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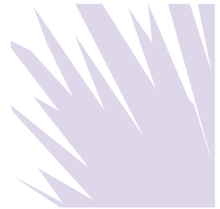

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PROOF OF CONSPIRACY IN VERTICAL AND HORIZONTAL PRICE-FIXING CASES: THE INTERSECTION OF LAW, ECONOMICS, AND POLICY

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I. INTRODUCTION

Section 1 of the Sherman Act prohibits contracts, combinations and conspiracies in restraint of trade. For many years, the courts have held that both horizontal and vertical price-fixing agreements are per se illegal. Because proof of concerted action to fix prices establishes liability, the focus in the cases has been primarily on what is required to prove concerted action. The purpose of this article is to compare and contrast how and why the courts have defined the line between unilateral and concerted action.

There are interesting parallels in the law relating to proof of horizontal and vertical agreements. In the horizontal context, merely "tacit collusion" is not sufficient to trigger Section 1 liability, although, as Richard Posner strongly argued before he went on the bench, the economic effect is indistinguishable from explicit collusion by the same firms. Similarly, in the vertical context, a manufacturer's unilateral policy not to deal with retailers who do not follow its suggested prices is not sufficient to trigger Section 1 liability, although it may be no less effective in achieving the desired result than a signed agreement with the same retailers.

In both contexts, it would not be a stretch to say that agreement existed. Members of a highly concentrated market are inevitably aware of the effect of their actions on the other firms. As Posner argued, one could use principles of unilateral contract to find an agreement sufficient for purposes of Section 1. The declaration of the "policy" by a manufacturer and the subsequent conscious acquiescence by retailers dependent on the manufacturer's products is, if anything, even easier to characterize as an agreement. It is fairly well established that a defendant will prevail if the plaintiff proves nothing more than those minimum facts. The interesting question is how much more proof is necessary to give the jury the opportunity to decide the case.

We have arrived at the current standards for separating permissible unilateral conduct from illegal concerted agreement through a long process of the courts mechanically applying precedent with an occasional overlay of antitrust policy as understood at the time.

I believe that the appropriate rule for horizontal conspiracies is correctly stated and applied in the recent decision of the Seventh Circuit in *In re High Fructose Corn Syrup Antitrust Litigation (HFCS),* 295 F.3d 651 (7th Cir. 2002). That ruling appropriately combines the economic concerns about cartel activity in concentrated industries with the statutory

* I appreciate the assistance of Aaron Myers of Fenwick & West L.L.P.

requirement of concerted action and role for the jury in our system of justice. In this context, there are no serious inconsistencies between the legal standards and a rational antitrust policy.

In contrast, the law concerning the standard of proof for a vertical price fixing agreement represents an effort to minimize the effect of substantive law that cannot be reconciled with changes in the closely analogous area of vertical non-price restrictions. While the current law effectively insulates the changes in the non-price arena from *per se* treatment, it leaves an unacceptably broad range of competitively harmless or even beneficial business practices subject to the draconian *per se* rule.

II. HORIZONTAL AGREEMENTS

Horizontal price-fixing agreements are the most fundamental violations of the antitrust laws. Treatment of such agreements as per se illegal is generally accepted as appropriate. As Richard Posner has pointed out, the per se standard means that the law prohibits *attempts* because no proof of actual market effect is required. However, since participants in the market are the best informed about the market conditions, the assumption that such agreements will rarely be futile is probably legitimate.

A more controversial issue has been whether to require proof of explicit agreement in the form of meetings, communications, and the like. Before he went on the bench, Richard Posner argued strongly that Section 1 could and should be applied to the type of tacit agreements involved in oligopolistic interdependence. Posner argued that tacit agreements had the same harmful effect on consumers as explicit ones. Indeed, he argued that the focus on proving explicit agreement had the effect of diverting enforcement resources from the practices that had the greatest risk to the economy to those that were far less serious. While he acknowledged that a finding of concerted action was required under Section 1, Posner argued that tacit agreements could qualify as a form of unilateral contract. Don Turner had argued that oligopolists were merely making a rational response to the market conditions in which they found themselves. Posner responded that the firms in highly concentrated markets always have the choice of producing the volume that would equate price with their marginal cost.

Ultimately, Posner's position proved to be too extreme for the courts. Ironically, in relatively recent years, the pendulum swung strongly in the other direction, based in substantial part on analogous observations about the nature of competition in concentrated markets. Confusion about the standard resulted in part from the mechanical lifting of language from one kind of case to another. In *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986), the Court faced a claim of a long-term *predatory pricing* conspiracy by Japanese television makers. Relying on economic studies concluding that predatory pricing was rarely successful, the Court required a higher level of proof for a conspiracy that it found to be inherently unlikely.

The language from *Matsushita* then was repeated in yet another type of case. In *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752 (1984), the Court addressed the sufficiency of the proof of conspiracy in the context of an alleged vertical price-fixing conspiracy. As discussed in more detail below, the decision in *Monsanto* was motivated in large part by a better economic understanding of the nature of the relationships and incentives of manufacturers and their distributors.

The language from *Matsushita* and *Monsanto* was then applied in the context of alleged horizontal price-fixing agreements in concentrated markets. Of course, in every case subject to the preponderance of the evidence standard, the plaintiff must show that conspiracy is more likely than not. But, the language from *Matsushita* took on a life of its

own, and courts (at least seemingly) began to hold that juries were not entitled to decide the case if there was any alternative reading of the evidence that was consistent with unilateral action. This standard became particularly problematic when applied in the context of highly concentrated markets. Those markets are the ones often characterized by the tacit collusion that so concerned Posner. However, since tacit collusion is not considered to be concerted action and the performance of concentrated markets often resembles that of markets where collusion is occurring, the result was to find alternative explanations for evidence that were fully consistent with collusion in markets where that danger was the greatest.

The ironic result of the "strong" application of *Matsushita* in concentrated markets was to make it hardest to prove conspiracy where conspiracy was more likely to succeed and, therefore, where it was most likely. This swung the pendulum to the polar opposite of Posner's suggestion that tacit collusion alone was sufficient to satisfy Section 1. It was therefore an interesting coincidence that now-Judge Posner was on the Seventh Circuit panel in *HFCS*. The trial judge had essentially taken the approach that if there was a possible non-conspiratorial interpretation of each piece of evidence (i.e. if it was ambiguous), the plaintiff had failed to meet its burden as a matter of law.

In *HFCS* the Seventh Circuit first considered whether the market was one that was conducive to conspiracy and found that it was. It next considered whether there was evidence that the market was performing in a non-competitive manner and found that there was. But, the court then recognized that, while this evidence might establish tacit collusion, the law required proof of express conspiracy. After reviewing the evidence, the court held that, while some of the evidence was ambiguous in the sense that it could possibly support different conclusions, the evidence as a whole was more than minimally sufficient to be submitted to the jury.

The problem is that circumstantial evidence is inherently ambiguous. If only unambiguous evidence were allowed, horizontal price-fixing could only be proved through direct evidence. Although such evidence sometimes exists, the nature of conspiracy is that one must often rely on indirect evidence.

The problem with the requirement of a strong reading of the *Matsushita* language is that some evidence that would be relatively clear in a relatively unconcentrated market is less clear in a concentrated market—precisely because of the potential for tacit collusion noted by Posner. To the extent that this reasoning prevailed, the result would be to make it harder to prove conspiracy in those markets where collusion is easiest and most likely to occur. While one might conclude that punishing purely tacit collusion is the wrong course, making it harder to prove conspiracy in concentrated markets is equally wrong.

The recent decisions from the courts of appeals on proof of conspiracy are fact-specific. It is possible to read HFCS as consistent with the other cases such as *See, e.g., In re Baby Food Antitrust Litigation*, 166 F.3d 112 (3d Cir. 1999); *Blomkest Fertilizer, Inc. v. Potash Corp. of Saskatchewan, Inc.,* 203 F.3d 1028 (8th Cir. 2000); *City of Tuscaloosa v. Harcros Chemicals, Inc.,* 158 F.3d (11th Cir. 1998). The courts cited the same cases, but one has to acknowledge that the tone of Judge Posner's opinion is different, as is his treatment of the issue of ambiguous evidence.

At the end of the day, the question of whether there is sufficient circumstantial evidence to go to the jury will be a matter of judgment. Certainly, more than a few isolated statements in memos should be required. However, where there is substantial evidence of explicit agreement—albeit capable of being interpreted either way—the case should be given to the jury. This result creates a strong incentive for companies in concentrated industries to go out of their way to avoid conspiracies.

III. VERTICAL AGREEMENTS

Vertical price-fixing has been per se illegal for almost as long as horizontal price-fixing. The basic rule dates from *Dr. Miles Medical Company v. John D. Park & Sons Company,* 220 U.S. 373 (1911). The case that has come to define the requirement of an agreement is *United States v. Colgate & Co.,* 250 U.S. 300 (1919). In *Colgate*, the Court held that a manufacturer is free to announce a policy defining the terms under which it will deal with retailers and then cease doing business with those retailers who violate the policy. Based on *Colgate* alone, one might argue that the underlying rationale for the decision was some poorly articulated sense of the inherent autonomy rights of manufacturers, rather than the absence of concerted action. In my discussion with ordinary citizens unemcumbered by any knowledge of the doctrine of unilateral contracts, they almost always think that the conduct unambiguously permitted by Colgate sounds like an agreement to them. However, numerous subsequent decisions have characterized the presence or absence of agreement as the key factor.

Over the years following *Colgate*, a number of cases essentially limited the case to its facts. To the extent that the manufacturer did anything beyond the simple announcement and refusal to deal, the courts tended to find evidence of agreement. These cases did not make much sense in the context of a discussion of agreement. Why, for example, does the fact that the manufacturer used its wholesalers to help police the policy make it more likely that there was an agreement with the retailers? Plainly, the point was that the additional steps made it more likely that the policy would be effective, and the courts started with the assumption that it was a bad thing for the policy to succeed.

The turning point for vertical price fixing law was the decision of the Supreme Court in *Continental T.V., Inc. v. GTE Sylvania, Inc.,* 433 U.S. 36 (1977). *Sylvania* was a non-price restriction case, and the Court took pains to point out that the issue of vertical price fixing was not presented. Nevertheless, the intellectual foundation of the decision severely undercuts the use of per se analysis for vertical price-fixing. *Sylvania*, of course, overruled the per se rule for vertical non-price agreements. It recognized that there were legitimate, pro-competitive reasons why a manufacturer might want to impose restrictions on its distributors in the interest of selling its product more effectively. It also recognized the disciplining effect of interbrand competition. To the extent that the manufacturer made a mistake about whether a non-price restriction would benefit its ability to compete, the existence of active interbrand competition would quickly reveal and punish that mistake.

In the absence of some market power, vertical non-price restrictions are unlikely to be found to be illegal. Yet, there was a significant risk to this new legal regime. The fact is that the whole point of using vertical non-price restrictions is to give some price protection. So, for example, if a manufacturer gives a retailer an exclusive territory, that retailer is a "monopolist" in that product and to the extent that the product is differentiated, may have some ability to price higher than it would have in the face of active intrabrand competition. It is the extra money from that higher margin that provides the money to provide additional display and demonstration, as with a stereo showroom for high-end stereo products. If an agreement that *affected* prices were sufficient to trigger Section 1, the decision in *Sylvania* would be effectively eliminated. So, in *Business Electric Corp. v. Sharp Electronics Corp.,* 485 U.S. 717 (1988) the Court held that the per se rule only applies where there is an agreement as to price or price levels.

Although *Sharp* did not directly address the standards for proving agreement, it was clearly motivated by a concern to protect *Sylvania*. The decision in *Monsanto* directly

addressed both *Colgate* and the proof necessary to establish agreement. The Court recognized the collaborative relationship between manufacturer and distributor and held that the mere fact that a manufacturer terminated a discounting dealer after complaints from another distributor was not sufficient to establish an agreement between the manufacturer and the complaining distributor. The Court also reaffirmed the *Colgate* doctrine as a limit on the per se rule against vertical price fixing.

Short of reversing the rule against vertical price fixing, the Court has done what it can do to limit the damage from that rule. At a minimum the ability to state a policy and act on it still exists as permissible action that is not subject to Section 1. The mere fact of acting after receiving a complaint from another distributor is not sufficient to go to the jury on the issue of agreement. And, only agreements that directly address prices are within the per se rule. But the fact remains that a wide area of policies addressing prices are at risk. It is not clear how much more than the mere announcement and refusal to deal is permitted without amounting to an agreement. If courts apply normal standards for when a fact question is presented, most cases will go to juries with extremely unpredictable results. As a practical matter, when large field organizations are involved, it is hard to imagine a case where there is not some evidence of something beyond the mere announcement of the policy and refusal to deal. Sales persons will lose their commissions when retailers are terminated, making it highly likely that some entreaties to "get back in line" and "get with the program" will occur. There is not much history of these cases being tried, but ordinary jurors may have trouble understanding the economic arguments for why it is legitimate for manufacturers to try to keep prices higher. A dislike for the goal makes it is much more likely that jurors would find that an agreement exists.

IV. CONCLUSION

Although there has been some intermingling of judicial standards for proving conspiracy between horizontal and vertical price fixing cases, the issue of agreement cannot be completely separated from the issue of the underlying substantive law. Society benefits from laws that make it costly to engage in cartel behavior. While it would be wrong to make it illegal for companies in concentrated industries to breathe, neither should they be given a pass because they are in markets where tacit (and explicit) collusion is easy. The *HFCS* case got it about right. In contrast, the law concerning vertical price fixing is decided unclear and bad. It is clear that the basic proposition of Colgate is good law, but the reality is that few cases will have such pristine facts. If, as seems likely, cases involving additional facts will will go to juries, there will be a great risk of liability for conduct that has essentially the same justifications and lack of competitive risk as vertical non-price restrictions that are now subject to the rule of reason.