Michigan Bar Journal
January, 1985

Antitrust Law

***36** THE RULE OF REASON

David A. Ettinger [FNa]
Gerard Mantese [FNaa]

I. Introduction

Section 1 of the Sherman Antitrust Act, 15 USC § 1, is the most commonly applied antitrust statute. That section provides in part:

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 declared to be illegal. . . . (Emphasis added.)

Yet despite this broad language, not all contracts, combinations or conspiracies that restrain trade are illegal. As the United States Supreme Court noted long ago, 'the legality of an agreement or regulation cannot be determined by so simple a test as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains.' [FN1] The test, then, is whether the restraint is unreasonable. [FN2]

Many potential antitrust claims involve questions as to whether restraints are unreasonable under the facts and circumstances of the particular case. This case-by-case antitrust analysis is known as a 'rule of reason' analysis.

Such practices as exclusive contracts, exclusive territorial arrangements with distributors, exclusion of physicians from hospitals, joint purchasing arrangements and termination of distributors, may limit competition and may involve unreasonable restraint of trade claims. However, after almost a century of litigation under the Sherman Act, a detailed analysis of the standards and methods of proof relating to rule of reason claims has begun to emerge only relatively recently.

This article discusses the basic outlines of a rule of reason case. It also offers some suggestions as to how such a case may be presented.

II. Basic Nature of Per Se and Rule of Reason Claims

Some conduct has been held to have such a pernicious effect on competition in the overwhelming majority of cases in which it occurs, and to be so lacking in any redeeming virtue, that mere proof of the conduct and injury resulting from the conduct establishes antitrust liability. Such conduct is called a per se antitrust violation. The clearest example of a per se violation is horizontal price-fixing: [FN3] an agreement among competitors to fix the price of a goods or services.

Among other practices which the courts have held to be per se illegal under the antitrust laws are vertical pricefixing, [FN4] horizontal division of markets, [FN5] certain group boycotts, [FN6] and certain tying arrangements. [FN7]

Most other practices involving a contract, combination or conspiracy are governed by the rule of reason, i.e., the plaintiff must prove that the practice is, on the particular facts before the court, an unreasonable restraint of trade. Most significantly, non-price vertical agreements-- agreements between members of the manufacturer/producer/distributor/retailer chain--are governed by the rule of reason. [FN8]

It is important to distinguish between 'horizontal' restraints, i.e., agreements between competitors at the same level of market structure, and 'vertical' restraints, i.e., combinations of persons at different levels of the market structure, such as manufacturers and distributors. . . . Horizontal restraints alone have been characterized as 'naked restraints of trade with no purpose except stifling competition,' . . . and, therefore, per se violations of the Sherman Act. On the other hand . . . vertical restrictions . . . [are] to be examined under the rule of reason standard. [FN9]

Per se violations thus involve relatively simple issues, (at least with respect to liability). In contrast, rule of reason violations are not so simple. Proof that the claimed conspiracy occurred is only the first step in establishing liability. The second and more substantial test is to prove that this conduct is 'unreasonable' under the particular facts of the case.

Under the rule of reason the factfinder takes into consideration all the circumstances of the case in assessing whether the challenged conduct imposes an unreasonable restraint on competition. [FN10] Justice Brandeis, in Chicago Board of Trade v. United States, [FN11] described the rule of reason as follows:

The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. [FN12]

As can be seen from this formulation, the rule of reason, is not actually a 'rule,' if a rule is defined to be a 'guide for action.' [FN13] That is, the 'rule' does not give clear guidance of what conduct is prohibited. Only since the Supreme Court held in Continental TV, Inc v. GTE Sylvania, Inc. [FN14] that vertical nonprice restraints are governed by the rule of reason have the parameters of the rule begun to become clear.

III. The Competitive Effects Test

The most important statement about the rule of reason relates to what it does not consider. The rule of reason is not concerned with whether conduct is reasonable in a common law sense. For example, the defendant may not defend its anticompetitive conduct by showing that the conduct promotes the public health or safety. This is to be contrasted with 'unreasonable' conduct in the law of negligence, where the defendant may show that its conduct is reasonable given the circumstances, and the costs and benefits to society of the conduct. The Supreme Court stated in Nat'l Society of Professional Engineers v United States [FN15] that the only relevant criterion in judging reasonableness is the effect of the practice on competition:

The Rule of Reason['s] . . . central principle of antitrust analysis has remained mained constant. Contrary to its ***37** name, the Rule does not open the field of antitrust inquiry to any argument in favor of a challenged restraint that may fall within the realm of reason. Instead, it focuses directly on the challenged restraint's impact on competitive conditions. [FN16]

In National Society of Professional Engineers the Society argued that certain ethical restrictions on price bids by engineers were necessary to the public interest. The Society maintained that these restrictions prevented the possibility of inferior and unsafe construction which could follow from bids which were too low to make safe construction methods profitable. The Court held that such arguments were irrelevant to an examination under the antitrust laws, because the only appropriate criterion under the antitrust laws is the effect of the practice on competition:

[T]he purpose of the [Rule of Reason] analysis is to form a judgment about the competitive significance of the restraint; it is not to decide whether a policy favoring competition is in the public interest, or in the interest of the members of an industry. Subject to exceptions defined by statute, that policy decision has been made by the Congress. **[FN17]**

The courts presume that in passing the antitrust laws, the Legislature has already decided, that competition is--like the world of Voltaire's Candide-- 'the best of all possible worlds.' The only relevant question is whether the defendant's conduct enhances or restrains competition.

The rule in National Society of Professional Engineers would appear to be a great boon in plaintiffs. Many activities in society may restrict competition. For example, manufacturers may enter into exclusive distributing arrangements with one or more distributors; such restrictions will limit the number of competing distributors. If the promotion of efficiency, safety or social welfare cannot provide defenses in cases such as these, it might appear that the antitrust laws forbid a vast number of activities occurring every day in American society. But as will be shown below, there are numerous restrictions on the application of the rule of reason which minimize the implications of the Professional Engineers decision.

Most important, the rule of reason requires a significant adverse effect on competition in the relevant market in order for an antitrust violation to exist. The effect of the practice is sufficient if it 'may suppress or even destroy competition' itself in the relevant market. [FN18] Thus it is not enough for the plaintiff to show that a conspiracy destroys plaintiff's ability to compete. Rather, the plaintiff must show injury to 'a more generalized market. . . .' [FN19] Accordingly, the courts often note that the antitrust laws are designed for 'the protection of competition, not of individual competitors.' [FN20] As the Ninth Circuit stated in Kaplan v Burroughs Corp: [FN21]

Proof that the defendant's activities had an impact upon competition in a relevant market is an absolutely essential element of the rule of reason case. It is the impact upon competitive conditions in a definable product market which distinguishes the antitrust violation from the ordinary business tort. As the Supreme Court has noted in another context, '. . . an antitrust policy divorced from market considerations would lack any objective benchmarks.' **[FN22]**

For these reasons, the mere replacement of one competitor with another, or even the elimination of one or more competitors, does not in and of itself rise to the level of an antitrust violation. This is the lesson stated by the Sixth Circuit's decisions in Ace Beer Distributors, Inc v Kohn, Inc, [FN23] and Dunn & Mavis, Inc v Nu-Car Driveaway, Inc. [FN24]

In Ace Beer the plaintiff beer distributor brought an antitrust claim based on its termination by the Stroh Brewery and replacement by another distributor. Defendants successfully moved to dismiss the case for failure to state a claim, and the Sixth Circuit affirmed the dismissal. The court held:

It is well settled that the 'restraint of trade' referred to in Section 1 of the Act, means only unreasonable restraint of trade, in that, as the cases point out, every commercial contract has some restraining effect upon trade. . . . The substitution of one distributor for another in a competitive market of the kind herein involved does not eliminate or materially diminish the existing competition of distributors of other beers, is not an unusual business procedure, and, in our opinion, is not an unreasonable restraint of trade. **[FN25]**

The typical grievance brought to an antitrust lawyer--that a company has been driven out of business, or has lost a line of business--therefore does not by itself state a rule of reason claim. To state a claim, the antitrust plaintiff must link this grievance to actions with a significant impact on the market.

IV. Proof of Effects on Competition

A. Market Share Analysis

The most common way that effects on competition have been proven is through their effects on the market power of the firms in an industry. In its 1982 Merger Guidelines, the Justice Department explains that firms with market power can thereby increase their prices and decrease output, to the detriment of the public:

A sole seller (a 'monopolist') of a product with no good substitutes can maintain a selling price that is above the level that would prevail if the market were competitive. Where only a few firms account for most of the sales of a product, those firms can in some circumstances coordinate, explicitly or implicitly, their actions in order to approximate the performance of a monopolist. This ability of one or more firms profitably to maintain prices above competitive levels for a significant period of time is termed 'market power.' Sellers with market power also may eliminate rivalry on variables other than price. In either case, the result is a transfer of wealth from buyers to sellers and a misallocation of resources. **[FN26]**

Market power can be enhanced by high 'concentration,' i.e., high market shares of the firms in an industry. The smaller the number of competitors and the larger the market shares of these firms (especially the largest firms), the more concentrated is an industry. As the Justice Department explains, there is ***38** generally held to be a relationship between concentration and market power:

Other things being equal, concentration affects the likelihood that one firm, or a small group of firms, could successfully exercise market power. The smaller the percentage of total supply that a firm controls, the more severely it must restrict its own output in order to produce a given price increase, and the less likely it is that an output restriction will be profitable. Where collective action is necessary an additional constraint applies. As the number of firms necessary to control a given percentage of total supply increases, the difficulties and costs of reaching and enforcing consensus with respect to the control of that supply also increase. **[FN27]**

This relationship between concentration and market power provides a first step in analyzing whether an unreasonable restraint of trade exists. A plaintiff may attempt to show that a practice has adversely affected competition as a whole by showing that the practice has eliminated some competitors (thereby decreasing the total number of competitors), has increased the market shares of the leading firms in the market, or has eliminated competition from some segment of the market. Any such effect could increase total concentration.

More frequently, this concentration analysis has been used by defendants. Many defendants have successfully argued that a particular practice involved too small a percentage of the market for overall concentration to have been significantly affected. The argument has frequently succeeded.

In Satellite Television v Continental Cablevision, [FN28] the Court found that an effect on only slightly more than eight percent of the market was insufficient in that case to avoid summary judgment. In DeVoto v Pacific Fidelity Life Ins Co, [FN29] the percentage of the relevant market affected by defendants' actions was slightly more than 1%. The court held that a violation of the rule of reason could not be shown 'merely be reference to the dollar volume of commerce $500 million in mortgage insurance affected by the alleged restraint.' [FN30] Focusing on the 1% of commerce affected by the restraint, the court found no substantial restraint, declaring 'we have not found any cases in which an impact on this small a percentage of the relevant market was held to be unreasonable.' [FN31]

In Magnus Petroleum Co, Inc v Skelly Oil Co, [FN32] foreclosure of less than one percent of the market was held to be de minimis as a matter of law, and in Valley Liquors, Inc v Renfield Importers, Ltd, [FN33] a 'substantial percentage of the sales in a market' was required before an unreasonable restraint could be inferred.

A proper concentration analysis will examine the current state of the market as well as the change in concentration caused by the practice at issue. An unreasonable restraint of trade is rarely found where the industry in question is unconcentrated. Under those circumstances, market power and an adverse effect on competition are considered extremely unlikely. [FN34] The competitive characteristics of the industry are judged by such indices as number of competitors, low barriers to entry, moderate or declining profitability, and product innovation.

Thus a concentration or market share analysis will often be fruitful for defendants and pose difficulties for plaintiffs. It may be rare that the elimination of the plaintiff alone from competition will itself be of sufficient magnitude to significantly change overall concentration in a market. Exceptions will be in fairly concentrated markets, including those with only a few significant competitors.

Another exception will arise where the plaintiff has suffered from a practice that affects competitors other than itself. If the plaintiff is only one of the victims of a practice which affects a large portion of a market, it may have a strong claim.

There are also many practical problems in developing a market share analysis to prove an unreasonable restraint of trade. Often, evidence of market shares will be difficult to obtain. In many cases, sales statistics will not be available for a given market from any recognized source, though census data and trade association data are always worth pursuing. Sometimes such data might need to be compiled by individual discovery of each of the firms in the business. Such discovery will often be resisted by firms wishing to protect the confidentiality of their sales data; the discovery will therefore be laborious and expensive.

Moreover, a lawyer cannot simply present market share data and argue its significance to the court. Generally, an expert economist will need to be retained to assess the significance of the data, and the given practice, to competition in a market.

These factors make rule of reason cases expensive affairs for plaintiff and defendant alike.

B. Alternatives to Market Share Analysis

Though it is commonly used, market share analysis is far from the only possible method of showing an adverse impact on competition. A variety of other methods exists.

One means is by relative price data. High prices are, of course, one of the main evils of reduced competition. Through relative price data, a party may be able to show that prices in the relevant market are higher than what they would otherwise have been in the absence of the defendant's assertedly unlawful conduct. Such data may include a comparison of prices between the geographic area in which the violation occurred and unaffected areas (the 'yardstick' method), [FN35] or of prices before and during the period in which the violation occurred (the 'before/after' method). [FN36]

Decreases in output might provide another measure of lessened competition. Again, comparison might be made between geographic areas affected by the practice and those which are not, or between output before and during the time of the practice.

Of course, these comparisons can be subject to significant disputes. For example, prices cannot be appropriately compared between two locations if the underlying production costs vary significantly between the areas. Output may vary with changes in demand due to overall economic conditions. Normally these kinds of comparisons, like a market share analysis, will have to be performed by an expert economist after a careful review of the relevant facts.

V. The Relevant Product and Geographic Markets

In rule of reason cases, injury to competition must be analyzed in the context of the relevant product market and the relevant geographic market. The relevant product market is composed of products that are reasonable interchangeable for the purposes for which ***39** they are produced--price, use and qualities considered. [FN37] The relevant geographic market is the geographic area in which sellers of the particular product or service operate and to which purchasers can practically turn for such products or services. [FN38] Definition of the market in the context of litigation is, not surprisingly, often the subject of significant legal and economic dispute.

A rule of reason case is often won or lost on the issue of relevant geographic market or product market. This is because of the importance of market share to many rule of reason analyses. The larger the geographic and product markets are held to be, the smaller will be the effect of the challenged practice as compared to the size of the total market.

An example of the importance of the delineation of market is United States v E. I. du Pont de Nemours & Co. [FN39] In that case the issue was whether the relevant product market was cellophane or all flexible packaging material. The court's conclusion on this issue was crucial, since du Pont had a 75% share of the cellophane market but less than 20% of the more expansive market.

Another case illustrating this point is M. Julia Dos Santos, M.D. v Columbus- Cuneo-Cabrini Medical Center, et al. [FN41] in which the issue was whether a hospital's exclusive anesthesiology contract constituted an unreasonable restraint of trade. The court noted that 'the plaintiff can prevail only by showing that the agreement in question results in a substantial foreclosure of competition in an area of effective competition, that is, in a relevant market.'

Any exclusive contract into which the hospital entered could have eliminated competition for anesthesiology business in the hospital during the duration of the contract. Thus one crucial issue in the case was the hospital's market share, and the relevant market. If the relevant market was defined as the area in which the defendant hospital was engaged in substantial competition for patients, it is possible that the hospital would have had a significant market share. This elimination of competition could therefore have involved a substantial portion of the market.

But, the court did not so define the market. It concluded that it was the hospital, 'rather than the patient, that can properly be characterized as the real purchaser of anesthesia services and the relevant market can be defined as the area in which the [hospital] can practicably turn for alternative provision of anesthesia services.' The court found that the defendant hospital 'can and does turn to a broad market across the nation and outside the United States for alternative provision of anesthesia services.' Thus the relevant market was found to be national or larger. Elimination of competition for the hospital's anesthesia services in connection with the exclusive contract involved a small percentage of this national market. Therefore, no unreasonable restraint was found.

VI. Balancing of Pro- and Anti-Competitive Effects

If the plaintiff can prove the existence of a significant impact on competition from the defendant's actions, that does not end the analysis. The defendant show that the practice has procompetitive effects which outweigh the effects explained by the plaintiff.

Common examples of such defenses arise when reviewing vertical restraints. For example, agreements between a manufacturer and distributor giving only that particular distributor the right to handle the manufacturer's products may detrimentally affect intra-brand competition, since no other distributors can compete with the preferred distributor with respect to that manufacturer's brands.

However, the manufacturer may show that inter-brand competition is thereby enhanced, i.e., competition between that manufacturer's brands and others may be increased if the exclusive arrangement results in greater marketing efforts by the exclusive distributor.

In Continental TV, Inc. v GTE Sylvania, Inc. [FN41] the Supreme Court explained that restrictions on distributors might encourage the remaining distributors to invest more in promotions, service, repairs and warranty work, because of the distributors' confidence that the fruits of their labors with regard to a particular brand will not be captured by other distributors of that brand seeking a 'free ride.' [FN42] These investments could thereby increase inter-brand competition. This 'free rider' defense can be very important in distribution cases.

***40** Litigants have also argued that 'pro-competitive effect' may be shown by the economies or efficiencies resulting from a practice. However, the defense that a practice improves efficiency has traditionally been rejected by the courts on the ground that the only issue is whether the practice enhances competition. For example, in United States v National Lead Co., [FN43] the defendants attempted to justify their actions by establishing that during the regime of the combindation, production had increased and prices had sharply declined. The court held:

The evidence does show as much; but it does not follow that the public interest has not been abused. Indeed, the major premise of the Sherman Act is that the suppression of competition . . . is in and of itself a public injury; or at any rate, that such suppression is a greater price than we want to pay for the benefits it sometimes secures. . . . The economic theory underlying the Sherman Act is that, in the long run, competition is a more effective prod to production and a more trustworthy regulator of prices than even an enlightened combination. **[FN46]**

Recently, however, the courts have given indications that the economies or efficiencies resulting from a practice will be considered in determining whether a practice is unlawful. In doing so the courts have equated economies with pro-competitive effects, though whether a practice enhances efficiency need have no relation to its impact on the degree of competition in the market. For example, in NCAA v Board of Regents of the University of Oklahoma, [FN45] the Supreme Court considered (though it rejected on the facts presented) the argument that restrictions on the broadcasting of college football games cut costs and therefore presented certain efficiencies. [FN46]

Also lending support to an 'efficiencies defense' is the Sixth Circuit's recent decision in White & White, Inc v American Hospital Supply Corp. [FN49] There, the court found that the practices at issue aided in cost containment in the purchasing of hospital supplies, and refused to condemn them:

[E]xpensive medical technologies, a progressively aging population, the strain on public and private payment plans, and competition from franchised for-profit hospital chains, forced non-profit hospitals to realize that they cannot continue business as usual, but must demand new, more cost-effective, products and services. One approach has been to purchase supplies in volume as a member of a group. AHSC, recognizing, as the district court also found, that local suppliers will decline as the market so reforms itself, sought to prepare itself for the future. This Court cannot, like King Canute, employ the antitrust laws to hold back the tides that threaten these plaintiffs**.**

[FN50]

The courts have thus let in the back door the type of 'reasonableness' arguments--at least economic 'reasonableness' arguments--they have traditionally eschewed under the rule of reason.

VII. Conclusion

The trend in rule of reason litigation in the last decade has not been favorable to plaintiffs. Substantial proof requirements have been added to the law, while previously rejected defenses are being permitted.

These decision do not sound the death knell for the rule of reason. But they do assure that any rule of reason case will be expensive and require thorough proofs. Careful economic analysis is now the essential basis for any rule of reason case.

[FNa] **David A. Ettinger is a partner in the Detroit firm of Honigman Miller** Schwartz & Cohn. He is a 1976 graduate of the University of Michigan Law School and attended graduate school in economics at the University of Michigan. He specializes in antitrust litigation and counseling, and has written and lectured on antitrust topics**.**

***

[FNaa] **Gerard Mantese** is a litigation associate of the Detroit firm of Honigman Miller Schwartz and Cohn. He is a 1982 graduate of the St. Louis University Law School**.**

[FN1]. Chicago Board of Trade v United States, 246 US 231, 238 (1918).

[FN2]. Chicago Board of Trade, supra.

[FN3]. United States v Socony-Vacuum Oil Co, 310 US 150 (1940).

[FN4]. Albrecht v Herald Co, 390 US 145 (1968).

[FN5]. United States v Topco Associates, Inc, 405 US 596 (1972).

[FN6]. United States v General Motors Corp, 384 US 127 (1966); Klor's, Inc v Broadway-Hale Stores, Inc, 359 US 207 (1959).

[FN7]. International Salt Co v United States, 332 US 392 (1947).

[FN8]. Continental TV, Inc. v GTE Sylvania, Inc., 433 US 36 (1977).

[FN9]. Oreck Corp v Whirlpool Corp, 579 F2d 126, 131 (2nd Cir 1978).

[FN10]. Arizona v Maricopa County Medical Society, 457 US 332, 343 (1982); Continental TV, Inc, supra.

[FN11]. 246 US 231 (1918).

[FN12]. 246 US at 238.

[FN13]. The New Webster Encyclopaedic Dictionary of the English Language (Consol Book Pub 1952).

[FN14]. 433 US 36 (1977).

[FN15]. 435 US 679 (1978).

[FN16]. 435 US at 688 (emphasis added).

[FN17]. 435 US at 692 (footnote omitted; emphasis added).

[FN18]. Chicago Board of Trade, supra, at 238.

[FN19]. Havoco of America, Ltd v Shell Oil Co, 626 F2d 549, 558 (7th Cir 1980).

[FN20]. Brown Shoe Co v United States, 370 US 294, 320 (1962) (emphasis in original deleted).

[FN21]. 611 F2d 286 (9th Cir 1979).

[FN22]. 611 F2d at 291 (quoting Continental TV, Inc. v GTE Sylvania, Inc, 433 US 36, 53, n.21 (1977)).

[FN23]. 318 F2d 283 (6th Cir 1963).

[FN24]. 691 F2d 241 (6th Cir 1982).

[FN25]. 318 F2d at 287.

[FN26]. United States Department of Justice, Merger Guidelines, at 2-3 (June 14, 1982).

[FN27]. Id., at 16-17.

[FN28]. 1982-2 Trade Cas (CCH) ¶ 64,773 (ED Va 1982).

[FN29]. 618 F2d 1340, 1345 (9th Cir 1980).

[FN30]. Id.

[FN31]. Id.

[FN32]. 599 F2d 196, 204 (7th Cir 1979).

[FN33]. 678 F2d 742, 745 (7th Cir 1982).

[FN34]. Muenster Butane, Inc v Stewart Co, 651 F2d 292, 296-97 (5th Cir 1981), and Valley Liquors, supra.

[FN35]. Volasco Products Co v Lloyd A Fry Roofing Co, 308 F2d 383 (6th Cir 1962).

[FN36]. Bigelow v RKO Radio Pictures, 327 US 251 (1946).

[FN37]. United States v El du Pont de Nemours & Co., 351 US 377, 404 (1956).

[FN38]. Tampa Electric Co v Nashville Coal Co, 365 US 320, 327 (1961).

[FN39]. 351 US 377 (1956).

[FN40]. Slip Op.81 C4296 (ND III 10/25/83).

[FN41]. 433 US 36 (1977).

[FN42]. 433 US at 54-55.

[FN43]. 63 F Supp at 525.

[FN44]. 52 USLW 4928 (US 6/27/84).

[FN45]. 52 USLW at 4935-36.

[FN46]. 723 F2d 495 (6th Cir 1983).

[FN47]. 723 F2d at 508-509.

[FN48]. ??

END OF DOCUMENT