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Are You Ready for the Behavioral Antitrust Approach?

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Introduction

It is hardly surprising to any antitrust practitioner that the law-and-economics (Chicago) school of thought has taken on an important role in both the theoretical and practical antitrust debate. It has significantly influenced the legal analysis of major antitrust issues including monopolization, mergers, resale price maintenance, predatory pricing, and tying.[1] A central theoretical assumption that has underlined the traditional law-and-economics analysis of antitrust law is that firm decision makers are perfectly rational.[2] A rational decision maker, according to the law-and-economics approach, makes cold and accurate economic calculations when judging the probable costs and benefits of different business policies.[3] Furthermore, a rational decision maker engages only in business practices that have a positive expected value.[4] In many cases, this approach is a very useful tool for a lawyer seeking to understand and explain how a market operates. In some cases, it can certainly provide enlightenment. In other cases, however, trying to fit observed behavior into the Chicago-school explanation can be a bit of a stretch. The data simply may not fit any rational patterns. Taking it a step further, using a strict law-and-economics approach may even provide a convenient tool to explain away conduct as harmless for an advocate seeking to defend a practice or a transaction that otherwise might seem an obvious target for challenge.

Recently, a new antitrust approach has emerged: behavioral antitrust.[5] In contrast to the theoretical rationality assumption that underlies the traditional economic analysis, the behavioral antitrust approach suggests that real-life decision makers are human. Namely, they are affected by emotions and personal motivations.[6] Their rationality is bound by cognitive constraints.[7] They make systematic mistakes under certain circumstances, and they sometimes engage in business practices that have a negative expected value.[8] When one starts with data about what actually happened, one can gain insight into why people do what they do, rather than just assuming that objective rationality will govern conduct.[9] In addition, behavioral antitrust theory is starting to provide insight into certain types of conduct where behavioral tools are used to influence competitive behavior, such tools not necessarily being linked to market share.[10]

It is fair to say that the practitioner will be seeing more examples of behavioral economics in everyday antitrust practice.[11] Behavioral analysis will become more frequently used in merger analysis and can be helpful in examining vertical relationships. Although it hardly sounds revolutionary, we anticipate more weight being given to evidence of what people (customers, suppliers, competitors) do, or were likely to do, based on observed behavior.

To provide an introduction to the area, this article will examine three areas that provide insights that challenge the conventional economic assertions when viewed through a behavioral lens: predatory pricing, entry, and franchising/distribution. We'll conclude with a way to reconcile the law-and-economics and behavioral approaches to antitrust, based on human rational behavior.

Predatory Pricing

Predatory pricing, the practice of selling at an unprofitable price to drive competitors out of the market, or exclude them from the market, has been researched extensively by legal economists. A central assumption at the core of the traditional law-and-economics analysis of predatory pricing is that potential pricing predators are rational. Building upon this assumption, the economic analysis is as follows:[12] A predator is likely to incur losses from selling at a low and unprofitable price. Accordingly, the rational predator is likely to engage in predatory pricing only if he is likely, following the predatory act, to recoup his losses by charging customers supra-competitive prices. For recoupment to be likely, two interrelated facts must be true: the potential predator must have an exceptionally large market share, and entry barriers into the market must be significantly high. These two factual conditions, however, are rarely met. Therefore, predators normally will not be able to recoup their losses. Consequently, rational predators are not likely to pursue predation in the first place. This economic reasoning led legal economists to conclude that there is no sufficient reason for antitrust law to take predation seriously.[13] The traditional economic analysis has influenced the Supreme Court, which tends to dismiss predatory pricing contentions where recoupment is implausible.[14]

The behavioral antitrust approach challenges the conventional economic assumptions, reasoning, and conclusions. According to legal behaviorists, potential predators are not always rational, as opposed to the economic view. Empirical evidence indicates that under some circumstances potential predators are likely to exhibit irrational risk-seeking behavior, namely by engaging in negative expected value predation.[15] Specifically, when executives of leading firms find their market share to have eroded, they are likely to use their long-lasting supremacy in the market as the relevant reference point when assessing various possible business policies. Rather than looking at long-term outcomes, an executive may be compensated based on market share or sales volume, and thus would have a personal interest in predatory pricing. Even without an incentive formula providing motivation, the manager may have his or her ego tied to "being number one" and will simply do whatever it takes to maintain that position. Aggressive behavior in business is often rewarded, and many individuals with strong egos and a risk-taking personality end up in management positions. In regional markets where competition is personal, sales below cost are the quickest way to get rid of competitors, even if reentry (or new entry) is relatively easy. This behavior is not necessarily "rational" in the traditional sense when rationality is defined by a safe predictable outcome. But it is "rational" in the sense that it is instinctive for the individuals involved; it is their nature and should be expected. They probably have been rewarded throughout their career for these behaviors, so why should they stop now?

As a result of these behavioral attributes, executives may be inclined to pursue risk-seeking predatory pricing without a rationally sufficient likelihood of recoupment. Given the potential for risk-seeking by predators, the behavioral antitrust approach suggests that a summary judgment against contentions of predatory pricing may not be warranted when recoupment is unlikely. The behavioral approach calls for a more cautious assessment of the evidence in order to determine whether risk-seeking predation has occurred.

Entry

Traditional law-and-economics analysis highlights the entry of new rational firms into the market as a reason to minimize antitrust legal intervention in the market.[16] The entry of new rational enterprises, according to legal economists, guarantees that a market share held by a firm will not translate to prolonged anticompetitive market power.[17] This is so, they claim, because new entrants may prevent the long-term maintenance of supra-competitive prices by firms with the potential to exercise market power.[18] In the face of the feasible entry of new rational enterprises into the market, legal economists assert that most claims of antitrust violations should be dismissed summarily.[19] Here, too, the conventional economic analysis has influenced the Supreme Court, which tends to reject antitrust allegations when entry of enterprises into the market is feasible.[20]

The behavioral antitrust approach refutes the economic analysis of this issue as well. To begin with, it challenges the assumption, embedded in the economic reasoning, that new entrants are rational. According to legal behaviorists, empirical findings indicate that new entrants are inclined to be irrationally overconfident, especially when making high-risk decisions under uncertainty.[21] This is consistent with the reward pattern for both entrepreneurs and corporate staffers. They like to be aggressive and take risks, and those who have not been weeded out have more power as they succeed in their ventures or rise in their organizations. In fact, our entire system has hinged on the "irrational" commitment of the aggressive businessperson who pushes into new markets without a guarantee of success. Many highly successful businesses grind to a halt due to an excess of analytical caution. Under these circumstances, of course, new entrants particularly may overestimate their business skills, overestimate the profitability of entry, and underestimate the costs of entry.[22] Given these errors in judgment, the behavioral approach asserts that overconfident entrants will excessively enter into the market without succeeding to penetrate it.[23] Consequently, legal behaviorists suggest that the mere existence of new entrants should not be viewed as sufficient evidence that market power is unlikely.[24] Instead, courts should examine the success of entrants in penetrating the market.[25] This success serves as better evidence of the competitive threat such entrants pose for allegedly anticompetitive firms.[26]

Franchising and Distribution

Franchise tying contracts – namely, agreements which obligate a franchi*see* to buy products from a franchisor or a specific supplier as a condition of receiving the franchise license – were also researched extensively by legal economists.[27] The conventional law-and-economics analysis asserts that the *per se* illegality rule that governs franchise tying contracts is inappropriate. This assertion is based on the claim that the *per se* illegal standard ignores a significant benefit that franchise tying contracts generate: the reduction of the franchisor's monitoring costs. By requiring a franchisee to purchase product inputs directly from the franchisor, a tying agreement – as legal economists suggest – decreases the expenditures that the franchisor will have to incur in order to scrutinize the quality of products sold by the franchisee to customers.

Building upon empirical research, the behavioral antitrust approach suggests that the conventional economic analysis of franchisor monitoring-cost reduction is incomplete. According to this approach, the conventional analysis ignores the *emotional* implications of a tying relationship, which may increase the franchisor's monitoring costs. Legal behaviorists suggest in particular that a franchise relationship, which is based on a tying regime, is likely to continually limit the franchisee's independence. As a result, the tying relationship is likely to increase the franchisee's frustration with the relationship. The continual emotional experience of frustration is likely to promote opportunistic retaliatory behavior on the part of the franchisee toward the franchisor. Ultimately, a tying relationship will increase the likelihood that the franchisee will take three central forms of opportunistic acts toward the franchisor: provide false information, provide inadequate customer service, and neglect cleanliness standards in the franchise unit. These potential opportunistic acts, as they amass, are likely to increase considerably the franchisor's information, customer-service, and cleanliness-related monitoring costs. These accumulated monitoring costs are likely to offset the product quality monitoring cost savings arguably generated by a franchise tying agreement.

This type of behavioral breakdown is also seen in vertical relationships that do not necessarily involve the interactions of franchises. Distribution litigation is often an outgrowth of a breakdown in the relationship between the manufacturer and dealer. This breakdown can happen because of a divergence in strategy when there is a corporate shift, or when there is a passage of a family business to a new generation. It may also occur because of a failure in the initial communications: each party hears what it wants and, as time passes, there is conflict because the distribution plan is not what either party anticipated. But trying to put what is a communications failure (parties not being on the same wavelength) into an antitrust law-and-economics context yields strange results.

The discussions of resale price maintenance (RPM) are another example of this divergence from reality. There is animus toward resale price maintenance because it is felt by the person being restrained as being just too much of a restraint. The concept that RPM is a substitute for detailed guidance on quality of service and a prevention of free-riding is elegant, but simplistic. A contractual requirement of performance standards is much more specific, and could substitute for misunderstanding, ambiguity, gamesmanship, and ultimately, litigation. The market-facing dealer may agree with every one of the manufacturer's requirements, but may feel absolutely hamstrung without the ability to respond to local market conditions by raising or lowering the price as conditions may dictate. Price maintenance in itself may or may not harm consumer welfare, but the justifications for it strain credulity. Any injury will usually be due to other factors like the market shares of the parties in the market.

The communications-breakdown cannot be analyzed in an antitrust context. If there are market abuses they are usually incidental to the cause of the dispute. The legal remedy is almost always in the world of contract law. If there is any type of behavioral exploitation other than poor communications, it may come from deception or fraud. The human reactions will govern what happens more than a strict analysis of what a "rational" person would do.

Suggesting a Behavioral Rationality Approach

Antitrust attempts to control conduct that reduces consumer welfare.[28] The traditional law-and-economics theory profoundly influenced antitrust law's evolution, but suffered from a rigidity that, ironically, could cause the ultimate in supposedly rational approaches to irrationally ignore reality. The behavioral antitrust approach reveals these departures from observed reality that should cause one to question a slavish devotion to a theory that does not fit with what people always do.

Instead, it is appropriate to combine the two approaches when analyzing a transaction or antitrust-sensitive conduct. What does the data tell one about why people do what they do? Were there some factors that induced people to behave in some way that might be considered against their self-interest because they were misled into acting in a way they thought was rational, but was really a reflection of market power abuse or false communications?[29] If an examination of the circumstances surrounding conduct shows that there is an abuse of *behavioral power* by a party[30] that may be an indicator of an abuse that antitrust should address. Thus, the rational examination of the evidence of behavior by all of the players in a market may indicate "irrational" behavior by some participants, but behavior that is consistent with human personality, and thus it would be irrational to ignore those tendencies.[31] Now, only time will tell whether the behavioral antitrust approach will have as profound an effect upon the judicial and legislative branches as the traditional economics analysis had.

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1 Of course, this is not meant to suggest that this approach was universally accepted, as there were many economists and attorneys who did not buy into the perfectly rational world that was part of the Chicago-school analysis.

2 Avishalom Tor, *A Behavioral Approach to Antitrust Law and Economics*, 14 CONSUMER POLICY 2, 2 (2004) [hereinafter Tor, *A Behavioral Approach*].

3 *Id*.

4 *Id*.

5 For seminal articles within this field of research see, for example, Avishalom Tor & William J. Rinner, Behavioral Antitrust: A New Approach to the Rule of Reason after Leegin, U. Ill. L. Rev. (forthcoming, 2011); Uri Benoliel, The Behavioral Law and Economics of Franchise Tying Contracts, 41 Rutgers L. J. (forthcoming, 2010); Maurice E. Stucke, Money, Is That What I Want? Competition Policy & the Role of Behavioral Economics, 50 Santa Clara L. Rev. 893 (2010); Maurice E. Stucke, Behavioral Economists at the Gate: Antitrust in the Twenty-First Century, 38 Loy. U. Chi. L.J. 513 (2007); Tor, A Behavioral Approach, supra note 1; Avishalom Tor, Illustrating a Behaviorally Informed Approach to Antitrust Law: The Case of Predatory Pricing, 18 Antitrust 52, 55 (2003) [hereinafter Tor, Illustrating a Behaviorally Informed Approach]; Avishalom Tor, The Fable of Entry: Bounded Rationality, Market Discipline, and Legal Policy, 101 Mich. L. Rev. 482, 553 (2002) [hereinafter Tor, The Fable of Entry]; Maurice E. Stucke & Amanda P. Reeves, Behavioral Antitrust 23, available at SSRN: http://ssrn.com/abstract=1582720.

6 Tor, *Illustrating a Behaviorally Informed Approach*, *supra* note 5, at 55.

7 *Id*.

8 *Id*.

9 Max Huffman, Behavioral Exploitation and Antitrust, paper prepared for the 10th Annual Loyola Antitrust Colloquium, Loyola University Chicago (April 30, 2010).

10 Concepts of nonprice predation might be considered behavioral tools.

11 For example, the Horizontal Merger Guidelines, released by the FTC and DOJ on August 19, 2010, make use of behavioral concepts in the increased emphasis on competitive effects analysis. http://www.ftc.gov/os/2010/08/100819hmg.pdf. Commissioner Rosch, in a separate statement, notes that he would have preferred that more attention be paid to the actual empirical data surround the effects of a merger and not just to price theory. http://www.ftc.gov/os/2010/08/100819hmg.pdf.

12 *Id*; Tor, *A Behavioral Approach*, *supra* note 2, at 2.

13 Stucke & Reeves, *supra* note 5, at 23.

14 To illustrate, the Supreme Court embraced the economic analysis in *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589-90 (1986). *See also* Tor, *Illustrating a Behaviorally Informed Approach*, *supra* note 5, at 55; Stucke & Reeves, *supra* note 5, at 23-24.

15 The following analysis is based on Tor, *Illustrating a Behaviorally Informed Approach, supra* note 5, at 55.

16 Tor, *A Behavioral Approach*, *supra* note 2, at 4.

17 *Id*.

18 Reeves & Stucke, *supra* note 5, at 40.

19 Tor, *A Behavioral Approach*, *supra* note 2, at 4.

20 *See, e.g., Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 226 (1993).

21 Tor, *A Behavioral Approach*, *supra* note 2, at 4.

[22] Tor, *The Fable of Entry*, *supra* note 5, at 507-508.
[23] Tor, *A Behavioral Approach*, *supra* note 2, at 4.
[24] Tor, *The Fable of Entry*, *supra* note 5, at 553.
[25] *Id*.
[26] *Id*.
[27] The analysis in this section is based on Benoliel, *supra* note 5.
[28] This involves, of course, certain judgments about the kind of welfare we want to enhance, which is beyond the scope of this article.
[29] A consumer that makes a purchase based on false advertising is acting rationally, since he or she is acting on what is perceived to be factual. The straight law-and-economics approach might say that a seller is not likely to engage in false advertising since the falsity would eventually become known to purchasers, damaging the reputation of the seller, and ultimately resulting in reduced income and profit. Theoretically true, but in reality absurd. A seller, with a short term orientation, may engage in false advertising, since he doesn't care about being caught and possible reputational injury. He is willing to use behavioral exploitation for short term gain, clearly injuring consumer welfare. Legal regimes should not be content to say that "eventually" the seller will pay a price so we shouldn't worry.
[30] For example, a store-owner has complete environmental control (behavioral power) over a shopper, and may be able to manipulate a customer into conduct that is not necessarily in the consumer's best interests, although the consumer may not know this. Is this something that should be a concern of the antitrust laws?
[31] *See generally* Dan Ariely, Predictably Irrational: The Hidden Forces that Shape Our Decisions (2008).