02: Horizontal agreements

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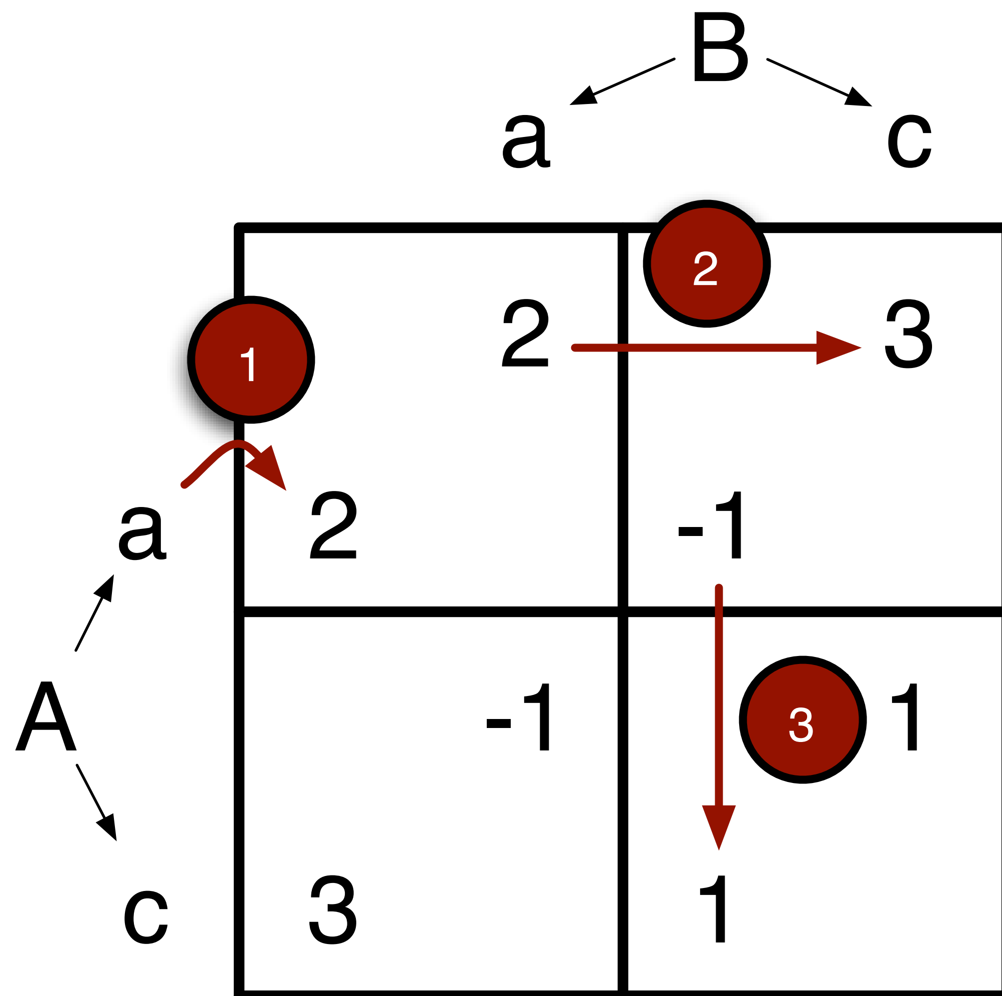
Cartel basics

The two basic cartel problems

1. Keep your friends in
   - Maintain the agreement – few firms, barriers to entry (e.g., IP), personal trust
   - Maintain the incentives – price fixing, production quotas, compensation mechanism
   - Monitor performance – transparent pricing, RPM, government involvement (e.g., import/export statistics, certificates of need)
   - Punish cheating – excess capacity, multi-market contacts
2. Keep everyone else out
   - Maintain entry barriers (e.g., exclusive cross licenses)
   - Predatory pricing in the entrant's "home market"
   - Limit pricing

In theory, “keeping your friends in” should be next to impossible



1. A moves first and agrees (a) to a price fixing arrangement. Payoff for A and B (2,2)
2. B can improve its payoff from 2 to 3 by cheating/competing (c)
3. A, having been pushed into the NE quadrant, can improve its payoff from -1 to 1 by cheating/competing
4. A and B are stuck in the SE quadrant (1,1). Every unilateral move yields a lower payoff (-1,-1)

- The more successful the group is at raising prices, the greater the individual incentives to cheat
- But – international cartels have an average lifespan of 6 years!

Market allocation v. price fixing

- There are three basic forms of market allocation
  - By territory: “You get Greece, I get Spain.”
  - By customer: “You sell to universities, I sell to businesses.”
  - By time: “You bid for this project, I bid for the next.” (bid rigging)
- Market allocation is worse than price fixing
  - Market allocation rules out *all* competition, while price fixing allows for competition on quality and other non-price dimensions
  - Market allocation is much easier to police than a price fixing agreement. Sales into someone else’s territories or “house accounts” are easier to detect than price shaving via intransparent discounts
  - Territorial market allocation delays the formation of a common market, which is a “trade law” objective of many antitrust regimes (EU, China)

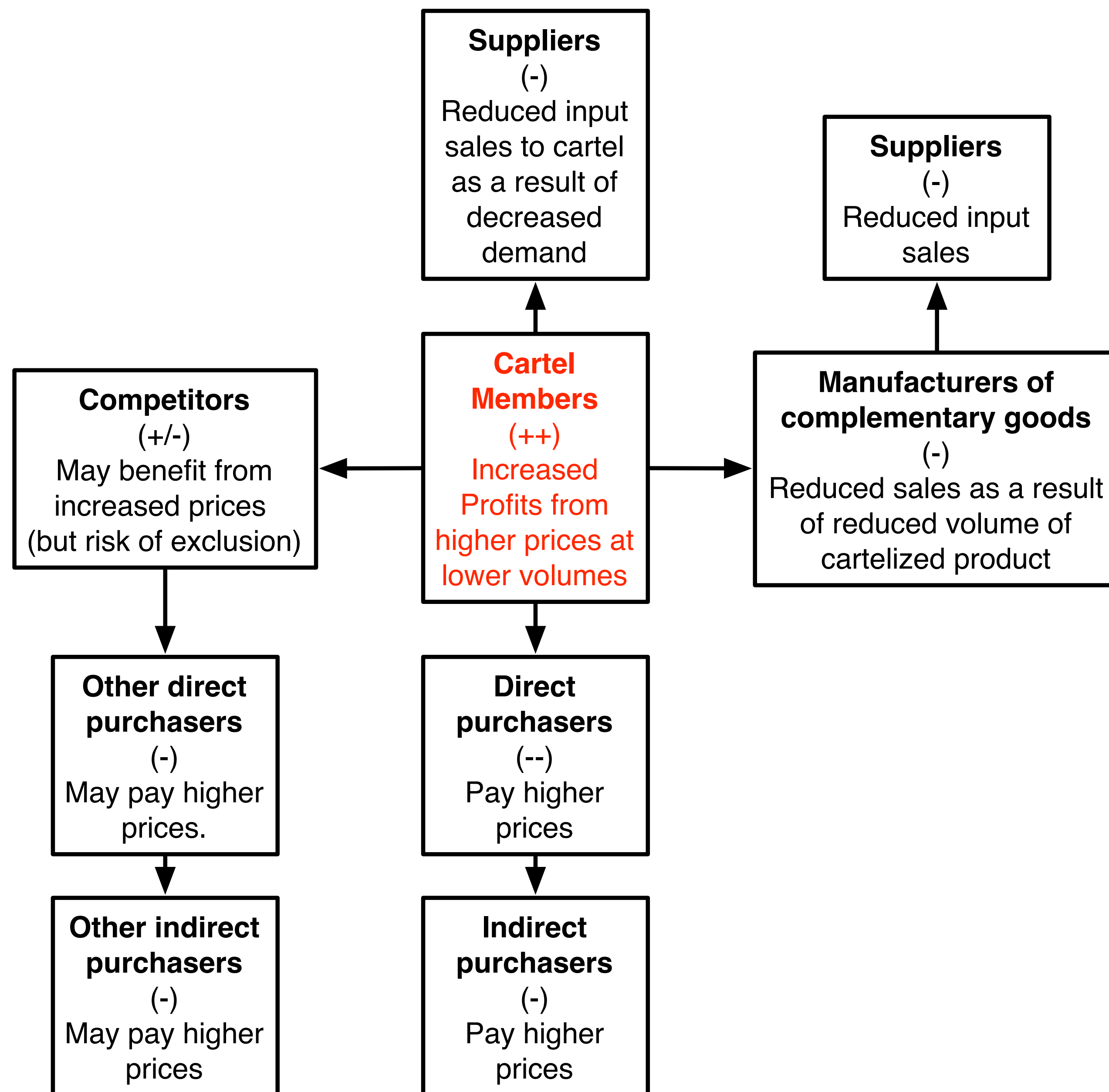
The typical international cartel: firms, products, market structure

- Participants
  - Multinationals (More than 80% headquartered in Europe and Asia).
  - Manufacturers, e.g., BASF ($42bn), ADM ($36bn), Roche ($28bn), Ajinomoto ($9bn).
  - Serial price fixing is common (Roche, Akzo Nobel, ADM).
  - Global cartels tend to have 3-5 core members
  - Involvement of multiple levels of management
- Products
  - Homogenous products
  - Organic chemicals (49 out of 167 cartels manipulated organic chemicals)
- Market characteristics
  - Concentrated at the manufacturer level
  - Dispersed at the buyer level
  - Mature market (no innovation, established price terms)
  - High barriers to entry

The typical international cartel: activities, effects, penalties

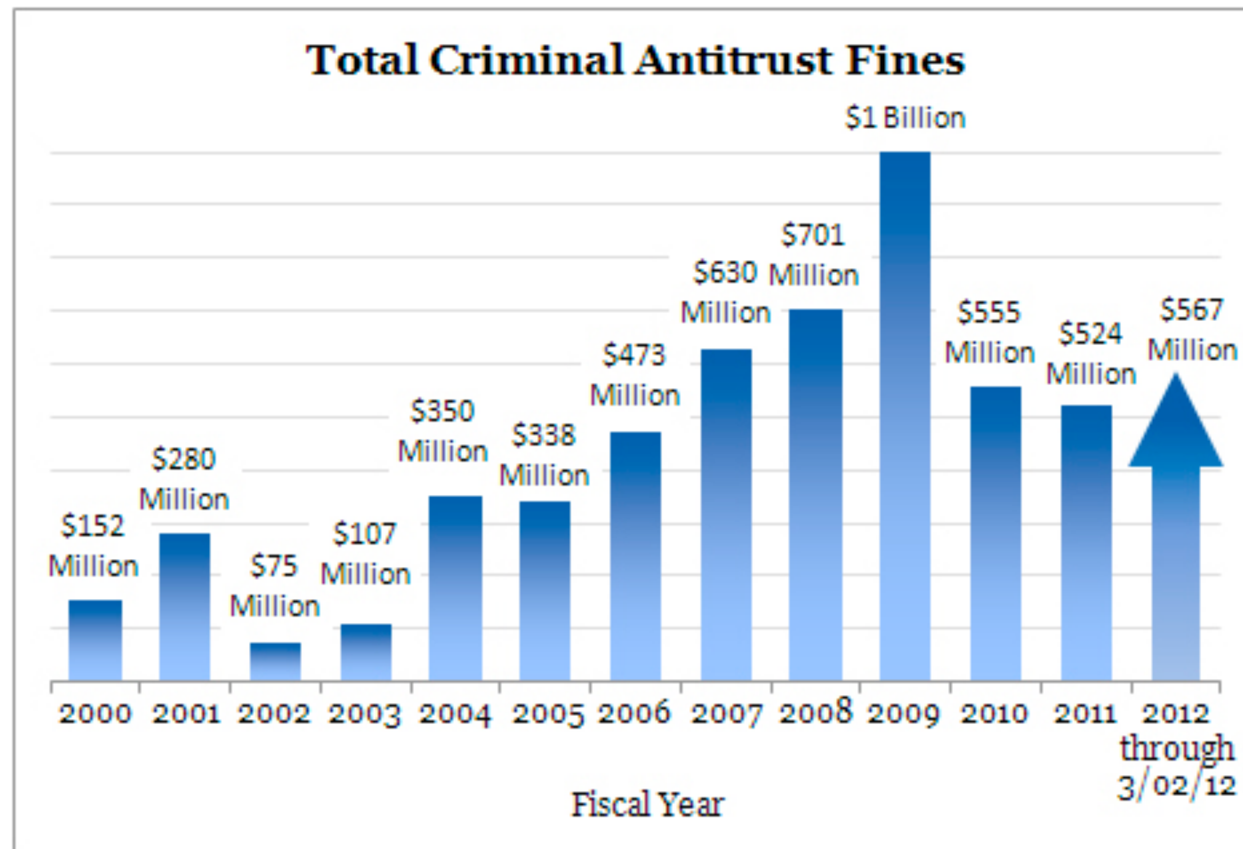
- Cartel activities
  - Price fixing and volume allocation
    - Territorial and customer allocation
    - Communication through trade associations and joint ventures
  - Monitoring
    - Audits of price and volume by region, import/export statistics
  - Compensation (cross-purchasing)
  - Punishment
  - Entry deterrence
    - Patent pools, anti dumping, quotas, common sales agency
- Effects
  - Average lifespan of international cartels in the 1990 was approximately 6 years.
  - Overcharges have been in the 25% (U.S.) to 40% (EU) range.
  - Distribution of overcharges is usually 1/3 U.S., 1/3 EU, and 1/3 ROW.
    - Vitamins, Inc. was unusually ROW-heavy.
- Penalties (fines + private)
  - 80% U.S.; 15% Europe; 5% ROW.
  - Probability of detection 10-30% over the average lifetime. (Speculative.)
  - In the U.S. the mean settlement value is ~ 75% of the actual damages.

Cartels: Who wins, who loses?



http://europa.eu.int/comm/competition/antitrust/others/private_enforcement/index_en.html

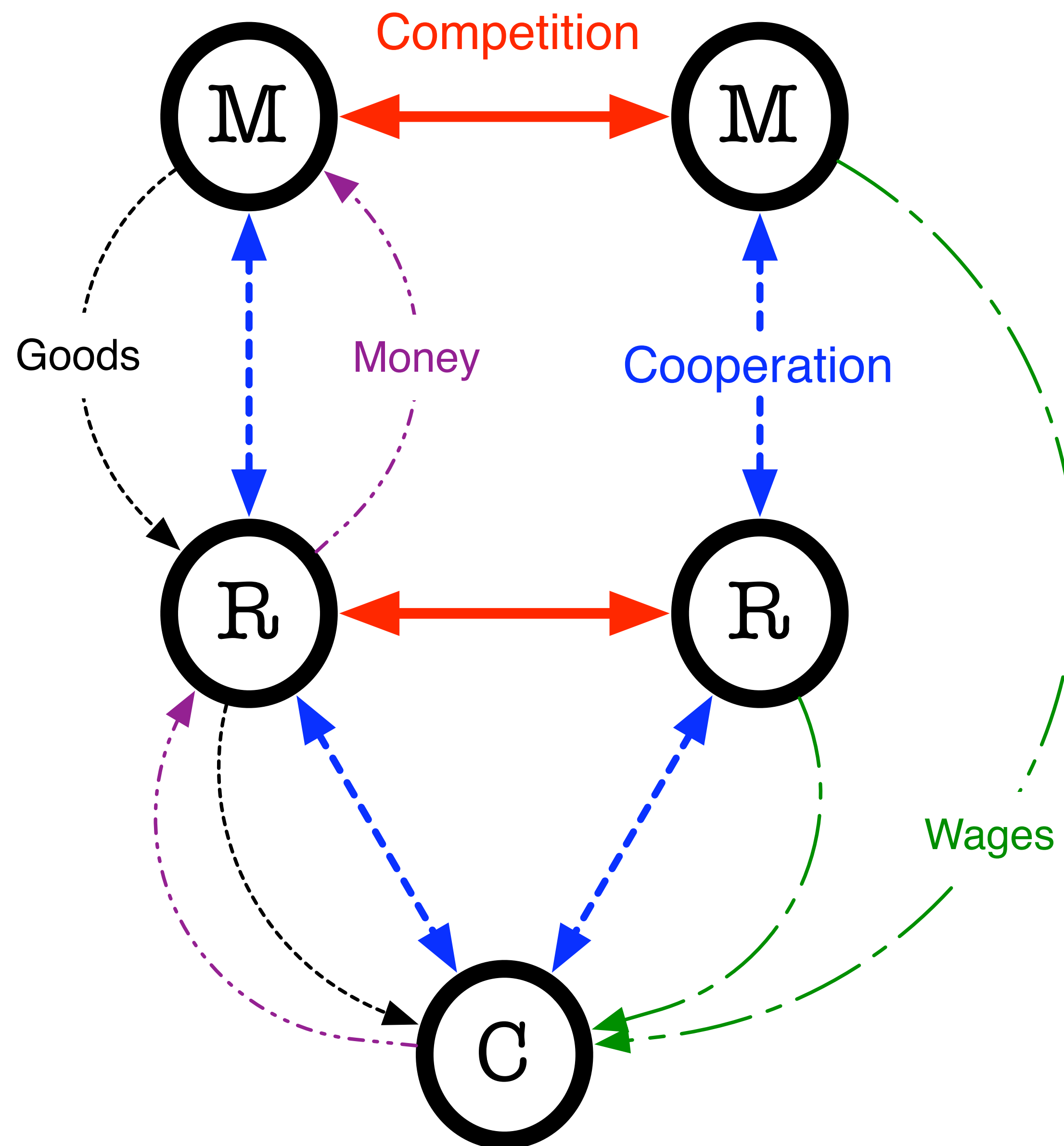
The real-world consequences of cartel violations can be dramatic



- Criminal penalties
  - Up to $100m or twice the pain/gain (corp)
  - Up to $1m (individual)
  - Jail time up to 10y (ø 24 mo)
  - Prima facie evidence of liability
- Non U.S. fines
  - EU (IBM > $1bn); Canada
- Civil damages
  - Claims of largest customers
  - Direct purchaser class actions (federal)
  - Indirect purchaser class actions (state)
- Cost of defense
- Loss of goodwill
- Opportunity cost

Horizontal agreements

Horizontal v. vertical agreements.
The normative premise



- Among the key normative design decisions for a market economy is the “compete horizontally, cooperate vertically” principle
  - Firms at the same stage of production, e.g., manufacturers (M) and retailers (R) are supposed to compete
  - Firms at different stages of production (M and R) are supposed to cooperate, to move goods from less finished to more finished states
- As a result, antitrust laws treat horizontal agreements with much greater suspicion than vertical agreements
- Competition is usually “competition for cooperation”
  - M1 and M2 are both vying for the services of the best retailer, i.e., they compete horizontally for vertical cooperation

"Every contract ... in restraint of trade ... is ... illegal" (§1)

- Element 1: Agreement (express or implied)
  - Conscious parallelism is not sufficient, e.g., two gas stations across from each other track each others' price movements and make their own judgments with the anticipated reaction of the other in mind. No "agreement."
- Element 2: In "restraint of trade" – not really.
  - Grocer A buys 90 loafs/day from baker X. X has a capacity of 100 loafs/day. As a result, grocer B can't buy 50 loafs from X. In a perfectly literal sense, the A-X agreement is a "restraint of trade." That makes no sense.
- In *unreasonable* restraint of trade – where "reasonable" is welfare enhancing and unreasonable welfare diminishing.
  - Compare anticompetitive effects (AE) with procompetitive effects (PE)
- Modern reading of §1: "Every agreement for which AE > PE is unlawful."

Agreements with object/effect of restraining competition, Art. 101(1)

The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:

(a) directly or indirectly fix purchase or selling prices or any other trading conditions;

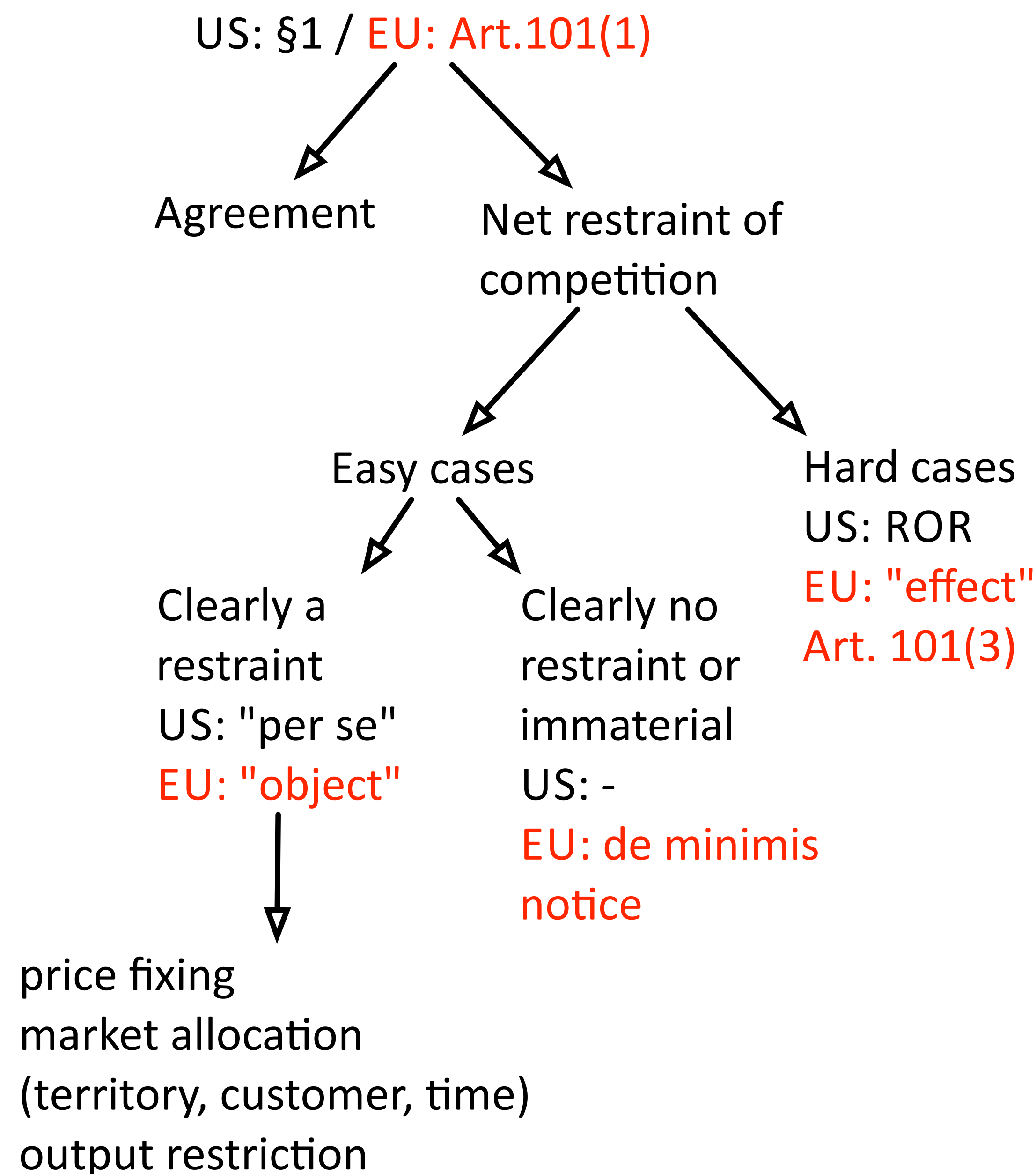
(b) limit or control production, markets, technical development, or investment;

(c) share markets or sources of supply;

(d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

Different standards of review: ROR and per se



- The ROR is conceptually simple (AE>PE) but very hard to apply
  - No accepted standard to quantify AE and PE
  - AE and PE may be of different nature (apples and oranges)
  - AE and PE may occur at different times
- To simplify the application of the AE>PE test, courts have grouped agreements into two buckets: easy cases and hard cases
  - Only the hard cases deserve an in depth inquiry (rule of reason, discussed later)
- §1 and Art.101(1)/(3) share the same basic two prong structure: agreement, AE>PE test

No need to prove AE or ability to consider PE for “hardcore restraints”

- For certain *categories* of hardcore restraints, the law conclusively presumes (a) the existence of AE and (b) that AE > PE. (= *per se* illegal)
    - Price fixing, market division (territory, customer, time), naked output restraint, group boycott to defend a cartel
- Courts and agencies will (generally) consider neither PE nor whether there are, in fact, any AE
    - Double AE + PE presumption in the U.S. Somewhat weaker presumption in the EU.

Presumed illegality: US and EU

"[T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use." *Northern Pacific Railway Comp., v. U.S.*, 356 U.S. 1, 5 (1958).

"It is not strictly necessary, for the application of Art. [81](1), given the overtly anticompetitive object of the agreement, for an adverse effect upon competition to be demonstrated."
Commission Decision of 23 April 1986 No 86/398/EEC, Polypropylene, O.J. 1986, L 230/1

Price fixing is a "tampering" offense, not a "price determination" offense

- Horizontal agreements involving price, minimum price levels, elements of price (e.g., discounts), and price determination formulae likely constitute *per se* illegal price fixing.
  - Price fixing does <u>not</u> require agreement on a determinable dollar amount, e.g., "We won't sell for less than $10/unit." It is sufficient to agree, for example, on a elements of price: "We won't grant volume discounts."
- Why the hair trigger standard?
  - No *private* override of the *public* (legislative) decision that "free competition is the rule of trade."

    "The Sherman Act reflects a legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services." The statutory policy underlying the Sherman Act "precludes inquiry into the question whether competition is good or bad." *Natl. Soc. of Professional Engineers v. U.S.*, 435 U.S. 679, ____ (1978)
  - Basic marketplace design rules are mandatory and cannot be modified by private agreement

    No tinkering with the "central nervous system of the economy." *Socony*, FN. 59.

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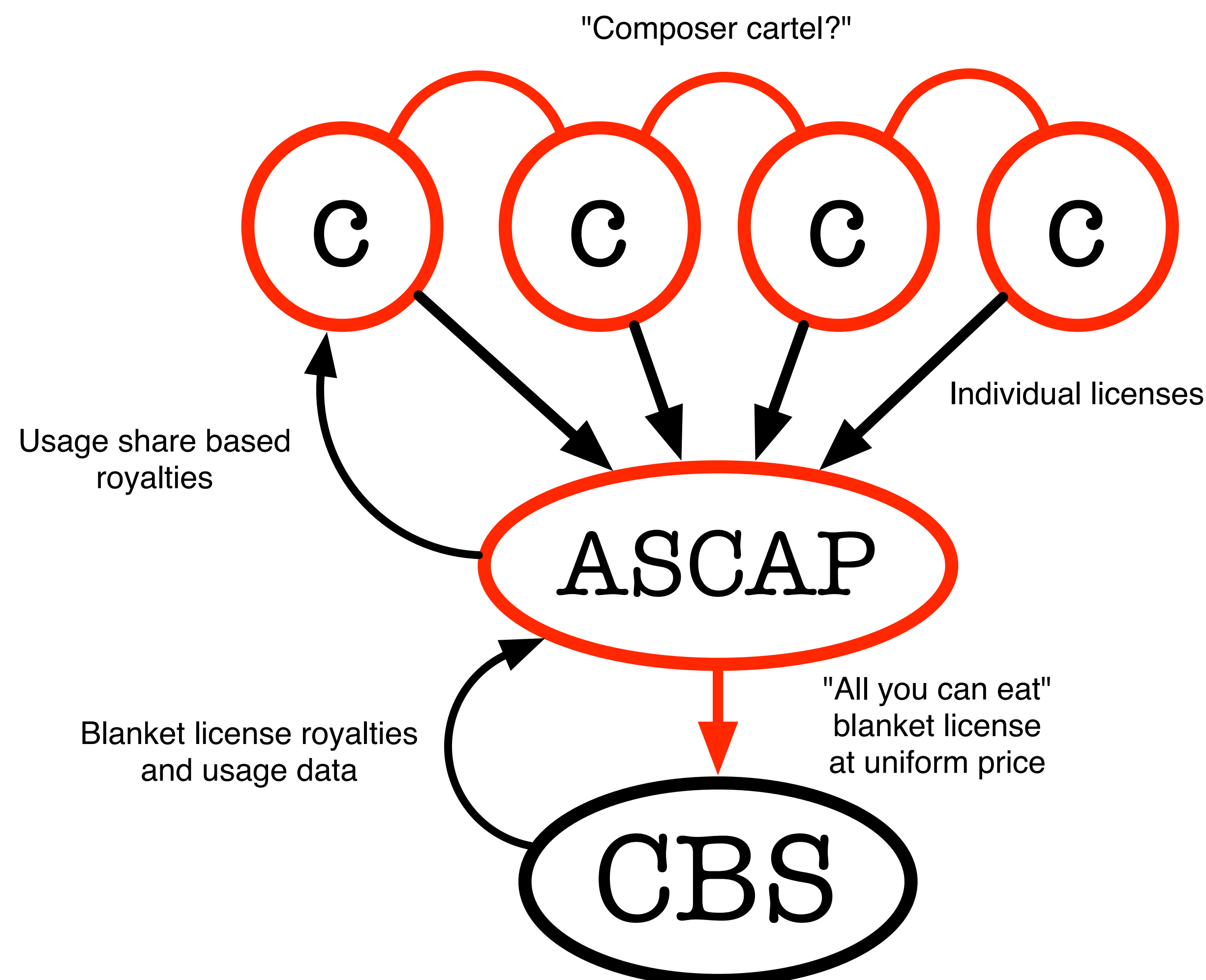
Problem: False positives

Broad. Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1 (1979)



BMI v. CBS, 441 U.S. 1 (1979)

- Setting up ASCAP literally requires "price fixing" by a composer cartel, but:
  1. The "all you can eat" fixed price is *absolutely necessary* for the venture to work
     - w/o the blanket license, costs for composers to monitor outlets and cost for outlets of finding composers would be excessive
     - The flat rate ensures that stations report usage truthfully (no incentive to underreport the playing of more expensive songs)
  2. The venture also involves the *creation of a new product*, with which the composers don't compete
- Limiting principle: *Per se* treatment appropriate only after extensive judicial experience
- Here: new market option added, output increased: ROR

Ancillary restraints analysis: Another tool to minimize false positives

Figure 1: "Naked non-compete agreement"

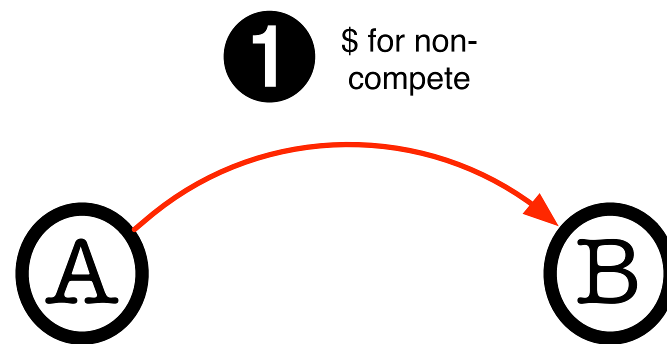
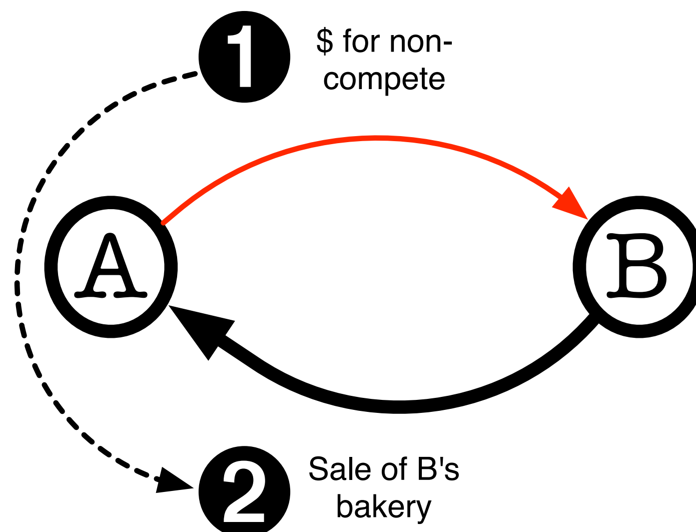


Figure 2: "Ancilary non-compete agreement"



- The *per se* categories are overinclusive. To avoid false positives, a second level test is required: whether the per se illegal restraint is naked and thus *really per se* illegal or ancillary and thus analyzed under the ROR
  - Suppose A pays B $100k not to compete with A's bakery. Without more, this is *per se* illegal. (Fig. 1)
  - If, however, the non-compete agreement is merely a means to enable an underlying bona fide transaction, e.g., the sale of B's bakery to A, then the PE from the sale may outweigh the AE from the restraint and the ROR is applied to both agreements. (Fig. 2)
- The ancillary restraints test requires (1) a restrictive agreement; (2) an underlying transaction; and (3) a causal relationship between (1) and (2).

Ancillarity can be strong or weak

Assuming that the rivals are engaged in a *bona fide* productive venture or sale (the underlying transaction), and:

1. The restraint is a *conditio sine qua non* for the underlying transaction (e.g., *CBS v. BMI*), then ROR applies.
2. The restraint *promotes* the underlying transaction (e.g., partnerships; seller non-compete clause in the sale of a business), then ROR applies (*Rothery Storage*).
3. The restraint is *basically unconnected* to the underlying transaction (*Palmer v. BRG*) – then we're dealing with a "naked restraint" and the *per se* rule applies

Both U.S. and EU law employ the ancillary restraints doctrine

- "To be ancillary … an agreement eliminating competition must be subordinate and collateral to a separate, legitimate transaction. The ancillary restraint is subordinate and collateral in the sense that it serves to make the main transaction more effective in accomplishing its purpose."
  Rothery Storage & Van Co. v. Atlas Van Lines, 792 F.2d 210, 224 (D.C.Cir. 1986)
- "The provisions of [Art.101(1)] may ... be declared inapplicable [to] ... any agreement ... which contributes to ... economic progress ... which does not ... impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives"
  Art. 101(3) EC Treaty

Structured approach to horizontal agreement fact patterns

1. Per se analysis?
   a. Literal "per se" category?
   b. Sufficient judicial experience?
2. Ancillary to an underlying procompetitive transaction?
   a. No. Naked restraint = per se
   b. Yes. Proceed to ROR analysis.
3. ROR analysis
   a. Plausible theory of harm (π: Plausible AE. AE without market power (< 30% share) are not plausible; Δ: Plausible PE)
   b. Proof of harm (π: Direct or circumstantial proof of AE); Δ: Proof of PE)
   c. Balancing (Court: AE > PE)

Sidebar: Law as an attempt to deal with the irrational in a rational manner

- At the end of the day, whether certain conduct is reasonable or unreasonable comes down to a value judgment.
- Any such judgment has an irreducible irrational core.
- Irrationality cannot be avoided, but it can be contained. That, in general, is the strategy of the law: *To deal with the irrational in a rational manner for as long as possible.*
- The per se and ROR treatment of restraints of trade are a great example of that strategy at work.

Rationalism, empiricism, virtue ethics, substance and process

- Consider how the law fences in the realm of the final irrational value judgment
- First, we identify easy cases, for which there is a strong empirical basis (per se)
- Second, the ROR proceeds in three steps, mixing elements of procedural rationality (burden shifting) with substantive criteria
  - Is there a plausible theory of harm (= rationalism)
  - Is there proof of harm (= empiricism)
  - Have an impartial arbiter make the final, irreducible value judgment
    - Judge (virtue, institution)
    - Jury (common sense)