumers to economize on judicial resources. The correct maximand must therefore be some combination of consumer welfare and judicial economy, rather than consumer welfare alone. Seen in this light, a more appropriate specification of the goal of antitrust is to promote the *commonwealth*. See D. Bruce Johnsen, *Wealth is Value*, 15 J. LEG. STUD. 263 (1986).

workable set of market share tests for identifying the mergers antitrust agencies can be expected to challenge for the likely exercise of market power.

Part A of this section briefly describes the simple economics of market power. Part B describes the practical analytical framework the antitrust agencies use to identify the extent of the market for assessing the effect of horizontal mergers on market power. Part C briefly describes how this framework can be adapted to assess the scope of price effects for the purpose of establishing federal jurisdiction under the geographic market power test.

## A. The Simple Economics of Market Power

Consider an isolated island economy in which there are a large number consumers and 100 wealth maximizing widget firms, all of whom face the same production technology and therefore operate at the same scale.[73] For simplicity, assume consumers believe there are no close substitutes for widgets and that any transaction costs consumers would ordinarily face in arbitraging the price of widgets across firms are zero. Under these circumstances, the "representative" firm shown in Figure 1 illustrates a competitive widget market in which no firm is able to exercise market power and resources are allocated efficiently. $D_R$ reflects this firm's *pro rata* share of total market demand for widgets and MC reflects its marginal cost of producing widgets. $D_R$ slopes down because the value consumers place on additional widgets declines as their consumption rate rises. MC slopes up because the value of the resources taken from other sectors of the economy to produce widgets increases as the rate of widget production rises.[74] The intersection of $D_R$ and MC determines the equilibrium market price, P*, and the representative firm's rate of production, Q*.

Because the marginal value consumers place on widgets is exactly equal to the marginal cost of widget production, this equilibrium achieves allocative efficiency in the sense that it maximizes the surplus value of widget production. The representative firm collects P*Q* revenue from consumers and earns producer surplus equal to area DFI, while consumers earn a

[73] The persistence of 100 equal size firms requires diseconomies of scale for any firm that attempts to expand production beyond its current scale.

[74] We assume there are no spillovers or externalities in either consumption or production, so that $D_R$ and MC reflect all social costs and benefits.

surplus equal to area DFA.[75] There is no way to reallocate resources to improve one party's welfare without reducing another party's welfare by a greater amount.

It is important to understand that $D_R$ is not the demand curve perceived by the representative firm if it considers adjusting its rate of output unilaterally. Rather, $D_R$ indicates its *pro rata* share of total market sales to consumers if all firms charge the same price. If the price of inputs critical to the widget production process were to decline, for example, MC would shift down and its intersection with $D_R$ would accurately describe the resulting equilibrium for the representative firm. All firms would increase their production rate and decrease price identically because consumers would stand ready to arbitrage any price differences between firms. If any single firm unilaterally lowers price even slightly below P*, consumers would react by offering to shift all their purchases to it. Since the firm can sell as many widgets as it wants at P*, however, it has no incentive to lower price. Alternatively, consumers would react decisively to even a modest increase in price above P* by a single firm, shifting all their purchases to the remaining 99 firms and leaving the recalcitrant firm with zero sales.[76] Thus, if any single firm considers adjusting price, while other firms maintain price at P*, it faces a demand curve equal to D* that is horizontal, or perfectly elastic, at P*. Because the firm receives P* on every unit it sells, D* is coincident with its marginal revenue curve, MR*. Recognizing it can have no influence on the market price by adjusting production, the firm takes the competitive market price as given and is completely devoid of market power.

It is fairly easy to see the effects of market power by hypothesizing that the island's widget firms suddenly gain the ability to coordinate production, either by colluding or by merging into a single firm. By coordinating, they are able to exercise market power, which is simply the ability to raise price above P* without experiencing a complete loss of sales. Unlike the situation described above, the representative firm now perceives a demand curve equal to $D_R$. Since $D_R$ is downard sloping, as the firm raises price it sells fewer widgets, but because consumers have imperfect substitutes for widgets they do not reduce their purchases to zero. Under the standard assumption that firms must charge a uniform price for all the widgets it sells,

[75] Producer surplus is defined as total revenue, P*Q*, minus the area under MC up to Q*, while consumer surplus is defined as the area under $D_R$ up to Q* minus total expenditures, P*Q*.

[76] This assumes the diseconomies of scale experienced by the remaining firms from expanding output by 1/99Q* (their share of the recalcitrant firm's normal sales) are trivial. Otherwise, as production costs increase the equilibrium market price must rise. This effect is relevant to our discussion of geographic market power, *infra*.

the representative firm's marginal revenue is now shown by $MR_R$.[77] To maximize wealth, the firm reduces its rate of output to $Q_C$, where $MR_R$ intersects MC, and then charges the highest possible uniform price at which all $Q_C$ widgets can be sold. This occurs at $P_C$. The motivation for exercising market power is that it may increase the firm's total surplus, now equal to total revenue ($P_CQ_C$) minus the area under MC up to $Q_C$. This corresponds to area BCHI.[78]

The problem with market power is not specifically that it allows colluding widget firms to earn additional profits, but that it allows them to earn additional profits by reducing output below Q*, which leads to allocative inefficiency. At the lower production rate of $Q_C$, the value consumers place on the marginal widget increases to $P_C$, while the cost of the marginal widget in terms of the value of resources forgone in production falls to $MC_C$. The difference is what Frank Easterbrook has characterized as the "monopoly overcharge."[79] Too few widgets are produced, too few resources are devoted to widget production, and too many resources are devoted to non-widget sectors of the economy, where they provide a smaller surplus. Consumers would have valued the production that has been lost equal to the area under $D_R$ from Q* to $Q_C$, while the costs saved are equal only to the area under MC between these two points. In total, the island economy loses consumer and producer surplus equal to area CFH, often characterized as the *deadweight loss due to monopoly* or simply as the *welfare triangle*.[80] Unlike the situation depicted above in which widget firms are unable to coordinate, resources can now be reallocated to improve the parties' net welfare, and this is exactly what the Sherman Act is designed to achieve under the consumer welfare standard.

The exercise of market power under these circumstances is a textbook example of a market failure, in which the decision maker — the organization of colluding firms — is unable to capture the full benefit from expanding output because some of the benefit spills over to consumers. This is because the private benefit to colluding firms, reflected by $MR_R$, declines more rapidly as production rises than the social benefit to consumers, reflected by $D_R$. The market failure is a direct result of the requirement that the cartel charge a uniform price for all

[77] The uniform pricing constraint essentially assumes away price discrimination.
[78] The exercise of market power increases the firm's total surplus if area BCED exceeds area EFH.
[79] Easterbrook, *Economics of Federalism*.
[80] Arnold C. Harberger, MONOPOLY AND RESOURCE ALLOCATION (1954); Bork, at 107-08. Note that consumer surplus declines by the difference between area DFA and area BCA. Of this difference, recall that BCED is transferred to producers. In certain circumstances producers may dissipate some or all of this value in an effort to effect the transfer. These losses, which result from productive inefficiency, must be added to the deadweight loss

the widgets it sells. Starting at any arbitrary price and production rate along $D_R$ in Figure 1, to increase sales under the uniform price constraint the cartel must reduce price on the additional widgets it wants to sell *and* on the widgets it would have sold absent the price reduction. The price reduction on these *intramarginal* widgets spills over to consumers, who otherwise would have purchased them at the higher price. The firm naturally fails to consider the spillover in determining its wealth maximizing rate of production; it produces too little because it is unable to realize the full value of production as revenue, hence the market failure.[81]

Many of the trade restraints addressed by the Sherman Act arise from horizontal arrangements between firms that would otherwise act as rivals. Horizontal arrangements involving no integration of productive activity are considered the most likely to result in the exercise of market power. The most obvious example is collusive agreements between independent firms to restrict production and raise prices. Horizontal division of territories or customer allocations between independent firms can have the same effect on production and prices. These are thought to be the most serious types of horizontal trade restraints because the participating firms remain independent. As a result, they are treated as unreasonable *per se* in the antitrust case law.[82] Horizontal mergers between competing firms can also lead to reduced output and increased prices, but given that the participating firms integrate their productive activities antitrust economists believe that any resulting allocative inefficiency may be offset by productive efficiencies that allow the new firm to cut production costs and possibly prices.[83]

B. Market Definition and Market Power

As Justice Scalia noted in his *Summit* dissent, antitrust analysis requires the definition of an appropriate market. The foregoing model can be used as the basis for identifying the extent of the market and assessing the likely affect of trade restraints on market power. It is important to keep in mind that there is no theoretically "correct" market in any given setting; the broader the market as defined, all else being equal, the smaller the combined market share of a group of

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for some purposes. See Richard Posner, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE (Chicago and London: University of Chicago Press, 1976), at 11.

[81] The analysis in this section is subject to any number of exceptions, qualifications, and conditions that have no immediate bearing on issues addressed in this paper.

[82] Insert citations.

coordinating firms and the less likely their restraint is to create market power. There are two dimensions to any market definition, the relevant product and the relevant geographic scope. Because our ultimate concern is the proper limit of Sherman Act jurisdiction — an inherently spatial concern — our primary focus is on the geographic scope of the market, although before proceeding it is necessary to briefly explain how to identify the relevant product.

In describing the widget market on our hypothetical island economy, we finessed the problem of defining the relevant product by assuming widgets have no close substitutes in consumers' perception. In reality, if a group of firms raises the price of their product relative to competing products, consumers are likely to substitute the low-priced product for the high-priced product, thereby limiting the firms' ability to sustain the price increase. Consumers' willingness to substitute between alternatives in the face of a relative price change determines the extent of the product market. In antitrust law, the more closely two goods compete the more likely they are to be considered in the same product market precisely because variations in their relative prices are will cause consumers to substitute between them.

It is fairly easy to imagine that widgets compete for consumers' favor with other products within a broader product category, just as aluminum ingot competes with other metals, cellophane competes with other flexible wrapping materials, and Brand X CD players compete with other audio equipment such as FM radios, cassette players, and DVD players. Naturally, the broader the product category the less likely it is to have viable substitutes and the more likely a price increase is to persist. In the face of an increase in the price of Brand X CD players, consumers are very likely to find viable substitutes among other brands of CD players and all other types of audio equipment. In the face of an increase in the price of all brands of CD players, however, consumers are far less likely to find viable substitutes among all other types of audio equipment. How to identify suitably close substitutes *in practice* is a question that must ultimately be answered empirically. Based on cross-elasticities between substitute product categories, economists can in principle identify the most narrowly defined product category for which a price increase is likely to persist if imposed by all sellers of that product. This product category identifies the relevant product market for antitrust purposes.

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[83] J.D. Rockefeller's Standard Oil Trust led to dramatic reductions in the price of kerosene and other petroleum products, for example. The same can be said for internal growth to monopoly, as in the case of Alcoa or Microsoft.

To determine whether a given restraint is likely to result in the creation of market power, we must also identify the relevant geographic market. The geographic scope of an *economic* market has been defined as "that set of demanders and suppliers whose trading establishes the price of a good [and] 'within which the price of a good tends to uniformity, allowance being made for transportation costs."[84] A workable empirical test for this definition is "the similarity of price movements within the market."[85] But neither this definition, nor its empirical counterpart, are especially useful in an antitrust setting because they assume the events that cause prices to change are be beyond the discretion of market participants. By way of example, in the island widget economy we hypothesized an exogenous economy-wide decline in the price of inputs critical to the widget production process and found that arbitrage would cause all firms to increase output and reduce price. In antitrust, however, the focus is on the ability of a group of coordinating firms to restrict output and raise price through the exercise of market power. Since the island's economic market had distinct limits due to its geographic isolation, a hypothetical cartel of all widget firms was able to do this successfully.

What has been characterized as the "geographic *antitrust* market" may be either broader or narrower than the economic market.[86] The accepted method of identifying the geographic antitrust market is the "hypothetical monopolist test," which is formalized in the *Merger Guidelines* and used by the antitrust agencies to assess the probable effect of horizontal mergers on market power.[87] According to this test, for any pair of firms proposing to merge the antitrust market is defined as the *narrowest* geographic area containing the merging firms in which all firms in the area, by coordinating their operating decisions, can profitably sustain a small but significant increase in the price of the relevant product above what would prevail absent the restraint.[88]

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[84] George J. Stigler & Robert A. Sherwin, *The Extent of the Market*, 28 J. LAW & ECON. 555 (1985), at 555, citing Marshall and Cournot. See, also, William M. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 937(1981). For an alternative method of defining markets in mergers cases based on "marketing concepts" see Thomas W. Dunfee, Louis W. Stern, and Frederick D. Sturdivant, *Bounding Markets in Merger Cases: Indentifying Relevant Compeititors*, 78 N.W.U.L. REV. 733 (1984).

[85] Kenneth G. Elzinga & Thomas F. Hogarty*, The Problem of Geographic Market Delineation in Antimerger Suits*, 18 ANTITRUST BULL. 45 (1973).

[86] David T. Scheffman & Pablo T. Spiller, *Geographic Market Definition under the U.S. Department of Justice Merger Guidelines*, 30 J. LAW & ECON. 123 (1987).

[87] Other empirical tests for identifying the antitrust market can be found in Herbert Hovenkamp, ECONOMICS AND FEDERAL ANTITRUST LAW 6364 (1985) *supra* note ?, §3.2-6; Arquit, insert citation, *supra* note ?, at 472; Gregory J. Werden, *The History of Antitrust Market Deliniation*, 76 MARQ. L. REV. 123 (1992).

[88] Schefman & Spiller, at 125, citing *Merger Guidelines*.

To show how this test works, we return to our isolated island economy. For simplicity, assume the island is perfectly round and that consumers and producers are evenly distributed within its borders, depicted by Circle E in Figure 2. We assume transportation costs for all firms on the island increase at a constant rate with distance. We then take a subgroup of firms that include the firms proposing to merge, say those within Circle A, and ask whether, by acting in concert they can profitably sustain a small but significant increase in the price of widgets. If not, then Circle A does not represent a geographic market for antitrust purposes because no single firm or narrower subgroup of firms within Circle A could hope to sustain a price increase if all the firms in Circle A acting together are unable to do so. The geographic antitrust market is broader than Circle A because outside firms must be added to the subgroup before it can hope to exercise market power. Suppose we expand the subgroup to include all firms in Circle B and again find that these firms acting together are unable profitably to sustain a price increase. By proceeding incrementally in this fashion, we can identify the narrowest geographic market in which the associated firms are capable of exercising market power. Suppose this coincides with Circle C.

The geographic antitrust market, depicted in Circle C, may be narrower than the entire island economy. For this to be true the firms outside Circle C must have sufficiently limited productive capacity that they are unable to expand output enough to completely undermine the cartel. With the higher price set by the firms inside Circle C, outside firms will attempt to arbitrage the price difference by expanding their production and selling into the colluders' market. As they do so they will succeed in taking a portion of sales away from the colluders, but their marginal production costs eventually increase so much that they are no longer willing to expand. The resulting hypothetical equilibrium is one in which prices throughout the island economy are higher than they would absent the colluders' exercise of market power, with any price differences reflecting transportation costs. This condition confirms that the entire island is an *economic* market even though the antitrust market is narrower.

There is nothing in this analysis that requires us to start the hypothetical monopolist test with Circle A. Quite the contrary; in the context of a real merger proposal the antitrust agencies begin with the narrowest geographic area that includes the merging firms, and of course they recognize that consumers are not uniformly distributed across space and that transportation costs can vary for many reasons. If, using the hypothetical monopolist test, the agencies find that

these firms would be unable profitably to sustain a small price increase they search for the narrowest geographic area that includes the next-best substitute for production at the merging firms' location and ask whether *all* firms in this area acting together could do so.

Once having identified the geographic antitrust market in this way, the antitrust agencies attempt to determine whether a merger, presumably between only two firms, is likely to generate market power absent the cooperation of the nonmerging firms. Obviously, the smaller the merging firms' combined share of the geographic antitrust market the less likely they are to possess market power given that a hypothetical monopoly of all firms is just barely able to sustain a profitable price increase. The agencies account for market shares by calculating the share of production attributable to each firm in the market. They then calculate the Hirfindahl-Hirschman Index (HHI) for the market by summing the firms' squared market shares. For example, if the market contains five firms each of which have market share of 20%, the HHI for the market is $(.2^2) + (.2^2) + (.2^2) + (.2^2) + (.2^2) = .2$, or 2000 by convention. The HHI gives proportionately greater weight to the market shares of the larger firms reflecting the belief that a firm's influence in coordinating production in the market is more than proportionate to its market share. The antitrust agencies consider an HHI below 1000 to reflect an unconcentrated market. An HHI between 1000 and 1800 is said to be moderately concentrated, and an HHI above 1800 is said to be concentrated, although it is widely understood that these thresholds are imprecise and somewhat arbitrary indicators of market power.

The agencies starting point for analysis of a given merger is to identify the defendants' geographic antitrust market, calculate the HHI, and then calculate the change in the HHI that would result from the proposed merger. As already explained, the resulting calculation is imprecise, among other reasons because the effect of the merger on the defendants' combined market share will depend critically on the extent to which the merger generates productive efficiencies. A merger that generates few productive efficiencies while creating market power in the geographic antitrust market is likely to reduce the defendants' combined market share over time, while a merger that generates substantial productive efficiencies while creating little market power is likely to increase the defendants combined market share over time.

For unconcentrated markets, the agencies presume little or no effect of the merger on the HHI. For markets whose post-merger HHI is between 1000 and 1800, the agencies presume a merger that increases HHI by less than 100 is unlikely to create market power, while a merger

that increase HHI by more than 100 raises significant concerns over the creation of market power. For markets in which the HHI exceeds 1800 the agencies presume a merger that increases HHI by less than 50 is unlikely to create market power, while a merger that increase HHI by more than 50 raises significant concerns over the creation of market power. Where the post-merger HHI exceeds 1800, the agencies presume that mergers producing an increase in the HHI of more than 100 points are likely to create or enhance market power or facilitate its exercise.[89]

It is important to understand that the antitrust agencies face a tradeoff in identifying the geographic antitrust market. The wider the product and geographic market to which they apply the hypothetical monopolist test, the more likely it is that a hypothetical monopolist would be able to exercise market power in that market. But by increasing the scope of the market in this way, they necessarily reduce the combined market share of the firms proposing to merger. Presumably, the agencies' recognition of this tradeoff is at least partly explains why they identify the geographic antitrust market as the narrowest market in which a hypothetical monopolist could profitably sustain an increase in price.[90] In practice, the agencies use market share thresholds established under the Merger Guidelines as crude proxies for the creation and probable exercise of market power, and the exact magnitude of the thresholds can therefore be adjusted to reflect the choice of the narrowest market. Federal courts are not bound by the *Merger Guidelines*,[91] but nevertheless many federal courts follow their approach to product and geographic market definition.[92] This is because the Merger Guidelines "represent mainstream economic thinking," and are functionally equivalent to other tests that the courts have developed over the years.[93]

C. Adapting the Framework to the Issue of Jurisdiction

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[89] For example, if two firms in an antitrust market of five equal-sized firms were to merge, the HHI would increase from 2000 to 2800. If two firms in an antitrust market of ten equal-sized firms were to merge, the HHI would increase from 1000 to 1200.

[90] Another rationale for choosing the narrowest market is that it leads to a standard basis for comparison across cases.

[91] F.T.C. v. PPG Industries, Inc., 798 F.2d 1500, 1503 (D.C. Cir 1986).

[92] *See e.g.* Community Publishers, Inc. v. Donrey Corp., 892 F.Supp. 1146, 1153 (W.D. Ark. 1995) *aff'd* 139 F.3d 1180 (8th Cir. 1998). [insert other citations].

[93] Insert citation.

Rather than focusing on the geographic scope of the price increase resulting from a given horizontal merger, the *Merger Guidelines* focus solely on whether the merger is likely to generate market power. To be useful in the context of a jurisdictional challenge, it is therefore necessary to adapt the *Merger Guidelines'* underlying logic to assess the geographic scope of price effects. For example, the geographic antitrust market as defined according to the hypothetical monopolist test is likely to overlap one or more economic markets, "within which the price of a good tends to uniformity, allowance being made for transportation costs." It is reasonable to expect an exercise of market power to cause a flow of goods into the geographic antitrust market as outside firms expand production in an attempt to arbitrage price differences within these overlapping economic markets. To some extent, prices will therefore rise outside the geographic antitrust market, possibly spilling over to neighboring states. Unless the defendants combined share of the geographic antitrust market is 100%, however, any such spillovers are less likely to occur. In defining the relevant market for antitrust jurisdiction, a proper test should formally recognize the tradeoff between the likelihood of interstate price spillovers and the likelihood the defendants can effectively exercise market power.

## III. THE GEOGRAPHIC MARKET POWER TEST FOR SHERMAN ACT JURISDICTION

*"The jurisdictional inquiry under general prohibitions like . . . the Sherman Act, turn[s] on the circumstances presented in each case and require[es] a particularized judicial determination . . . ."*[94]

It is well settled that plaintiffs seeking redress in federal court must allege and bear the burden of proving the facts necessary to support subject matter jurisdiction.[95] The defendant, in turn, has the right to rebut the plaintiff's allegations.[96] If the plaintiff is unable to provide substantial competence evidence to overcome the defendants' rebuttal, the defendant can move to dismiss under Rule 12(b)(1) of the Federal Rules of Civil Procedure and federal subject matter

[94] 500 U.S. 322, 333-34 (citing Gulf Oil Corp. v. Copp Paving, 419 U.S. 186, 197, n. 12 (1974).
[95] Insert citation.
[96] As Justice Burger stated in McLain: "To establish jurisdiction a plaintiff must allege the critical relationship in the pleadings and if these allegations are controverted must proceed to demonstrate by submission of evidence beyond the pleadings either that the defendants' activity is itself in interstate commerce or, if it is local in nature,

jurisdiction will be defeated. To establish Sherman Act jurisdiction under the geographic market power test, then, the plaintiff must allege and prove that the defendants engaged in a restraint of trade that generated (or if successful would be reasonably likely to generate) market power that caused prices to rise in more states than one. More particularly, the plaintiff must identify a relevant product and a geographic antitrust market in which a hypothetical monopoly of all firms, including the defendants, would be reasonably likely to sustain a profitable price increase that substantially spilled across state lines. In addition, the plaintiff must allege and prove that overall market concentration and the defendants' combined market share are sufficiently large that their restraint would be reasonably likely to generate market power. As under the *Merger Guidelines*, market concentration could be expressed in terms of the HHI, and the likelihood the restraint would generate market power could be based on the associated change in HHI from combining the defendants' market share.

The geographic market power test imposes an economically appropriate tradeoff on the plaintiff when alleging jurisdiction under the Act. The narrower the market the plaintiff alleges the more likely a restraint by the defendants' will generate market power. The narrower the market, however, the less likely the defendants' restraint will increase prices outside the state. Plaintiffs will naturally want to allege the narrowest market consistent with the plausible allegation of interstate price spillovers because this maximizes both the defendants' measured share of the market, HHI, and change in HHI. The defendants can respond by offering to prove they have such a small share of the market that the effective exercise of market power is economically implausible. Alternatively, they can offer to show that the market alleged by the plaintiff is so narrow even a hypothetical monopolist would be unlikely to sustain a profitable price increase that substantially spilled across state lines. On either showing, the defendants' conduct would be presumptively intrastate and unless rebutted by the plaintiff would be sufficient to support a Rule 12(b)(1) motion for lack of Sherman Act jurisdiction.

One of the attractive attributes of the geographic market power test is that it imposes a tradeoff on the plaintiff's reliance on vertical aggregation without strictly preventing it, thereby providing the plaintiff with the flexibility to define the market according to the facts at its disposal and the circumstances of the particular restraint at issue. This is because defining the

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that it has an effect on some other appreciable activity demonstrably in interstate commerce." 444 U.S. 232, 243 (1980) (quoting from Gulf Oil Corp. v. Copp Paving Co.).

product category broadly to include vertically-related goods or services raises the plaintiff's evidentiary burden regarding the defendants' market share, HHI, and change-in-HHI. As in *McLain*, for example, the plaintiffs would be free to allege a relatively broad product category that includes complements to real estate brokerage such as financing and title insurance. Although unlikely, it is economically possible that fixed minimum brokerage fees in the greater New Orleans area would cause such a dramatic decline in the number of real estate transactions that the price of financing and title insurance outside the state would substantially decline, possibly even leading to an indirect increase in out-of-state brokerage fees. Including financing and title insurance in the product definition increases the likelihood a hypothetical monopoly of the broad product category in the Greater New Orleans area would have substantial interstate price effects. At the same time, however, by reducing the defendants' combined market share it raises the plaintiff's burden of demonstrating that their restraint could plausibly have such an effect.[97] In any event, under the geographic market power test the interstate scope of price effects is a question of fact that Sherman Act defendants have a due process right to resolve at the jurisdictional stage.

The tradeoff imposed by the geographic market power test has similar implications for horizontal aggregation. The plaintiff is free to allege a geographic antitrust market sufficiently broad that a hypothetical monopolist would be extremely likely to sustain a profitable increase in prices outside the state in question, but defining the market broadly raises the plaintiff's jurisdictional burden elsewhere. As in *Mandeville*, for example, the Court might hypothesize that the effect on interstate commerce would be substantial if all sugar refiners in the country adopted the same grower contracts as the defendant. In essence, the Court would be applying the hypothetical monopolist test to the national market and would no doubt conclude that interstate sugar prices would suffer a substantial effect. The *Mandeville* Court neglected to recognize, however, that the refiners' share of such a broadly defined geographic antitrust market was absolutely trivial and beyond any plausible suggestion of market power. Whereas such unconstrained aggregation may be appropriate to establish constitutional jurisdiction in cases such as *Wickard*, where Congress has made specific findings as to the need for federal

[97] Similarly, as in *Summit*, the plaintiff would be free to allege that the relevant product category includes an entire collection of vertically-related activities associated with general hospital services and that the relevant geographic antitrust market is the entire Los Angeles area. A hypothetical monopoly in such a broadly defined market might

regulation, it is inappropriate to establish jurisdiction under general prohibitions such as the Sherman Act that require a particularized judicial determination in light of the circumstances at hand and the underlying goal of the statute.

Note that the geographic market power test in no way recognizes formalistic distinctions. Applied to the facts in *E.C. Knight*, for example, the geographic market power test would surely have found that the defendants' "manufacturing" operations caused sugar prices to increase in more states than one, and Sherman Act jurisdiction was therefore appropriate. Neither does the geographic market power test rely on the distinction between "direct" and "indirect" effects, although it will ordinarily give effects that are economically remote from the defendants' restraint limited weight in the jurisdictional calculus. What is more, whether the defendants' goods are in the stream of commerce is neither a necessary nor a sufficient condition to establish federal jurisdiction. An effective restraint by firms whose sales are entirely within their home state may cause prices to increase outside the state even though the defendants' goods never cross state lines. Alternatively, the defendants may sell their goods in a national market in which they have absolutely no hope of affecting prices, even though they have market power in their local intrastate market. The sole question relevant to Sherman Act jurisdiction is whether the alleged restraint affects prices outside *any* state in which the restraint operates.

A second attractive feature of the geographic market power test is that it need not be applied identically to all restraints. No jurisdictional test can be expected to perform without error, but the geographic market power test establishes a substantively reasoned basis for Sherman Act jurisdiction that allows the legal system to iterate toward an articulate set of presumptions that minimize the weighted sum of Type I and Type II errors.[98] In the context of antitrust, judicial measurement error is small enough that practical market share thresholds for HHI and changes in HHI can be established for various categories of restraints. Below these thresholds the exercise of market power is economically implausible and presumptively beyond federal jurisdiction. Different restraints would very likely be subject to different presumptions regarding the thresholds necessary for the plaintiff to make out a prime facie case for federal

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well cause the price of eye surgery to increase in neighboring states, but the exclusion of a single eye surgeon from the market would be extremely unlikely to generate market power.

[98] The Sherman Act's language "among the several states" is regarded as both a jurisdictional requirement and an element of the substantive offense. See Gavil, etc, *supra* note ?. Type I errors can be seen as situations in which the court allows jurisdiction over defendants whose activities later prove on the merits to have no substantive interstate

jurisdiction. In all cases determination of the appropriate threshold would properly be tempered by courts' recognition that the category of alleged restraints may, in fact, generate productive efficiencies that more than offset any associated allocative inefficiencies. Horizontal pricing arrangements would no doubt be subject to a very low threshold, possibly approaching zero as is currently the case, because it is relatively unlikely such arrangements can generate productive efficiencies. Vertical price fixing and horizontal nonprice restraints might be subject to marginally higher thresholds, and so on, because the likelihood that they can generate productive efficiencies is somewhat greater. Of course, the antitrust agencies would face a jurisdictional restraint in assessing purely local horizontal mergers that has thus far been formally absent.

## IV. NORMATIVE JUSTIFICATION

*"The greatest threat to consumers' welfare is not states, and their competition, but a uniform national regimen that stifles the power of exit — that is, a monopoly of lawmaking."*[99]

This section outlines the normative case in support of the geographic market power test. We show that it is consistent with the framework of competitive federalism, with much of the case law on general Commerce Clause jurisdiction, and with the statutory intent behind the Sherman Act. We also show that the geographic market power test promises benefits in the form of more rapid evolution of substantive rules as the result of inter-jurisdictional competition over optimal antitrust policy.

### A. Competitive Federalism

The general economic theory of regulation recognizes that competition ensures a tendency toward optimal resource allocation if all spillovers are internalized. Just as antitrust policy is premised on the conviction that economic competition best promotes consumer welfare, competitive federalism is premised on the conviction that political competition best promotes the general welfare of the citizenry. If economic market spillovers are confined within state borders,

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component. Type II errors can be seen as situations in which the court denied jurisdiction to plaintiffs whose claims would prove on the merits to have a substantive interstate component.

[99] Easterbrook, at 50.

political competition ensures that each state has an incentive to choose the optimal framework for regulating its internal economic markets. The citizens of the respective states can limit any excesses toward which their regulators might be inclined either by making their voices heard through voting and other governance mechanisms or by exiting the state for more hospitable jurisdictions. This provides state regulators with an incentive to focus on the spillovers they can truly remedy and to adopt novel methods of addressing these spillovers as the weight of political competition and local circumstances dictates.[100]

In the face of interstate spillovers, states acting independently will misallocate their regulatory resources when viewed from the standpoint of the national economy. If citizens of the regulating state bear all the costs while citizens of neighboring states capture a share of the benefits, the state will engage in too little regulation; if citizens of the regulating state capture all the benefits while citizens of neighboring states share the costs, the state will engage in too much regulation.[101] As with state regulation of internal economic markets, federal regulation of national markets is justified when competition between states leads to this kind of a political market failure. As long as federal courts respect the states' regulatory autonomy over completely internal spillovers, a state's citizens can avoid any excess toward which federal regulators might be inclined by focusing their commercial attention specifically on activities that lie beyond the scope of federal jurisdiction. Competitive federalism thus identifies a substantively reasoned balance between state and federal regulation that encourages both economic and political competition and ensures a tendency toward optimal resource allocation. The resulting balance of dual sovereignty involves both competition between different states' regulators and competition between state and federal regulators.[102]

The geographic market power test applies the framework of competitive federalism to the specific context of antitrust. The sole concern for Sherman Act jurisdiction under this test is whether the defendants' conduct in one state results in a monopoly overcharge that spills across state lines. For those trade restraints where the monopoly overcharge is confined to the defendants' home state, that state's antitrust regulators can be adequately address the problem. Political competition between states will result in optimal, though not necessarily uniform,

[100] Insert citation on exit and voice.
[101] The latter situation was the driving force behind inclusion of the Commerce Clause in the new constitution. Under the Articles of Confederation, the states engaged in protracted trade wars and other "beggar-thy-neighbor" policies that undermined the national economy. Insert citation.

antitrust policy with due regard for experimentation to address novel business practices addressed to local conditions. When the monopoly overcharge spills across state lines, the citizens of neighboring states bear a portion of the losses when firms restrain trade in their home state unchallenged by home-state antitrust regulators. If the restraining firms are careful to keep their capital out of the neighboring state, there is little that state's antitrust regulators can do to address the problem. With citizens of the home state bearing less than the full monopoly overcharge, while — assuming the owners of the restraining firms are citizens of the state — receiving one hundred percent of the benefits, the state's antitrust regulators are unlikely to pursue antitrust policy with the same zeal as in the absence of a spillover. Only in these cases is federal antitrust regulation warranted.

The alternative view is that antitrust regulation is subject to such dramatic scale economies that exclusive federal authority is efficient. But this argument applies only to legal administration, and not to lawmaking per se. Lawmaking is a public (nonrivalrous) good. Under the geographic market power test, states can easily capture any scale economies attributable to federal lawmaking at no cost to the federal system simply by adopting federal rules to cover their purely internal activity if they so choose. Conversely, federal courts are free to rely on state court decisions covering novel questions of law or fact purely internal to the state. The geographic market power test in no way inhibits the inter-jurisdictional sharing of legal rules.[103] Any state that chooses to adopt novel rules tailored to local circumstances is either acting foolishly, in which case it will suffer from competition by other states, or it is acting properly in the interest of its own citizens as local consumers.

If the scale economies argument does not apply to lawmaking, it must be based on scale economies in legal administration. But the claim that federal regulators should therefore have exclusive authority over the legal administration of antitrust amounts to a rejection of any kind of

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[102] If no area of economic activity lies beyond federal reach, then state-federal competition is precluded.

[103] The issue over scale economies in lawmaking bears a striking similarity to the issue over internalization versus fragmentation of securities trading in the national market system. Some have made the argument that securities trading is best routed to a central market to improve the depth of the market and the integrity of its prices. Fragmented trading off the central market fails to provide these benefits unless all price making can be linked to an instantaneous central reporting system. This argument is quite forceful in the case of securities prices, whose fleeting character renders them almost valueless in a matter of a few minutes, and where the argument in favor of fragmented trading to meet local market conditions is weak. In the case of lawmaking, time is not of the essence; the precedential value of a given legal decision can persist indefinitely. In addition, the benefits to the states from specialized lawmaking to meet purely local circumstances are seemingly large, as are the benefits to the entire system from local innovation of lawmaking whose precedential value is a public (nonrivalrous) good and can therefore be captured, if appropriate, by the federal courts.

federalism whatsoever. In an area of law whose primary concern is the suppression of economic market power, it is somewhat anomalous to suggest that political market power reposed exclusively in the hands of the federal government is in the long run interest of the citizenry; a monopoly of legal administration is no less alarming than a monopoly of widget making.[104]

Note that under the current system a state can preclude federal antitrust regulators from attacking both the internal and external activities of firms doing business within the state by integrating into the activity in question. Under the state action doctrine established in *Parker v. Brown* (1943),[105] states are free from federal antitrust prohibitions as long as they refrain from acting in an overtly commercial capacity.[106] To the extent the current system allows federal regulators inefficiently to expand their lawmaking power over otherwise *private* business activity that is purely internal to the states, we would expect states to integrate into those activities at the margin to protect them from federal antitrust authority. The adoption of the geographic market power should therefore to lead states to divest themselves of activities better performed by private firms under the state's choice of antitrust rules.

B. Constitutional Commerce Clause Principles

According to the geographic market power test, the most important question when deciphering the proper balance of dual sovereignty is whether the states are independently capable of addressing the underlying economic market spillover.[107] This test appears consistent both with the Founders intent when they included the Commerce Clause in the new constitution and with a substantial body of Commerce Clause case law. It is widely recognized that the Commerce Clause was necessary to prevent states from engaging in protracted trade wars that

[104] Note that the current system does not strictly give the federal government a monopoly over antitrust enforcement because states are free to exercise their own limited antitrust policy. At the very least, however, this subjects the citizenry to concurrent antitrust jurisdiction. Substantial differences between the application of federal and state antitrust law to completely local activities risks imposing unnecessary legal uncertainty on the citizenry. If, for example, a state was to permit certain horizontal pricing restraints in the face of federal per se prohibition it would no doubt face a preemption challenge. Thus, the federal government currently has a virtual monopoly on antitrust lawmaking.
[105] 317 U.S. 341 (1943).
[106] See City of Columbia v. Omni Outdoor Advertising, 111 S. Ct. 1344 (1991).
[107] Note that an intermediate solution is an interstate compact subject to Congressional blessing, which would presumably apply where the particular circumstances facing a small handful of states resulted in a spillover only as between them, such that Congressional legislation aimed at the national economy would be redundant or

stifled interstate commerce and undermined national prosperity. Trade wars are one form of interstate spillover in which the state erecting the trade barrier receives the benefits while imposing the costs on the citizens of other states.[108] By focusing on the substantive nexus between the underlying goal of the Sherman Act and the alleged restraint on interstate commerce, the geographic market power test establishes a functional blueprint for identifying the exact nature of the effects necessary to establish federal jurisdiction that Marshal failed to address in *Gibbons*. This blueprint is remarkably consistent with *Cooley's* finding that the proper regulation of certain activities demands the discretion to meet local necessities, while the proper regulation of other activities demands a single uniform rule.

Even the New Deal cases that dramatically expanded federal commerce power contain language consistent with the framework of competitive federalism and the geographic market power test. In *NLRB v. Jones & Laughlin Steel Corp.* (1937), the Court emphasized in upholding federal labor market regulation that "[t]he congressional authority to protect interstate commerce from burdens and obstructions . . . must be considered in the light of our dual system of government and may not be extended so as to embrace effects upon interstate commerce so indirect and remote that to embrace them, in view of our complex society, would effectually obliterate the distinction between what is national and what is local and create a completely centralized government."[109] Although the case law on Commerce Clause jurisdiction over the ensuring 50 years dramatically expanded the scope of federal power, very recent Supreme Court decisions suggest that a majority of the justices are anxious to establish clear constitutional principles that limit federal regulatory encroachment on traditional state police powers.

In *U.S. v. Lopez* (1995) the Court struck down the federal Gun-Free School Zones Act, specifically rejecting the aggregation principle and the nebulous but-for approach to establish a substantial effect on interstate commerce.[110] As Chief Justice Rehnquist stated for the majority, "possession of a gun in a local school zone is in no sense an economic activity that might, through repetition elsewhere, substantially affect any sort of interstate commerce. [To hold otherwise] would bid fair to convert congressional authority under the Commerce Clause to a

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counterproductive. Michael S. Greve, *Compacts, Cartels, and Congressional Consent* (American Enterprise Institute working paper).

[108] See Easterbrook and Resvez.

[109] 301 U.S. 1, 36-37 (1937).

[110] 514 U.S. 549 (1995).

general police power of the sort retained by the states."[111] In a concurring opinion, Justice Thomas noted the many inconsistencies in the substantial effects test and singled out the aggregation principle for special criticism. In his view, under this principle,

> Congress can regulate whole categories of activities that are not themselves either "interstate" or "commerce." In applying the [substantial] effects test, we ask whether the class of activities *as a whole* substantially affects interstate commerce, not whether any specific activity within the class has such effects when considered in isolation. . . . The aggregation principle is clever, but has no stopping point. . . . [O]ne *always* can draw the circle broadly enough to cover an activity that, when taken in isolation, would not have substantial effects on commerce. [112]

In *U.S. v. Morrison* (2000) the Court struck down the civil remedy provision of the Violence Against Women Act, specifically rejecting Congress's reliance on the aggregation principle and the nebulous but-for approach to establish a substantial effect on interstate commerce.[113] According to Chief Justice Rehnquist, it is unworkable to extrapolate a "but-for causal chain from the initial occurrence of violent crime . . . to every attenuated effect upon interstate commerce. If accepted, [this] reasoning would allow Congress to regulate any crime as long as the nationwide, aggregated impact of that crime has substantial effects on employment, production, transit, or consumption."[114]

Various justices in *Lopez* and *Morrison* implicitly relied on the framework of competitive federalism as a basis for resolving the balance of dual sovereignty. In *Lopez*, Justices Kennedy and O'Connor emphasized the importance of political innovation. In their words:

> While it is doubtful that any State, or indeed any reasonable person, would argue that it is wise policy to allow students to carry guns on school premises, considerable disagreement exists about how best to accomplish that goal. In this circumstance, the theory and utility of our federalism are revealed, for the States may perform their role as laboratories for experimentation to devise various solutions where the best solution is far from clear. . . . If a State or municipality determines that harsh criminal sanctions are necessary and wise to deter students

[111] 514 U.S. 549, 567.
[112] 514 U.S. 549, 600.
[113] 529 U.S. 598 (2000).
[114] 529 U.S. 598, 615.

> from carrying guns on school premises, the reserved powers of the States are sufficient to enact those measures. Indeed, over 40 States already have criminal laws outlawing the possession of firearms on or near school grounds.[115]

More recently, in *Solid Waste Agency of N. Cook County v. U.S. Army Corps of Eng'rs* (2001),[116] the Court struck down the Corps' regulation of "isolated wetlands" pursuant to the 1986 Migratory Bird Rule. In the majority's view, the rulemaking authority Congress granted to the Corps under the Clean Water Act (1972) lacked the clear expression of Congressional intent to encroach on the traditional state police powers necessary to support the Migratory Bird Rule. Notable in this decision is Justice Stevens's dissent, joined by three other justices, which makes a strong theoretical case for competitive federalism as a basis for federal regulation:

> The migratory bird rule does not blur the "distinction between what is truly national and what is truly local." . . . Justice Holmes cogently observed in *Missouri* v. *Holland* that the protection of migratory birds is a textbook example of a *national* problem. . . . The destruction of aquatic migratory bird habitat, like so many other environmental problems, is an action in which the benefits (*e.g.*, a new landfill) are disproportionately local, while many of the costs (*e.g.*, fewer migratory birds) are widely dispersed and often borne by citizens living in other States. In such situations, described by economists as involving "externalities," federal regulation is both appropriate and necessary.[117]

Nothing in this statement is inconsistent the reasoning the majority used to arrive at its decision. It appears simply that the majority considered migratory bird populations' use of isolated wetlands to be so remote from Congress's purpose in passing the Act that the Corps' adoption of the Migratory Bird Rule required a specific Congressional grant of rule making authority.

C. Statutory Intent

The legislative history of the Sherman Act clearly indicates that its primary proponents in Congress intended it to reach the outer limits of federal power over interstate commerce,[118] although they considered that power limited to the narrow confines of dual federalism as most

[115] 514 U.S. 549, 581-82.
[116] 531 U.S. 159 (2001).
[117] 531 U.S. 159 (2001).

recently expressed in cases such *Kidd v. Pearson*.[119] Indeed, Congress viewed *Wabash's* proscription of discrimination against interstate commerce as a major impediment to the states' ability unilaterally to control the trusts, whose goods invariably moved in interstate commerce.[120] In the words of Senator Sherman, the bill's primary sponsor, "[t]he purpose of this bill is to enable the courts of the United States to apply the same remedies against combinations . . . that have been applied in the several states to protect local interests. If the combination is confined to a state the State should apply the remedy; if it is interstate and controls any production in many states, Congress must apply the remedy."[121]

Those who criticize legislative intent as a guide to judicial decision making may be correct that it is impossible to discern the intent of any collective body, and that in any event the legislative intent behind the Sherman Act is irrelevant given the inability of members of Congress to foresee the dramatic changes that have taken place in the national economy and the scope of general federal commerce power.[122] Yet even admitting all this, there is a measure of durability in Senator Sherman's pronouncement as a manifestation of statutory intent. Whatever Congress may or may not have foreseen when it passed the Act, it is clear that it sought to resolve a political spillover between states that prevented them from unilaterally regulating the trusts. For the purpose of identifying the proper limits of Sherman Act jurisdiction, it is just as relevant to inquire into the nature and scope of this spillover today as it was in 1890. The most important change that has occurred in antitrust policy since 1890 is the level of understanding among courts and commentators about the economic effects of market power. That this should lead the Court to revise the limits of Sherman Act jurisdiction to better account for the underlying political spillover would seem uncontroversial.[123] Viewed from this perspective, the

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[118] See Little, *supra* note ?, text following nn. 9, 12, and 194. Also, see McLean. See Gavil, *supra* note ?, at 693, citing Mandeville, 334 U.S. 219, 229-35 (1948). See Gavil, supra note ?, at 695 and n. 167.

[119] Robert H. Bork, *Legislative Intent and the Policy of the Sherman Act*, 9 J. LAW & ECON. 7, 31-35 (1966) and Gavil atn. 114. *See, also*, Richard A. Epstein, *The Proper Scope of the Commerce Power*, 73 VA. L. REV. 1387, 1413 (1987).

[120] Easterbrook, at 41 n. 40.

[121] 21 Cong. Rec. 2456-57 (1890), quoted in Ga. L. Rev, at n. 110.

[122] Easterbrook, especially at 40-41. Easterbrook's view is that courts must resort to some substantive method for resolving the balance of dual sovereignty and competitive federalism provides a superior framework. Easterbrook does not use the term "competitive federalism," but his notion of the "economics of federalism" is virtually identical.

[123] Antitrust policy in the European Economic Union apparently follows the geographic market power test fairly closely. That is, authority over purely local restraints is left to the host country. Insert citation.

geographic market power test is a straightforward application of the Court's general dictum that the structure of antitrust law should evolve along with advances in economic understanding.[124]

A potential criticism of the geographic market power test is that it appears to depart from the Court's repeated dictum that Sherman Act jurisdiction is concurrent with expanding federal commerce jurisdiction. But the geographic market power test shows that this dictum is just that — unnecessary, inappropriate, and gratuitous. The outer limits of commerce clause jurisprudence has been shaped by situations in which "Congress itself has defined the specific persons and activities that affect commerce and therefore require federal regulation" have shaped the outer limits of federal commerce jurisdiction. On the other hand, "[t]he jurisdictional inquiry under general prohibitions like . . . §1 of the Sherman Act, turn[s] on the circumstances presented in each case and require[es] a particularized judicial determination."[125] In the civil rights cases, for example, the Court relied on both vertical and horizontal aggregation to establish federal commerce jurisdiction, but those findings were made in the context of Congress's specific pronouncement that racial discrimination in restaurants affects interstate commerce. Moreover, in the context of civil rights, and many other federal statutes tied to the Commerce Clause, an exact specification of the economic effect on interstate commerce caused by the evil the statute seeks to address has proven elusive. Under circumstances involving such dramatic political and legal uncertainty, it may be appropriate to resort to expansive and nebulous tests of federal commerce power, but where, as in antitrust, the nature of the economic effect on interstate commerce the statute seeks to address is subject to a particularized judicial determination economic theory should prevail.

## D. General Benefits of the Geographic Market Power Test

Perhaps the most obvious general benefit of the geographic market power test is that it reduces the problem of concurrent antitrust enforcement.[126] Subjecting all U.S. firms to federal enforcement by both the Department of Justice and the Federal Trade Commission, and to private civil actions, is troublesome enough without adding concurrent state enforcement.[127] As

[124] Insert citation.
[125] Scalia citing Gulf Oil Corp. v. Copp Paving Co., 419 U.S. 186, 197, n.12, (1974).
[126] Insert citations.
[127] Note that Microsoft first had to respond to the FTC, and once the FTC dropped the case the DOJ picked it up. In what other cases has this occurred?

to purely local restraints, the geographic market power test takes a first step toward limiting concurrent enforcement. It is worth noting that increasing globalization is fast reducing the relative size of the U.S. economy in world markets and subjecting U.S. firms to increasing competition from foreign firms. Increasing globalization no doubt has the effect of reducing the optimal scope of federal antitrust enforcement. In response, federal regulators inclined toward regulatory excess are likely to direct increasing attention to local markets, which, by definition, are largely insulated from the competitive effects of globalization.[128] The geographic market power test constrains any such excess in the face of what is a natural decline in the optimal scope of federal antitrust enforcement.

In his *Summit* dissent, Justice Scalia pointed out that *McLean* had left the lower federal courts in disarray over the issue of Sherman Act jurisdiction and that the *Summit* majority missed an opportunity to clear up the resulting confusion when it found in favor of federal jurisdiction. Since then, the lower courts have continued in disarray, with an unduly large number of suits aimed at purely local activities, many of which are arguably frivolous on either jurisdictional or substantive grounds. In a large number of these cases, plaintiffs succeed at the jurisdictional stage only to fail on the merits as a result of their inability to prove a substantive restraint of trade *among the several states*.

In *BCB Anesthesia Care, Ltd. v. Passavant Memorial Area Hosp. Ass'n* (1994),[129] the Seventh Circuit Court of Appeals affirmed the District Court's dismissal of a Sherman Act claim brought by a physician against a local hospital. Whereas the district court dismissed the case on jurisdictional grounds, the Seventh Circuit granted summary judgment on the merits, noting the large number of Sherman Act cases in which physicians sue hospitals in federal court for revoking their staff privileges only to suffer dismissal on the merits.[130] A similar case is *Brader*

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[128] The goods and services produced in purely local markets are best seen in the context of international trade as "nontraded goods." Increased competition in global markets should have less of an effect on the price and output of nontraded goods than on the price and output of traded goods.

[129] 36 F.3d 664 (7th Cir. 1994)

[130] 36 F.3d 664, 667 (7th Cir. 1994). *See e.g.,* Balaklaw v. Lovell, 14 F.3d 793 (2d Cir.1994) (affirming dismissal by District court of antitrust action by anesthesiologist challenging exclusive contract that excluded him from working at hospital); Flegel v. Christian Hosp., N.E. - N.W., 4 F.3d 682 (8th Cir.1993) (affirming dismissal of antitrust action against hospital by osteopaths denied privileges because they lacked certification from a particular organization); Capital Imaging v. Mohawk Valley Med. Assoc., 996 F.2d 537 (2d Cir.1993) (affirming dismissal of antitrust action by radiologists challenging exclusive contract by hospital in Albany and upstate New York that excluded the radiologists); Lie v. St. Joseph Hosp., 964 F.2d 567 (6th Cir.1992) (affirming dismissal of antitrust action by a physician whose surgical privileges were suspended); Tarabishi v. McAlester Regional Hosp., 951 F.2d 1558 (10th Cir.1991) (affirming dismissal of antitrust action against hospital by physician who opened up a

*v. Allegheny General Hosp.* (1995),[131] where the district court again dismissed the physician's Sherman Act claim on jurisdictional grounds. The Third Circuit Court of Appeals reversed, ruling that it was sufficient for the plaintiff simply to allege, without any evidentiary burden, that the defendant's activities were in or substantially affected interstate commerce. On remand, the district court granted summary judgment on the merits, and the Third Circuit affirmed on appeal.[132] The entire adjudication took an additional four years and no doubt consumed considerable private and public resources. Under the geographic market power test, these cases would be dismissed at the outset on jurisdictional grounds.

Consider *Hamilton Chapter of Alpha Delta Phi, Inc. v. Hamilton College*,[133] where a group of fraternities sued a private college that required all students to live in college housing and participate in the college meal plan. The district court dismissed the case on jurisdictional grounds.[134] The Second Circuit Court of Appeals reversed, finding that the College's activities had the necessary connection to interstate commerce because many of its students were nonresidents.[135] On remand, the district court dismissed on the merits for lack of market power.[136] Here, as in *Brader*, the final decision took four years from the initial dismissal on

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treatment center and the hospital greatly reduced his privileges); Oksanen v. Page Memorial Hosp., 945 F.2d 696 (4th Cir.1991) (affirming dismissal of antitrust action by physician who was suspended, put on probation and then terminated); Bhan v. NME Hospitals, 929 F.2d 1404 (9th Cir.1991) (affirming dismissal of antitrust action by anesthetist who was excluded by policy of allowing only physicians to perform anesthesia services); Todorov v. DCH Healthcare Authority, 921 F.2d 1438 (11th Cir.1991) (affirming antitrust action by physician who was denied radiology privileges); Morgan, Strand v. Radiology, Ltd., 924 F.2d 1484 (9th Cir.1991) (affirming dismissal of action by radiologists challenging exclusive contract); Nurse Midwifery v. Hibbett, 918 F.2d 605 (6th Cir.1990) (affirming dismissal of action by midwives and obstetrician allege they were prevented from operating a maternity practice or offering midwifery services at hospitals); Beard v. Parkview Hosp., 912 F.2d 138 (6th Cir.1990) (affirming dismissal of action by radiologist challenging exclusive contract); Ezpeleta v. Sisters of Mercy Health Corp., 800 F.2d 119 (7th Cir.1986) (affirming dismissal of action by anesthesiologist's privileges terminated); Goss v. Memorial Hosp. System, 789 F.2d 353 (5th Cir.1986) (affirming dismissal of action by physician whose privileges terminated); Konik v. Champlain Valley Physicians Hosp., 733 F.2d 1007 (2d Cir.1984) (affirming dismissal of action by anesthesiologist challenging contract); Dos Santos v. Columbus-Cuneo-Cabrini Med. Ctr., 684 F.2d 1346 (7th Cir.1982) (vacating preliminary injunction which was decided in favor of anesthesiologist challenging exclusive contract); Cogan v. Harford Memorial Hosp., 843 F. Supp. 1013 (D.Md.1994) (dismissing of action against hospital whose policy excluded unaccredited radiology center); Willman v. Heartland Hosp. East, 836 F.Supp. 1522 (W.D.Mo.1993) (dismissing action by physician excluded after peer review); Scara v. Bradley Memorial Hosp., 1993 WL 404150 (E.D. Tenn.) (dismissing action by anesthesiologist challenging exclusive contract); Miller v. Indiana Hosp., 814 F. Supp. 1254 (W.D.Pa.1992) (dismissing action by physician whose privileges terminated); Jackson v. Radcliffe, 795 F. Supp. 197 (S.D.Tex.1992) (dismissing action against hospital that terminated radiologist's contract).

[131] 64 F.3d 869 (3rd Cir. 1995).

[132] 167 F.3d 832 (3rd Cir. 1999)

[133] 128 F.3d 59 (2d Cir. 1997).

[134] Hamilton Chapter of Alpha Delta Phi, Inc. v. Hamilton College, 1996 WL 172652 (N.D.N.Y. 1996).

[135] 128 F.3d 59, 67 (2d Cir. 1997).

[136] Hamilton Chapter of Alpha Delta Phi, Inc. v. Hamilton College, 106 F.Supp.2d 406 (N.D.N.Y. 2000).

jurisdictional grounds but was finally decided on the basis of facts that could well have been used to defeat jurisdiction under the geographic market power test.[137]

In many Sherman Act claims brought today plaintiffs decline even to raise the issue of jurisdiction. Knowing the court will simply assume jurisdiction is satisfied, they proceed to a trial on the merits. In *County of Tuolumne v. Sonora Community Hosp.*,[138] for example, a family practice physician sued a local hospital, claiming the hospital's practice of granting the privilege to perform caesarian sections only to certified obstetricians or physicians passing rigorous special training violated the Sherman Act. The district court granted the hospital's motion for summary judgment, and the Ninth Circuit Court of Appeals affirmed. Nowhere in the decision is the issue of jurisdiction discussed, let alone adjudicated. In *Wagner v. Magellan Health Services, Inc.*,[139] a psychiatrist sued a managed care organization claiming it had blacklisted him in violation of the Sherman Act. The plaintiff alleged that the relevant geographic market was the town of Barrington, apparently in an effort to make the defendant's measured market share and likely market power appear large. The defendant in this case did not even bother to move for dismissal for lack of jurisdiction. Yet, the district court granted the defendant's motion for summary judgment. According to the court, the plaintiff's case failed on the merits because the market was entirely intrastate and therefore the alleged restraint was not, *in substance*, the kind prohibited by the Act.[140] The lesson from these cases is that defendants with legitimate jurisdictional claims would rather litigate on the merits outright than press their jurisdictional claims and face the uncertainty and expense of an appeal on jurisdictional grounds.[141]

These and many other cases suggests that Sherman Act defendants are being deprived of a nontrivial measure of due process rights with little corresponding benefit other than the opportunity for plaintiffs to extract concessions by engaging in costly discovery and then

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[137] *See, also,* Lifeline Ltd. No. II v. Connecticut General Life Ins. Co., 821 F.Supp. 1201 (E.D.Mich. 1993) (dismissing antitrust action based on merits but not on jurisdiction); Patel v. Scotland Memorial Hosp., 91 F.3d 132 (4th Cir. 1995) (affirming dismissal on ,merits and not on jurisdiction); Brown v. Our Lady of Lourdes Medical Center, 767 F. Supp. 618 (D.N.J. 1991) (dismissing on the merits but not on jurisdiction); Tropical Air Flying Services, Inc. v. Carmen Feliciano de Melecio, 158 F.Supp.2d 177 (D. Puerto Rico 2001) (dismissing antitrust action on merits but not on jurisdiction). *But see* Tice v. Hoff, 29 F.3d 634, (9th Cir. 1994) (affirming on jurisdictional grounds dismissal of claim because not too particular in alleging nexus with interstate commerce).

[138] 236 F.3d 1148 (9th Cir. 2001)

[139] 121 F.Supp.2d 673 (N.D. Ill. 2000).

[140] *See also* Levine v. Central Florida Medical Affiliates, Inc., 72 F.3d 1538 (11th Cir. 1996) (affirming dismissal on merits of antitrust action by physician against Orlando area hospital); Betkerur v. Aultman Hosp. Ass'n, 78 F.3d 1079 (6th Cir. 1996) (granting summary judgment with no discussion of jurisdiction).

proceeding to a full trial on the merits. In the physician termination cases, it is easy to imagine that hospitals have a legitimate stake in the conduct of their staff physicians but very difficult to imagine how a uniform national rule on the subject promotes consumer welfare in any way. With even a remote threat of treble damages, many defendants no doubt settle what should be considered frivolous federal claims. By establishing a clear and substantively reasoned basis for Sherman Act jurisdiction, the geographic market power test would prevent waste of judicial resources and restore defendants' due process rights. It holds out the prospect that the proper treatment of novel business practices can be more quickly and reliably discerned by allowing states to innovate their own rules where the resulting effects are completely internal to the state.

A virtual revolution in economic theory over the past 40 years has shown that competition leads private parties to choose the form of organization that internalizes, as far as possible, what would otherwise be economic market spillovers.[142] By allowing political competition between states to resolve any remaining internal spillovers according to local circumstances, the geographic market power test promises to hasten the rate at which antitrust law evolves toward the optimal treatment of alleged trade restraints. The weight of federal antitrust case law and commentary makes abundantly that clear considerable disagreement exists about the nature or effect of novel business practices. Federal courts have often failed to correctly assess many such practices, with a decidedly negative effect on consumer welfare during the interim. Examples include the Court's recent reversal of the per se rule against vertically imposed maximum prices, its earlier reversal of the per se rule against vertically imposed exclusive territories, and the advent of the characterization question to parse horizontal restraints that are unreasonable per se from those subject to a full reasonableness inquiry.[143] Even now federal courts are struggling with the proper application of the Sherman Act to horizontal aggregations in so-called "network industries," for which the optimal tradeoff between allocative and productive efficiency is far from clear.[144] This is not to criticize our federal courts

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[141] Mid-Michigan Radiology Associates, P.C. v. Central Michigan Community Hosp., 1995 WL 239360, (E.D.Mich. 1995).

[142] Cite Coase, Modigliani & Miller, Alchian, Alchian & Demsetz, Cheung, Barzel, North, . . .

[143] See State Oil. v. Kahn, 552 U.S. 3 (1997), GTE Sylvania, BMI v. CBS, respectively. The Court's tendency prematurely to condemn novel business practices under the per se rule is puzzling given the recognized judicial norm that the per se rule should apply only after the Court has had sufficient experience with the practice at hand to make an informed judgment regarding the probable effect on consumer welfare. See Arizona v. Maricopa County Medical Society, 457 U.S. 332 (1982).

[144] Cite Microsoft case; Stanley J. Liebowitz & Stephen E. Margolis, *The Fable of the Keys*, 33 J.L. & ECON. 1 (1990).

out of hand, it is simply to say that they have failed to preserve a federal system in which competitive state lawmaking could be mobilized to provide a more rapid information feedback mechanism as to the competitive effect on consumer welfare of novel business practices.

The question antitrust regulators face in reviewing horizontal arrangements under the consumer welfare standard is whether the associated productive efficiencies, if any, are likely to offset the allocative inefficiency from the creation of market power. Because horizontal mergers are likely to enhance productive efficiency by integrating productive activity, their net effect after accounting for allocative inefficiency may be to increase consumer welfare, and federal courts therefore address them under the rule of reason.[145] Horizontal arrangements that involve no apparent integration of productive activity are considered unlikely to generate productive efficiency, but, following the Court's recognition of the importance of properly characterizing practices that appear on the surface to constitute garden variety price fixing or other horizontal restraints, this presumption has changed.

Commentators now recognize that, even though they may generate market power, horizontal restraints may also generate offsetting productive efficiencies.[146] Unadulterated naked price fixing between rival firms with large market share is unlikely to generate productive efficiencies, but ever since the Court's decision in *U.S. v. Trenton Potteries* business combinations seldom come so neatly packaged. Many horizontal business arrangements designed to avert moral hazard, agency, or other incentive problems may appear at first glance to have the sole effect of generating market power for the participating firms, while on closer examination they are found to generate offsetting productive efficiencies. Syndicates formed by investment banks to market initial public offerings of corporate stock are one example,[147] vertically imposed resale price maintenance may be another,[148] vertically imposed exclusive territories between horizontally situated retailers are another, and copyright licensing arrangements yet another.[149]

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[145] One proxy for productive efficiency where an industry is composed of publicly traded corporations is the effect of the proposed merger on nonmerging firm's stock price. If these firms' stock prices decline in response to an unanticipated merger announcement, the inference — assuming the antitrust agencies properly decline to challenge the merger — is that the proposed merger will reduce the merged firm's production costs and make it a more aggressive competitor. If these firm's stock prices increase, on the other hand, the inference is that they will be the fortunate beneficiaries of market power created by the merging firms.
[146] Insert citation.
[147] See U.S. v. Morgan Stanley, 118 F. Supp. 621 (1953).
[148] See Lester Telser, *Why Should Manufacturers Want Fair Trade*, 3 J. LAW & ECON. 86 (1960).
[149] See Broadcast Music Inc. v. CBS, 441 U.S. 1 (1979).

Although courts have yet to formally adopt a full reasonableness inquiry for horizontal restraints, they have done so where the restraint nonprice restraints are vertically imposed.[150] But even for pure horizontal restraints, including price restraints, where the participating firms' combined market share is small and increasing over time a compelling case can be made that, absent the use of exclusionary practices, the arrangement generates productive efficiencies that outweigh any allocative efficiency from the creation of market power. Otherwise, the participating firms' combined market shares would decline over time as rivals expand production and undercut prices. By promoting inter-jurisdictional competition over optimal antitrust policy, the geographic market power test will more quickly resolve any uncertainties regarding the proper treatment of novel business practices.

One need not look very far to find evidence that state competition over antitrust policy will improve the judicial treatment of novel business practices. Recall the *Mandeville* case, for example, where the defendant and its alleged co-conspirators sold their sugar into a national market in which their market share was so small that they could not possibly have influenced prices. As beet buyers, they may have enjoyed market power in northern California that allowed them to impose a monopsony underpayment on beet growers. But together with substantial evidence that sugar refining is subject to various incentive problems resulting from economic spillovers — including the difficulty of measuring sugar beet quality and the attendant moral hazard — the plaintiff's willingness to enter into the challenged contract ex ante raises at least a modicum of doubt that the contract constituted a naked restraint.[151] More than likely, the agreement there was designed to internalize an economic spillover that otherwise would have resulted in resource misallocation. Given that the market for sugar beets was entirely local, with no possibility that a monopsony underpayment could spill across state lines, *Mandeville* stands as a poster child for the geographic market power test. By allowing the states to "perform their role as laboratories for experimentation . . . where the best solution is far from clear,"[152] the

[150] The Court applied this reasoning in overturning the per se rule against vertical division of territories in Continental TV v. GTE Sylvania, 433 U.S. 36 (1977).
[151] See Jeanine Koenig Balbach, *The Effect of Ownership on Contract Structure, Costs, and Quality: The Case of the U.S. Beet Sugar Industry*, THE INDUSTRIALIZATION OF AGRICULTURE: VERTICAL COORDINATION IN THE U.S. FOOD SYSTEM (Edited by Jeffrey S. Royer and Richard T. Rogers) (Brookfiled USA, Singapore, Sydney: Ashgate: 1998) and Jeanine Ruth Koenig, VERTICAL INTEGRATION AND CONTRACTS: APPLICATION TO THE U.S. BEET SUGAR INDUSTRY (unpublished Ph.D. dissertation, Washington University Department of Economics, 1996).
[152] Lopez, at 581.

geographic market power test ensures that the entire body of antitrust law, both state and federal, will iterate more quickly toward the optimal set of legal rules.

## V. CONCLUDING REMARKS

*"Choose your rut carefully, you may be in it for a long time."*[153]

The Court's recent decisions in *Lopez*, *Morrison*, and *Solid Waste* suggest that a majority of the justices are anxious to establish a clear and substantively reasoned basis for resolving the balance of dual sovereignty under the Commerce Clause. In part, this appears to reflect the Court's discomfort over its inability to bound the substantial effects test. As Justice Thomas stated in his *Lopez* concurrence,"[i]n an appropriate case, I believe that we must further reconsider our 'substantial effects' test with an eye toward constructing a standard that reflects the text and history of the Commerce Clause without totally rejecting our more recent Commerce Clause jurisprudence."[154] The question is how? Although the geographic market power test is concerned solely with the limits of statutory Sherman Act jurisdiction, in our view it provides a potentially useful template for limiting general Commerce Clause jurisdiction.

By focusing on the substantive nexus between the underlying evil addressed by the Sherman Act — the exercise of market power — and the likely geographic extent of any associated spillover, our test effectively limits antitrust plaintiffs' reliance on horizontal and vertical aggregation and the nebulous but-for approach to demonstrate a substantial effect on interstate commerce. In the framework of competitive federalism, practical antitrust economics as developed by courts, commentators, and the antitrust agencies provides the substantive nexus necessary to bound the substantial effects test for Sherman Act jurisdiction. Over time, advances in economic understanding can be used to identify the substantive nexus, if in fact one exists, between interstate commerce and Congress's goal in enacting virtually any regulatory statute. It is this substantive nexus in the framework of competitive federalism that promises to render the substantial effects test workable. Since the Commerce Clause is inherently concerned with

[153] South Dakota farm-road sign.
[154] Lopez, 585 (Justice Thomas concurring).

economic activity, it is entirely appropriate that its application should be guided by economic understanding.

Our approach to resolving the balance of dual sovereignty responds directly to Justice Thomas's concern in *Lopez* regarding the Court's unbounded application of the substantial effects test. Thomas was careful to point out that Marshal's opinion in *Gibbons* said only that Congress cannot regulate commerce completely internal to the states, and not that Congress can necessarily regulate all commerce that has even a remote effect outside the state. In our view, Congress should have the authority to regulate only those activities whose effects bear a substantive nexus to the underlying economic market failure addressed by the statute and that substantially spill across state lines such that the states, acting alone, would be unlikely to correct problem. This approach excludes from Congressional regulatory authority economic spillovers the states are able to address on their own, even though in some nebulous but-for sense these spillovers might have a substantial effect on interstate commerce.

Under this approach, the charge to Congress in passing Commerce Clause regulation should be to identify what it believes to be an economic market failure common to more states than one and to make a plausible case that the states, acting independently, face a political market failure precluding them from correcting the problem. This would provide the Court with a substantive basis for assessing whether the regulation falls within Congress's constitutional authority. The Court could then review the regulation under the rational basis or strict scrutiny test, giving due deference to Congress, and uphold it, strike it down, or enforce it to the extent necessary to achieve legitimate Congressional ends. Of course, Congress is unlikely to be able to identify the exact economic nature of the market failure in any given situation, just as it was unable to do when it passed the Sherman Act. But competitive federalism provides a sufficiently broad framework that the Court could nevertheless make an initial assessment that political competition between states is unlikely to resolve the problem as Congress has identified it and then to articulate the proper limits of Congress's regulatory response as it gains additional experience with the subject, quite possibly guided by concurrent advances in economic understanding.

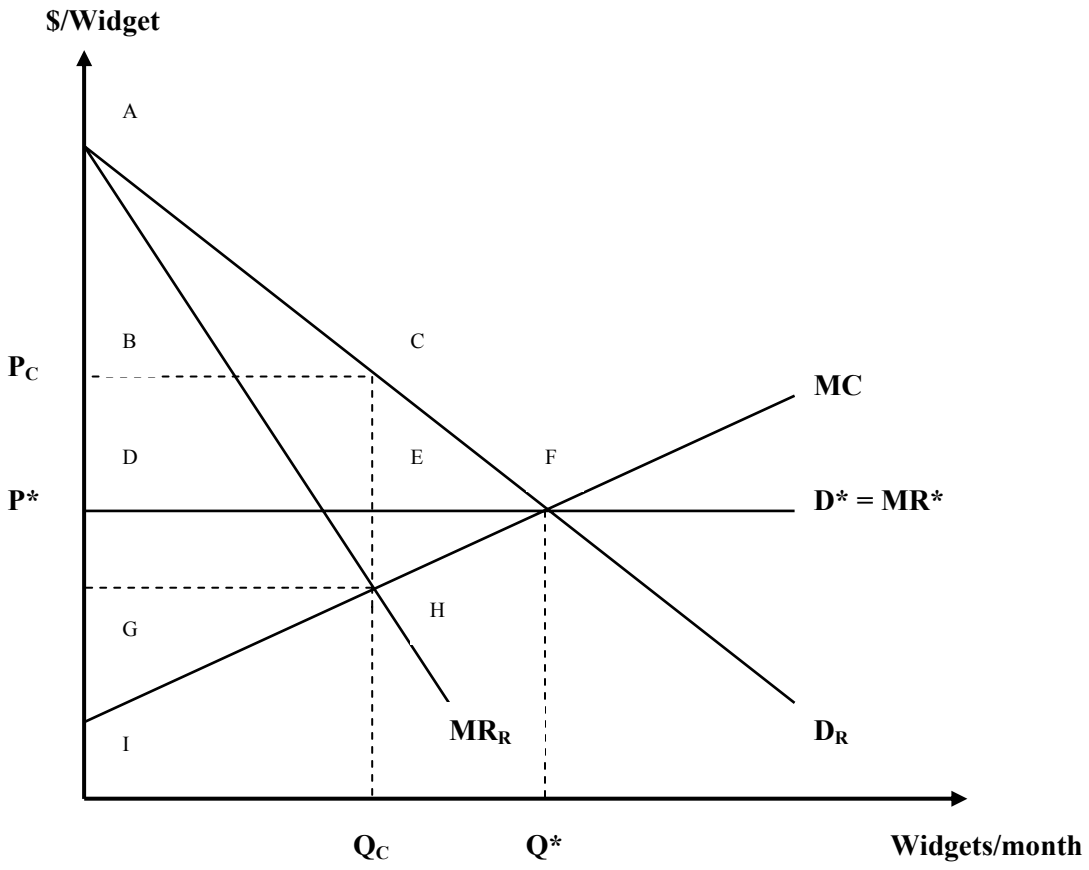


**FIGURE 1. — Market Power**

**FIGURE 2. — Hypothetical Monopolist Test Island Economy**