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SHOULD ANTITRUST CONDEMN TYING  
ARRANGEMENTS THAT INCREASE PRICE WITHOUT  
RESTRAINING COMPETITION?

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Responding to Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 HARV. L. REV. 397 (2009).

Early in the development of the antitrust laws, the U.S. Supreme Court declared that conditioning the sale of one product on the customer's agreement to purchase another ("tying" or "tie-in sales") was inherently anticompetitive and lacked any redeeming virtue.<sup>1</sup> During the Chicago School's ascendancy, article after article appeared challenging that notion and explaining how tying could benefit consumers.<sup>2</sup> Professor Einer Elhauge's article, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, finally turns the tables, purporting to show that tying, in many of its forms, is bad for consumers after all.<sup>3</sup> In the process, Elhauge takes on not just the old Chicago School, but also the current mainstream commentators who oppose existing law's tough approach to tying.

Valuable as all this is, Elhauge makes one less than convincing claim: antitrust law should condemn tying by firms with market power *even when the practice does not restrain competition in the tied product market*. Although he systematically seeks to show that tying enables a firm with market power to charge higher prices than it could if it simply charged the profit maximizing price on the tying product alone, he shortchanges the most compelling counterargument — namely, that granting firms with market power broad leeway to exploit that power actually benefits consumers over time so long as competing firms are not restrained. Despite the short-run harm from temporarily higher prices, the opportunity to charge them encourages rival firms to invest in innovative activities that are essential to a vibrant economy.

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<sup>1</sup> *Black v. Magnolia Liquor Co.*, 355 U.S. 24, 25 (1957) (asserting that tying agreements "serve no purpose beyond the suppression of competition").

<sup>2</sup> See, e.g., Ward S. Bowman, Jr., *Tying Arrangements and the Leverage Problem*, 67 YALE L.J. 19 (1957); Keith K. Wollenberg, Note, *An Economic Analysis of Tie-In Sales: Re-examining the Leverage Theory*, 39 STAN. L. REV. 737 (1987).

<sup>3</sup> Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 HARV. L. REV. 397 (2009).

This Response first articulates the case for permitting firms that do not restrain competition to exploit market power through tying. Second, it criticizes Elhauge's likely counterpoints. Finally, it contends that irrespective of who wins the economic debate, Elhauge's approach necessarily conflicts at a deep level with the theory of competition policy that underlies antitrust law. As a result, one who accepts his argument with respect to tying would be compelled to reexamine antitrust doctrine all the way down to its core.

#### I. THE CASE FOR PERMITTING TYING THAT DOES NOT RESTRAIN COMPETITION

Elhauge argues that tying should violate the antitrust laws whenever it inefficiently raises prices, even if the practice does not hinder the ability of other firms in the industry to respond competitively.<sup>4</sup> This outcome can occur, he explains, when a firm has market power over the tying product, but does not foreclose enough of the tied product market to limit the ability of firms to compete in that market.<sup>5</sup> The tying firm's customers are harmed, but not its competitors.

This scenario can be illustrated through a simple hypothetical involving printers and ink cartridges. If a printer manufacturer can tie the purchase of cartridges to the purchase of printers, consumers may be harmed in two ways. First, if a consumer's desire for the manufacturer's printer is strong enough, the tie may result in the consumer paying more for the package than it would pay if it were free to purchase the printer and ink separately. Elhauge shows that this may happen because the tie enables the manufacturer to capture more consumer surplus than it could simply by charging a monopoly price on the printer.<sup>6</sup>

Second, the tie may harm consumers by restraining competition in the market for printer cartridges. By foreclosing ink dealers from selling to those consumers who purchase the manufacturer's printer, the tie may increase the costs of cartridge makers and thus the prices that they charge.<sup>7</sup>

There is no dispute that current law prohibits tying that causes the second type of consumer harm. Elhauge's principal claim, however, is that current law does and should prohibit tying even when the customers foreclosed from buying ink cartridges as a result of the tie do

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<sup>4</sup> See *id.* at 421–22 (“[A]ntitrust does condemn conduct that distorts the competitive process in ways that harm consumer welfare even if that conduct does not harm competitors.”).

<sup>5</sup> See *id.*

<sup>6</sup> See *id.* at 407.

<sup>7</sup> See *id.* at 417.

not negatively impact the ink market, and thus consumers suffer only the first type of harm.

To support his view that tying absent substantial foreclosure violates the antitrust laws, Elhauge relies on case law and legislative history emphasizing the law's consumer-welfare focus.<sup>8</sup> Since consumers are harmed when they pay supracompetitive prices, Elhauge argues, existing law should prohibit ties that raise price.

A similarly impressive list of case law quotations, however, would support the view that antitrust is concerned with protecting consumers *only* by facilitating competition. Where anticonsumer behavior actually enhances competition — such as charging monopoly prices that encourage new competitors to enter the market — federal courts have long held that antitrust law does not interfere.<sup>9</sup> For example, Chief Justice Roberts recently wrote for the Court in *Pacific Bell Telephone Co. v. Linkline Communications, Inc.*<sup>10</sup> that “businesses are [generally] free to choose . . . the prices, terms, and conditions” with which they deal with their customers.<sup>11</sup>

In the 2004 case *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*,<sup>12</sup> Justice Scalia offered the clearest articulation of this principle, explaining that the short-run consumer harm from higher prices spurs competitive entry and thus over time benefits consumers. He explained that although forcing a monopolist to share its facilities with rivals would push prices toward the competitive level, “it may lessen the incentive for the monopolist, the rival, or both to invest.”<sup>13</sup> He elaborated that:

The mere possession of monopoly power, and the concomitant charging of monopoly prices, is not only not unlawful; it is an important element of the free-market system. The opportunity to charge monopoly prices — at least for a short period — is what attracts “business acumen” in the first place; it induces risk taking that produces innovation and economic growth. To safeguard the incentive to innovate, the possession of monopoly power will not be found unlawful unless it is accompanied by an element of anticompetitive *conduct*.<sup>14</sup>

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<sup>8</sup> See *id.* at 436–38.

<sup>9</sup> See *Olympia Equip. Leasing Co. v. W. Union Tel. Co.*, 797 F.2d 370, 376 (7th Cir. 1986) (Posner, J.) (“A monopolist has no duty to reduce its prices in order to help consumers.”).

<sup>10</sup> 129 S. Ct. 1109 (2009).

<sup>11</sup> *Id.* at 1118; see also *id.* at 1122 (“[A]ntitrust law does not forbid lawfully obtained monopolies from charging monopoly prices.”).

<sup>12</sup> 540 U.S. 398 (2004).

<sup>13</sup> *Id.* at 408.

<sup>14</sup> *Id.* at 407. At least three lower courts have quoted *Trinko*'s key language. See *Four Corners Nephrology Assocs., P.C. v. Mercy Med. Ctr. of Durango*, 582 F.3d 1216, 1221–22 (10th Cir. 2009); *Digene Corp. v. Third Wave Techs., Inc.*, 563 F. Supp. 2d 996, 1005 (W.D. Wis. 2008); *NicSand, Inc. v. 3M Co.*, No. 1:03CV2619, 2005 WL 4704988, at \*4 (N.D. Ohio Mar. 1, 2005).

In their recent work, economists Dennis Carlton and Ken Heyer articulate well the persuasiveness of Justice Scalia's language in terms of both common sense and economic policy. They observe that "most of us accept that high profits are a deserved reward for success" and denying a firm the opportunity to benefit from lawfully obtained market power would thus be unfair.<sup>15</sup> With respect to economic policy, they argue that the prospect of earning high profits "provides a critically important incentive for welfare-enhancing investment and innovation."<sup>16</sup> And the value of incentives to innovate is not solely the province of intellectual property law. Antitrust recognizes it too, in part by permitting monopoly pricing even though, as Carlton and Heyer point out, it "produces a clear and well-recognized static deadweight loss to the economy."<sup>17</sup> Despite the short-run consumer harm, the high prices stimulate competition by making alternative goods more attractive and more successful. By encouraging customers to switch to new suppliers if they can produce better products, high prices effectively grease the competitive wheels, benefiting consumers over time.

Critically, Carlton and Heyer contend that profits earned simply by charging high prices on one product, which the antitrust laws unambiguously permit, and profits earned through unilateral business practices that do not extend a firm's market power are indistinguishable in the sense that both extract greater profits in the short run without "weakening the competitive threats or constraints provided by rival firms."<sup>18</sup> In fact, inefficient tying that does not restrain competitors would necessarily boost competition in the tying product market even more than straight monopoly pricing. As Elhauge demonstrates, when a firm ties a good over which it has market power to another good or service, it increases its profits compared to what it would have earned by simply setting a high price on the tying good. Because consumers must pay even more when the manufacturer ties one product to another, they would surely view tying as worse than straight monopoly pricing, creating an enhanced opportunity for competitors to erode the tying firm's market power by innovating better products.

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<sup>15</sup> Dennis W. Carlton & Ken Heyer, *Appropriate Antitrust Policy Towards Single-Firm Conduct* 3 (U.S. Dep't of Justice, Antitrust Div., Econ. Analysis Group, Working Paper No. EAG 08-3, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1111665](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1111665).

<sup>16</sup> Dennis W. Carlton & Ken Heyer, *Extraction vs. Extension: The Basis for Formulating Antitrust Policy Towards Single-Firm Conduct*, COMPETITION POL'Y INT'L, Autumn 2008, at 285, 288.

<sup>17</sup> *Id.* at 291.

<sup>18</sup> *Id.* at 298; cf. Steven Semeraro, *The Efficiency and Fairness of Enforced Sharing: An Examination of the Essence of Antitrust*, 52 U. KAN. L. REV. 57, 99-100 (2003) (proposing that unilateral refusals to deal be subjected to similar analysis).

## II. ELHAUGE'S LIKELY RESPONSE

Although Elhauge does not mention Justice Scalia's language in *Trinko*, his article suggests that he would respond to the above argument in three ways. First, he would likely contend that *Trinko* is inapplicable because it involved a single firm's refusal to deal. Tying, by contrast, involves a vertical agreement between the seller and buyer. While he believes that antitrust law should and does apply to true unilateral action — such as predatory pricing or refusing to deal — only when it restrains competition, Elhauge claims that existing law condemns “multifirm agreements” that increase price if “the buyer agrees to abide by some seller condition restricting buyer choice,” even if the agreements do *not* restrain competitors.<sup>19</sup>

In support of this view, Elhauge cites *Jefferson Parish Hospital District No. 2 v. Hyde*,<sup>20</sup> the Supreme Court's leading tying case. Read as a whole, however, that case is ambiguous with respect to whether tying should violate the antitrust laws when the practice has no restraining effect on competitors. Elhauge points to language in which the *Jefferson Parish* majority noted that tying may facilitate price discrimination.<sup>21</sup> And he shows that a firm may discriminate among its customers in a way that harms them without distorting the competitive options of rival firms.<sup>22</sup> He thus concludes that the Court would condemn tying without proof of a competitive restraint.<sup>23</sup>

Justice Stevens's majority opinion, however, includes language that more directly suggests that only anticompetitive ties trigger antitrust scrutiny. For example, he stressed that tying is unlawful when a defendant with market power attempts “to impose restraints on competition in the market for a tied product” or when “that power is used to impair competition on the merits in another market.”<sup>24</sup> This language is entirely consistent with the notion that the Court either (1) assumed that price discrimination would restrain competitors in the tied market, or (2) did not seriously consider the possibility that it would not.

Case law aside, Elhauge's distinction between tying and unilateral conduct is tenuous. To be sure, one can meaningfully distinguish some vertical agreements from unilateral conduct. When a vertical agreement effectively induces downstream dealers to refrain from competing among themselves — by, for example, assigning exclusive territories or setting minimum retail prices — it may harm consumers by restraining competition in ways that a single firm acting alone could

<sup>19</sup> Elhauge, *supra* note 3, at 439 n.112.

<sup>20</sup> 466 U.S. 2 (1984).

<sup>21</sup> Elhauge, *supra* note 3, at 423.

<sup>22</sup> *See id.* at 404–07.

<sup>23</sup> *Id.* at 423–25.

<sup>24</sup> *Jefferson Parish*, 466 U.S. at 14.

not accomplish. But tying does not fall into this category. The customer forced to buy a tied good in order to purchase the tying good does not agree to limit its choices in a way that has independent competitive significance so long as *competition in the tied market is not adversely affected*. Moreover, a firm's decision to tie is as much a unilateral decision as a firm's decision to charge predatory prices or to refuse to deal, conduct that Elhauge agrees does not violate the anti-trust laws absent some restraint on competitors.<sup>25</sup> Tying thus cannot be meaningfully distinguished from other unilateral forms of exercising market power.

Second, regardless of the form of the arrangement, Elhauge would likely contend that tying can be distinguished from simply increasing price because "setting prices is unavoidable" and scrutinizing all pricing decisions "would raise serious administrability problems and impede routine procompetitive price changes."<sup>26</sup> Tying, by contrast, could be banned without similar negative consequences.<sup>27</sup>

That might be true of a rule that simply prohibited all forms of tying.<sup>28</sup> But Elhauge does not advocate such a rule. He would allow tying whenever the defendant demonstrated that it was efficient.<sup>29</sup> Just as antitrust scrutiny of pricing decisions has costs, so too would the scrutiny necessary to isolate inefficient tying. Efficiencies are notoriously hard to prove, and placing the burden on a defendant would thus create uncertainty. As a result, some firms would refrain from engaging in efficient tying arrangements for fear of antitrust liability, just as the scrutiny of pricing decisions could chill procompetitive price changes. And if a firm sought to tie anyway, the courts would face a significant administrative burden in determining precisely what sort of tying is efficient. No doubt, policing pricing would be more difficult than policing tying, but the difference is one of degree, not kind.

Finally, Elhauge would likely reiterate his contention that Carlton and Heyer's analysis is "radical" and relies on the "mistaken premise" that a firm should be permitted to capture all of the surplus resulting from its innovations.<sup>30</sup> Empowering an innovator in such a way, Elhauge recognizes, would lead firms to invest excessively in research and development in an effort to create new products and capture all of

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<sup>25</sup> See Elhauge, *supra* note 3, at 439 n.112.

<sup>26</sup> *Id.* at 428.

<sup>27</sup> *Id.*

<sup>28</sup> Even a blanket prohibition would create difficulties because many products could be characterized as ties among components, rather than single products, triggering potential antitrust scrutiny in a wider variety of cases than one might initially think.

<sup>29</sup> Elhauge, *supra* note 3, at 430.

<sup>30</sup> *Id.* at 439.

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the associated value.<sup>31</sup> Socially optimal investment requires that consumers share in the surplus generated by a new product.

Although Elhauge is surely right about that, Carlton and Heyer's proposal cannot be criticized on this ground. Their analysis assumes that consumers would benefit sufficiently from future innovations to more than offset the short-run loss from higher prices. As they put it, "interference with a firm's efforts to capture more of the value generated by its product will likely lead to a reduction in the quantity and quality of desirable products and services created in the future."<sup>32</sup> Fairly read, Carlton and Heyer seek to justify economically the common sense assumption that underlies Justice Scalia's *Trinko* language: the prospect of exploiting market power — when it does *not* limit competitive threats to the dominant firm — positively stimulates socially beneficial risk taking and investment.

In response, Elhauge contends that allowing a firm to earn supra-competitive profits would simply produce wasteful investment to be the first to market a new product. Most, if not all, of the social benefits of those products, he contends, will be competed away by the firms anticipating high profits. As a result, the benefits from innovation will rarely, if ever, outweigh short-run harm to consumers from higher prices.<sup>33</sup>

This theoretical argument likely goes too far. Economists like Carlton and Heyer may well underestimate the extent to which competition forces firms to innovate simply to avoid losing customers to their rivals. But Elhauge's criticism swings too far in the other direction, suggesting that the prospect of high profits has little or no beneficial effect. Identifying the precise balance would require empirical evidence that neither provides.

### III. COMPETITION, CONSUMER WELFARE, AND THE ESSENCE OF ANTITRUST

Showing that Elhauge has not made his case, of course, does not establish that he is wrong. But even if, as he predicts, ties harm consumers even when they do not restrain competition, he would still be wrong to claim that the antitrust laws should prohibit tying in these cases.

Antitrust policy rests on the core principle that over reasonable time frames competition will yield the socially optimal balance among

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<sup>31</sup> *Id.* at 440.

<sup>32</sup> Carlton & Heyer, *supra* note 16, at 291–92.

<sup>33</sup> See Elhauge, *supra* note 3, at 441–42.

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price, quality, and innovation.<sup>34</sup> That principle is deeply inconsistent with Elhauge's assertion that antitrust prohibits conduct that does not restrain competition. If competitors are *not* hindered when Firm A ties one good to another, then these competing firms will develop and sell the tying good either (1) without the tie or (2) in a package that has greater appeal to consumers than the package currently offered. By simply reaping the benefits of lawfully acquired market power through tying, Firm A actually increases the incentive for other firms to compete with it, precisely the alternative that antitrust law prefers. This dynamic competition to innovate over time, antitrust theory predicts, will benefit consumers because new and better products will generate more utility than consumers lose through higher short-run prices. Moreover, the legal system's intervening to keep prices down would have the perverse effect of expending social resources in a way that reduces the incentives of nondominant firms to improve their products. Permitting tying that does not restrain competition would thus rest comfortably within the accepted antitrust paradigm.

This reasoning, of course, does not prove that Elhauge is wrong in his consumer welfare calculations. One could surely imagine cases in which innovation would come too slowly to make up for the harm consumers would suffer from the high prices charged in the interim. If antitrust's fundamental postulate is correct, however, these cases must be rare, and the law must tolerate consumer harm sometimes in order to preserve the incentives to compete and innovate throughout the economy that generally best promote consumer interests.

But if empirical evidence ultimately demonstrates that Elhauge has correctly predicted that the benefits of competitive innovation do not outweigh the harm from short-run price increases, then antitrust's foundation would collapse. And antitrust theorists would be compelled to acknowledge explicitly that competition may not best serve consumer interests.

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<sup>34</sup> See *Nat'l Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679, 695 (1978) ("The Sherman Act reflects a legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services."). To be sure, there may be natural monopoly markets and other pockets within the economy that the government may decide require regulation, rather than free competition, to maximize social welfare. But where antitrust applies, competition best protects consumer interests.