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# **THE CHICAGO SCHOOL, TRANSACTION COST ECONOMICS AND THE ROBERTS COURT'S ANTITRUST JURISPRUDENCE**

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*The Chicago School, Transaction Cost Economics and the  
Roberts Court's Antitrust Jurisprudence*

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The Roberts Court's reign at the United States Supreme Court is only in its nascent stages. Already, however, its antitrust activity level has far exceeded the Court's single case average prior to the 2003-04 Term by a significant margin. This flurry of antitrust activity, combined with an apparent willingness to reconsider long-established precedents that conflict with modern antitrust theory, suggests that the Roberts Court will play a relatively significant role in shaping antitrust doctrine for years to come.

The recent flurry of antitrust activity and the likely significance the Roberts Court will have on the development of antitrust jurisprudence warrants some reflection and analysis. In the decades prior to the Roberts Court's first Term, antitrust jurisprudence could be summarily, but accurately, described as slowly but surely absorbing the insights of the Chicago School and New Institutional Economics: per se prohibitions against vertical restraints gave way to rule of reason analysis, the 'per se' rule against tying softened, hostility to vertical integration and predatory pricing all but disappeared, and the law incorporated a more sophisticated understanding of the procompetitive uses of exclusive dealing contracts. As courts increasingly incorporated the lessons of the Chicago School contributions of the 60s, 70s, and 80s, the hostility toward various business practices was relaxed in favor of a rule of reason approach that

placed evidentiary burdens on plaintiffs to demonstrate these practices would generate anticompetitive effects (Wright 2007a).

Identifying the economic influences underlying a court decision is a difficult task. But that task is rendered impossible without some guidelines as to what the author intends when he claims that a particular set of decisions is influenced by the Chicago School, transaction costs economics (TCE), or New Institutional Economics (NIE). In that spirit, some definitions and disclaimers are in order. First, the Chicago School's history and its influence on antitrust is well documented (Bork, 1978; Posner, 1979; Kitch, 1983; Page, 1989; Meese, 1997; Kovacic and Shapiro, 2000). Professors Jonathan Baker and Timothy Bresnahan (2006) usefully decompose the Chicago School's influence on antitrust into two separate components. The first component, 'the Chicago School of industrial organization economics,' consists of the work in industrial organization economics that aimed, and succeeded, at debunking the structure-performance-conduct paradigm and its hypothesized relationship between market concentration and price or profitability (see, e.g., Brozen, et al., 1982; Goldschmid et al. eds., 1974).<sup>1</sup> The second component, 'the Chicago School of antitrust

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<sup>1</sup> Especially influential in the dismantling of the structure-conduct-performance hypotheses was UCLA economist Harold Demsetz (1974), whose work was central to exposing the misspecification of this relationship in previous work by Joe Bain and followers, as well as

analysis,' primarily (but not exclusively) contributed empirical work in the form of case studies demonstrating that various business practices previously considered manifestly anticompetitive could be explained as efficient and procompetitive. The second component's basic features of are generally attributable to the work of Aaron Director (see Newman ed., 1998; Peltzman, 2005) and others from 1950 to the mid 1970s (see, e.g., Bork 1954; Director and Levi, 1956; Bowman, 1957; McGee, 1958; Tesler, 1960). A group of eminent antitrust scholars, such as Richard Posner, Robert Bork, and Frank Easterbrook, followed in Director's footsteps, building on these studies and economic analysis and advocating bright-line presumptions, including, but not limited to, *per se* legality. Antitrust liability rules, Chicago School scholars argued, should reflect the competitive reality and economic consensus that the marketplace produced many contracts, but few that would systematically produce anticompetitive effects.

This is not to say that the Chicago School's contributions to antitrust economics were completed by the 1970s, or inappropriately to imply that they

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offering efficiency justifications for the observed correlation, which is that firms with large market shares could earn high profits as a result of obtaining efficiencies, exploiting economies of scale, or creating a superior product. The contributions of Demsetz and other participants in the famous Airlie House Conference are discussed by Timothy J. Muris (1997).

were limited to the ultimate rejection of the structure-conduct-performance paradigm. For example, 'Chicago School' industrial organization economists have continued to contribute to our economic understanding of various business practices, despite the fact that developments in industrial organization economics for the past 20 years have relied primarily on game-theoretic modeling techniques. Recent Chicagoan contributions to antitrust economics include work on exclusive dealing (Marvel, 1982; Klein and Lerner, 2007), slotting contracts (Klein and Wright, 2007; Wright, 2007b; Wright, 2006) and vertical restraints theory (Klein and Murphy, 1988).

The Chicago School's influence on antitrust law and policy has been substantial, particularly in the Supreme Court. Supreme Court decisions such as *Sylvania* (1977), *Khan* (1997), *Trinko* (2004) and *Brooke Group* (1993) were influenced by Chicago School thinking, not to mention the development of the 1982 *Horizontal Merger Guidelines* by Assistant Attorney General William Baxter. Indeed, the 1970s and 1980s were marked by a dramatic shift in antitrust policies, a significant reduction in agency enforcement activity levels, and calls from Chicago School commentators for the use of bright line presumptions (e.g., Easterbrook, 1984), per se legality of vertical restraints (Posner, 1981), and even repeal of the antitrust laws altogether (e.g., Armentano, 1986).

Richard Posner (1979) has described the key distinguishing feature of Chicago School antitrust analysis as its unique view of antitrust policy ‘through the lens of price theory.’ While there is no doubt that neoclassical price theory is a fundamental building block of Chicago School antitrust analysts, it should be also be noted that the Chicago School approach has not been limited to applying the model of perfect competition.<sup>2</sup> Chicagoans have also incorporated the insights of NIE and its focus on comparative institutional analysis and transaction costs. For example, Benjamin Klein has integrated the insights of transaction cost economics to explain a number of contractual arrangements such as resale price maintenance, tying, block booking, exclusive dealing, and slotting contracts (Klein, 1980, 1999; Klein and Kenney, 1983; Klein and Lerner, 2007; Klein and Murphy, 1988, 1998, 2008; Klein and Saft, 1985; Klein and Wright, 2007).<sup>3</sup> TCE, as Joskow (2002) notes, ‘has always had a policy dimension as well, especially applications to antitrust and competition policies.’ The most prominent non-Chicagoan contributor to TCE has been Oliver Williamson, beginning with his seminal work, *Markets Versus Hierarchies: Analysis and Antitrust Implications*, and in later work (Williamson, 1975, 1985, 1996).

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<sup>2</sup> Chicagoans themselves were among the first to criticize reliance on the model of perfect competition as a useful benchmark for antitrust analysis (Demsetz, 1991).

<sup>3</sup> On Klein’s contributions to law and economics more generally, see Wright (2008).

There are some important general differences between the Chicago School and TCE contributions to antitrust analysis, with the latter focusing its efforts almost exclusively on how transacting parties mitigate ex ante contracting costs associated with the potential for hold up with vertical integration and other non-standard arrangements (Joskow, 2002). These insights have been critical in relaxing some of the hostility antitrust regulators and courts demonstrated toward vertical integration, franchising and other vertical restraints through the 1960s. Both Chicago School and TCE analysts have both made giant strides toward producing a modern antitrust policy that is no longer systematically economically incoherent.

However, as discussed in greater detail below, the growing Post-Chicago School (PCS) movement in the economic literature and the antitrust community more broadly has become a strong force that would restore, with more rigorous economics and modeling, at least some of the hostility towards vertical arrangements observed in the 1960s. Joskow (2002) describes the tension in the TCE and PCS literatures:

At the present time TCE and [PCS] and are like ships passing in the night.

The development of sound antitrust legal rules and remedies would benefit from integrating these approaches and realizing that they are complements rather than substitutes. Otherwise [PCS] runs the risk of

returning us to the 1960s antitrust treatment of nonstandard vertical arrangements.

The quote could accurately describe the interaction between PCS economics and both the Chicago School and TCE literatures. Indeed, it is the powerful combination of both Chicago School and TCE insights that have been the driving force behind what I describe here as the 'Chicago School/TCE' revolution in antitrust.

Conventional wisdom predicted that the PCS economics movement, which is favored in most economics departments around the country (and in top economic journals), would soon result in a paradigm shift in antitrust. PCS is the leading alternative to the Chicago School approach (see Baker, 2002). The PCS challenged the conditions under which well-known Chicago School results, such as the single-monopoly-profit theorem, held. Indeed, authors in the PCS movement produced a series of models in which a monopolist in one market has the incentive to monopolize an adjacent product market (see, e.g., Whinston, 2000). PCS economists also created a literature focusing on possible vertical foreclosure. This raising rivals' costs strand of literature has become the most influential PCS contribution, and has provided a theoretical framework for a number of theories exploring the possibility of anticompetitive effects of various exclusionary business practices (Salop, 1986). For example, such theorems have

been produced to demonstrate that it is possible for tying (see, e.g., Whinston, 2000; Carlton and Waldman, 2002; Kobayashi, 2005), exclusive dealing (Rasmusen, Ramseyer and Wiley, 1991; Bemheim and Whinston, 1998; Simpson and Wickelgren, 2007), and predatory pricing (Bolton, Brodley and Riordan, 2000)<sup>4</sup> to generate anticompetitive effects under certain conditions, including an assumed absence of any procompetitive justifications for the conduct examined (Kobayashi, 1997; Evans and Padilla, 2005).

It momentarily appeared that the PCS movement would indeed claim its victory in 1992 when the Supreme Court issued its decision in *Eastman Kodak Co. v. Image Technical Services, Inc.* (1992).<sup>5</sup> *Kodak* allowed an aftermarket tying claim to survive summary judgment based largely on the PCS theory that competition in the equipment market would not be sufficient to protect consumers who did not have complete information in the aftermarket. However, *Kodak* failed to start a PCS revolution in antitrust jurisprudence and was not more than a hiccup in the Chicago School march. Further, the Supreme Court's most recent tying

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<sup>4</sup> These arguments were endorsed by the Department of Justice in *United States v. AMR Corp.* See Brief for the Appellant United States of America, *United States v. AMR Corp.* (2003).

<sup>5</sup> In aftermarket 'lock-in' cases most closely resembling the Post-Chicago theories in *Kodak*, lower courts have 'bent over backwards to construe *Kodak* as narrowly as possible' (Hovenkamp, 2002, p. 8; Klein, 1996).

decision in *Independent Ink, Inc. v. Illinois Tool Works, Inc.*, which unanimously rejected the presumption that a patent warranted a presumption of antitrust market power in tying cases, failed to mention or even cite *Kodak* in passing.

So what would be the economic underpinnings of the Roberts Court's antitrust jurisprudence? Would it reflect the Chicago School and transactions cost-based approach that has dominated legal scholarship and antitrust jurisprudence for the past several decades? Or would the Roberts Court be influenced by the newer, game theoretic PCS scholarship and trigger the regime change that had been anticipated? After all, the country's top economics departments were producing industrial organization theorists who developed PCS models.

The somewhat surprising answer, in my view, is that the Roberts Court's antitrust jurisprudence has clung tightly to and been heavily influenced by the Chicago School and TCE approaches to antitrust analysis.<sup>6</sup> This development is surprising for several reasons. First, the Supreme Court's jurisprudence, as discussed, has been historically linked to advances in mainstream economics with some time lag. Because recent advances leading up to the Roberts Court's

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<sup>6</sup> Wright (2007a) elaborates and provides support for this claim. Some disagree. For example, Elhaage (2007) argues that the Roberts Court's antitrust jurisprudence reflects a distinctively Harvard School approach.

first term had consisted primarily of the PCS variety, it is somewhat of a surprising development that the Court so strongly embraced Chicago School and TCE economics. Further, despite the fact that Chief Justice Roberts and Justice Alito were presumed to be conservative antitrust thinkers, there was little evidence from their prior judicial output or litigation experience that either would exercise any distinctively 'Chicagoan' or TCE influence on the Court's jurisprudence.<sup>7</sup> Finally, PCS theoretical contributions had been becoming increasingly popular in the increasingly international antitrust community, and had caught the eye of foreign regulators, especially in Europe. Despite the convergence of these forces in favor of a 'Post-Chicago Revolution,' the Roberts Court's antitrust output for the 2006-07 Term strongly demonstrates the Chicago and TCE influence in the Court's analytical approach.<sup>8</sup>

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<sup>7</sup> In a law review article, Justice Roberts (1994) had praised the Supreme Court for 'regain[ing] its equilibrium after the dizzying Kodak decision of two Terms ago' with the three decisions in the 1992-93 Term where the Court 'returned to a regime in which the objective economic realities of the marketplace take precedence over fuzzy economic theorizing or the conspiracy theories of plaintiffs' lawyers. This is bad news for professors and lawyers, good news for business.'

<sup>8</sup> I will discuss three of the four antitrust decisions the Court decided in the 2006-07 Term. I omit *Credit Suisse Securities (USA) LLC v. Billing* (2007), which involved the Court's implied preemption of antitrust in favor of securities regulation in the context of allegations involving

Consider first the Supreme Court's most controversial decision, at least if controversy is measured by vote count, in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.* (2007). *Leegin* is a typical resale price maintenance (RPM) case involving a terminated dealer. The plaintiff, PSKS, operated a women's apparel store in Texas. The defendant, Leegin, manufactures and distributes a number of leather goods and accessories including handbags, shoes, and jewelry under the 'Brighton' brand name. In 1997, Leegin introduced its RPM program, the 'Brighton Retail Pricing and Promotion Policy,' a marketing initiative under which it would sell its products exclusively to those retailers who complied with the suggested retail prices. When Leegin learned that PSKS was discounting the Brighton product line below the suggested retail prices, Leegin terminated PSKS and PSKS, in turn, filed suit alleging that Leegin's new marketing and promotion program violated the Sherman Act. The trial court found Leegin's policy per se illegal under the standard set forth in the Supreme Court's *Dr. Miles* decision. The jury awarded a US\$1.2 million verdict that was upheld by the United States Court of Appeals for the Fifth Circuit.

Justice Kennedy authored the Supreme Court's majority opinion, reversing the Fifth Circuit. He was joined by Justices Scalia, Thomas, Roberts,

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conspiracy and manipulation of the IPO underwriting process. Wright (2007) discusses *Credit Suisse* in greater detail.

and Alito. Justice Kennedy's analysis largely adopted the argument offered by both the antitrust agencies and a group of economists in amicus briefs filed in support of Leegin and in favor of overturning *Dr. Miles* and evaluating minimum RPM under a rule of reason standard. Justice Kennedy's majority opinion offers four central points: (1) per se analysis is reserved for restraints that, echoing the language of *Sylvania*, 'always, or almost always, reduce consumer welfare by limiting competition and output;' (2) economic theory strongly suggests that RPM does not meet that stringent standard; (3) empirical evidence comports with economic theory on RPM; and (4) stare decisis rationales for continuation of a per se rule and adhering to *Dr. Miles* are unpersuasive.

The majority launched their attack on *Dr. Miles* with a reminder that the rule of reason, and not per se analysis, is the appropriate default rule for antitrust analysis of any economic restraint, and deviation from this default is warranted only when the restraint is known to be 'manifestly anticompetitive' and 'would always or almost always tend to restrict competition and decrease output.' Measured against this standard, and after a review of the theoretical justifications for RPM and the empirical evidence concerning its competitive effects, Justice Kennedy found the case for continued application of the per se rule profoundly lacking. Importantly, from an economic perspective, the majority did not limit its discussion of justifications for RPM to the conventional discount

dealer free-riding story. Instead, it finds the literature ‘replete with pro-competitive justifications’ and notes the consensus on this point amongst economists.

Significantly, the majority also recognizes that RPM might be used to encourage retailer services even where inter-dealer free-riding is not possible.<sup>9</sup> While recognizing the potential for RPM to produce anticompetitive effects by facilitating collusion, the majority finds that the empirical literature suggests that efficient uses of RPM are not ‘infrequent or hypothetical,’ and, therefore, the standard for applying the per se rule has not been satisfied. *Leegin* at least temporarily symbolizes the end of the era of hostility towards vertical restraints and relies extensively on a Chicago School/ TCE approach, as well as a more general sensitivity to the social welfare consequences of antitrust false positives. However, the per se rule lives on through state antitrust regulation, and federal legislation is pending that would revive *Dr. Miles*.

In *Bell Atlantic Corp. v. Twombly* (2007), the Roberts Court took the opportunity to clarify the pleading requirements under Section 1 of the Sherman

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<sup>9</sup> This argument has long been accepted in the economics literature, first introduced in Klein & Murphy (1988), and later formalized in Mathewson & Winter (1998). Until *Leegin*, antitrust analysis had focused primarily on Telser’s (1960) pathbreaking but narrow ‘discount dealer’ free-riding analysis which did not explain many uses of RPM observed in practice.

Act. The plaintiff class alleged that four major local exchange carriers—Bell Atlantic, Bell South, Qwest Communications International, and SBC (known as Incumbent Local Exchange Carriers or ILECs)—colluded to block competitive entry by Competitive Local Exchange Carriers (CLECs) pursuant to the framework established by the 1996 Telecommunications Act, which required the incumbent carriers to sell local telephone services at wholesale rates, lease unbundled network services, and permit interconnection. The allegations themselves consisted of claims that the defendants agreed not to enter each other's territories as CLECs and to jointly prevent CLEC entry altogether.

The district court found that these allegations amounted simply to assertions of parallel conduct and, as such, were vulnerable to dismissal, pursuant to the defendants' Federal Rule of Civil Procedure 12(b)(6) motions, without allegations of additional 'plus factors,' such as those required at the summary judgment stage. The Second Circuit reversed unanimously, despite some hesitation and concern regarding the 'sometimes colossal expense' of discovery in complex antitrust cases, and held that Federal Rule of Civil Procedure 8(a) did not require allegations of the 'plus factors' required to survive summary judgment.

Justice Souter authored the 7-2 majority opinion holding that 'stating [a Section 1 claim] requires a complaint with enough factual matter (taken as true)

to suggest that an agreement was made . . . [This requirement] simply calls for enough fact to raise a reasonable expectation that discovery will reveal evidence of illegal agreement.’ The majority clarifies that allegations of parallel conduct alone are not sufficient to survive the pleading stage, ‘retiring’ and rejecting the ‘no set of facts’ formulation favored by *Conley v. Gibson*, despite the conventional rule disfavoring motions to dismiss in antitrust cases. The Court’s rationale for increasing a plaintiff’s pleading burden in antitrust conspiracy cases is explicitly motivated by the desire to avoid the extraordinary costs of discovery unless there is good reason to believe that an agreement will be unearthed. Applying the new plausibility standard to plaintiffs’ claims was relatively straightforward as the allegations consisted of parallel conduct alone and no independent allegation of an actual agreement among the ILECs. While *Twombly*’s full implications are yet to be realized, concerns with false positives in Section 1 cases and the massive social costs of discovery motivated the Court to increase an antitrust plaintiff’s pleading burden. *Twombly* reflects the Roberts Court’s implicit, and correct, view that there were a host of procompetitive reasons why the ILECS would stay out of each others territories that had nothing to do with anticompetitive collusion.

In *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*,<sup>10</sup> the Court tackled the issue of identifying the appropriate standard for ‘predatory buying’ claims under Section 2 of the Sherman Act. Ross-Simmons, a saw mill in the Pacific Northwest, alleged that Weyerhaeuser overpaid for alder sawlogs in a scheme designed to drive its rivals out of business. The district court instructed the jury that Ross-Simmons was required to prove that Weyerhaeuser engaged in ‘conduct that has the effect of wrongly preventing or excluding competition or frustrating or impairing the efforts of the firms to compete for customers within the relevant market.’ With respect to the ‘predatory buying’ allegation specifically, the district court instructed the jury that finding Weyerhaeuser ‘purchased more logs than it needed or paid a higher price for logs than necessary, in order to prevent Ross-Simmons from obtaining the logs [it] needed at a fair price’ was sufficient to conclude that an anticompetitive act had occurred.

The jury found in favor of Ross-Simmons and awarded US\$78.7 million. The United States Court of Appeals for the Ninth Circuit affirmed the judgment, despite Weyerhaeuser’s contention that the district court erred by not including both the pricing and ‘recoupment’ prongs of the conventional *Brooke Group*

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<sup>10</sup> The author participated in this case as a signatory to the Law Professors’ Amicus Brief in Support of Petitioner (filed Aug. 24, 2006).

standard in the jury instruction. The DOJ and FTC petitioned the Supreme Court for certiorari and submitted joint amicus briefs recommending that the Court apply the *Brooke Group* standard to predatory buying.

Justice Thomas authored the unanimous decision on behalf of the Supreme Court, agreeing with the position the enforcement agencies advocated and reflecting much of the insight of the Chicago School/ TCE learning with respect to predatory pricing. Justice Thomas wrote that in predatory buying cases, plaintiffs must demonstrate both that the buyer's conduct led to below-cost pricing of the buyer's outputs and that the buyer 'has a dangerous probability of recouping the losses incurred in bidding up input prices through the exercise of monopsony power.' Because Ross-Simmons conceded that it had not satisfied the *Brooke Group* standard, the Court vacated the Ninth Circuit's judgment and remanded the case.

The Supreme Court's endorsement of the *Brooke Group* standard appears to rest on three principles that suggest the Court adopted the Chicago School/ TCE learning on predatory pricing. First, the Court drew attention to the fact that 'predatory-pricing and predatory-bidding claims are analytically similar' as a matter of economic theory, suggesting that similar legal standards are appropriate. Second, the Court espouses a view that the probability of successful predatory buying, like predatory pricing, is very low, in part because of the

myriad of explanations for 'bidding up' input prices in an effort to increase market share and output, hedge against price volatility, or as a result of a simple miscalculation. Finally, the Court notes that, like low output prices, higher input prices may result in increased consumer welfare as firms increase output. While the Supreme Court does not take the lower court to task for allowing this jury instruction, there is little, if any, doubt that the Supreme Court was correct to reverse the Ninth Circuit's affirmation of a disastrous jury instruction that would require a determination as to whether a firm purchased more inputs than it 'needed' or paid more than 'necessary.' Rather, the Supreme Court focused almost exclusively on the theoretical similarities between predatory pricing and buying, the attributes of the *Brooke Group* standard, and why the economic similarity should translate into symmetrical legal treatment.

These cases, taken together, embody an approach to antitrust analysis that is consistent with the lessons of the Chicago School/ TCE approach. First, the cases clearly favor price theory and NIE over the formal game theoretic contributions of the PCS literature. Second, the Roberts Court decisions embrace the principle of institutional modesty for antitrust. Each of the three decisions is motivated, at least in part, by the possibility of chilling procompetitive conduct by erroneously assigning liability to efficient conduct. A corollary is that the Court, again in each of the cases but especially *Leegin*, is sensitive to what is

known and unknown about the competitive effects of RPM and other contractual arrangements. The combined affinity for price theory and TCE, emphasis on empiricism and knowledge, and institutional modesty in light of the potential for significant error costs follow directly from Chicago School/ TCE analytical principles.

The economic rationalization of antitrust is one of the great success stories of the law and economics movement and was motivated, in large part, by the contributions of Chicago School/ TCE economics. Perhaps the overwhelming analytical and explanatory power of the Chicago School/ TCE approach, in combination with the fact the PCS model has been heavily criticized for its failure to produce testable implications, is responsible for the Roberts Court's somewhat surprising adherence to these principles in the face of strong forces to abandon them in favor of the PCS model. Nonetheless, antitrust jurisprudence stands at an interesting crossroad as antitrust economics, especially in top economics departments and journals, becomes more mathematically formal and less accessible to generalist judges. These trends might give one reason to believe that the once solid Chicago School/ TCE foundation of antitrust analysis might finally be starting to crack. However, the Roberts Court's antitrust jurisprudence, combined with the relative youth of its recent additions, suggests

a significant amount of skepticism is appropriate concerning any prediction of the demise of the Chicago School or TCE in antitrust in the coming years.

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