

How the Chicago School Overshot the Mark

By Robert Pitofsky
and Steven C. Salop

Introduction: Setting the Stage

by Robert Pitofsky

The occasion for this book is a growing concern that antitrust, a system of regulation that for over a century has generally had wide professional and public support, is under attack. The recent trend appears to be toward more limited interpretation of doctrine (especially in the Supreme Court) and less aggressive federal enforcement.

A brief review of the essence of antitrust and the highs and lows of enforcement should help frame the important issues.

For most of our history, a free market and free trade have been central characteristics of the United States economy. These approaches have contributed to the efficient use of resources and the avoidance of predatory behavior by particular firms toward other businesses and consumers. Toward the end of the nineteenth century, however, people began to realize that absolute free market opportunities could be abused by giant corporations, and indirectly by the concentration of economic power, and that some limits on private sector behavior had to be established.

General suspicion of concentrated economic power led to the enactment of the Sherman Act in 1890 and the initiation of antitrust, a set of rules designed to outlaw the worst abuses by players in the private sector of the free market. The principal targets were improper exercise of monopoly power and agreements among rivals to set prices and divide markets. Over time, other forms of behavior that facilitated such abuses — mergers, distribution practices, boycotts — were incorporated into the antitrust system. Eventually basic concepts of a free market, regulated in some aspects by the government, migrated to other sectors of the economy — for example transportation and communication — and eventually to many other countries throughout the world.

Fashions in levels of enforcement have varied, including two time-outs to fight two world wars and a period of serious neglect in the 1920s. But in general, a free market approach protected by antitrust has served the country well — demonstrably better than the centralized control that produced unfortunate results in Stalinist Russia, Maoist China, North Korea and East Germany. In general, the system had wide popular support, even among people who may not have understood its arcane jargon, but knew,

almost instinctively, that private interests, unchecked by some government-inspired rules, could serve the interests of corporate officers and shareholders but might abuse consumer welfare.

During the 1920s, most of the 1930s and during World War II, antitrust often appeared to be a “faded passion.” But after World War II things began to change. First, antitrust enforcers, backed by a Congress generally hostile to Big Business and an unusually liberal and indulgent Supreme Court, introduced the most aggressive enforcement program in the nation’s history — before or since. During the 1950s and 1960s, tiny mergers that could not seriously be viewed as challenges to a competitive market were consistently blocked, abbreviated (so-called *per se*) rules were introduced to outlaw behavior that rarely produced anticompetitive or anticonsumer effects and licensing practices were challenged, which were little more than efforts to engage in aggressive innovation. All of this was accompanied by an almost total disregard for business claims of efficiency.

The period of the 1950s and 1960s — often associated with the Warren Court — did not just result in unwise decisions that are almost impossible to defend today; more important, it offered an inviting target for conservative lawyers and scholars, subsidized by generous private sector grants to think tanks and universities, to demonstrate how much damage overenforcement of antitrust could do. Two brilliant academics, Richard Posner and Robert Bork, led a small army of academics in devastating criticism of the output of the Warren Court.

During the same period, a more subtle and in the long run more influential trend was developing. Antitrust had been fueled by a general popular mistrust of Big Business and a desire to divide, diffuse and control economic power for political reasons. But now a band of economists and economically trained lawyers and academics began to challenge that premise. Their approach was to examine business behavior from a purely economic point of view and to exclude from consideration any political or social values

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— for example, protection of small business for the sake of the social values inherent in smallness — and place their faith in an automatic beneficial free market system. Considerations of noneconomic factors — for example, concern that a wave of mergers among TV outlets or book publishers might have adverse effects on opportunities for free speech — were dismissed as vague and therefore irrelevant.

Those concerned about the excesses of the Warren Court and in favor of the ascendance of economics were handed an enormous political boost when President Ronald Reagan announced that “government was the problem and not the solution.” It is unlikely President Reagan had antitrust in mind, but aggressive antitrust enforcement fell squarely in the crosshairs of that approach, with the result that in the 1980s, antitrust enforcement virtually disappeared. There was a continuation of challenges to cartels and very large mergers during the decade, but virtually all the rest of antitrust — challenges to vertical mergers, boycotts, all distribution practices, price discrimination and so forth — disappeared. There was, in effect, a return to the period of neglect of the 1920s.

Post-Reagan, there occurred a decade or so — the Clinton years and the first term of President George W. Bush — when there was an effort to find a middle ground between overenforcement of the 1960s and underenforcement of the 1980s, but that came to an end with appointments during President Bush’s second term of some agency enforcement officials, lower court judges and, most important, the confirmation of two conservative justices to the Supreme Court, who produced a working majority for the skeptical view that antitrust really did more harm than good.

All of this history brings us to the occasion for this book.

Contributors to this collection of essays are Republicans and Democrats, lawyers and scholars left of center and right of center, one-time enforcers, and private sector representatives. But virtually all share the view that U.S. antitrust enforcement, as a result of conservative economic analysis, is better today than it was during the Warren years — more rigorous, more reasonable, more sophisticated in terms of economics. But virtually all also confess to a sense of unease about the direction of antitrust interpretation and enforcement. Specific concerns include current preferences for economic models over facts, the tendency to assume that the free market mechanisms will cure all market imperfections, the belief that only efficiency matters, outright mistakes in matters of doctrine, but most of all, lack of sup-

port for rigorous enforcement and willingness of enforcers to approve questionable transactions if there is even a whiff of a defense. Like the indulgent Warren Court of the 1960s, which found the government was right every time, the current Supreme Court majority, often on the basis of what is called “Modern Economic Analysis,” finds a way of insuring that the pro-antitrust position always loses.

Why should we care? Contrary to what some believe, antitrust is not only or primarily a system to insure that business rivals do not behave unfairly or in a predatory manner toward other businesses. It is rather a “consumer welfare” system of laws. If businesses grow in unfair ways to be too dominant in their sectors of the market, rivals conspire to raise prices or divide markets, use patents and other forms of intellectual property to fence out rivals in unreasonable ways, merge to monopoly or dominant positions, or engage in the scores of other practices that traditionally have been regarded on balance as anticompetitive, and are protected by less than vigorous enforcement, prices will be higher, quality of products lower, and innovation diminished.

Because extreme interpretations and misinterpretations of conservative economic theory (and constant disregard of facts) have come to dominate antitrust, there is reason to believe that the United States is headed in a profoundly wrong direction. This collection of essays is designed to examine and analyze these issues.

Economic Analysis of Exclusionary Vertical Conduct: Where Chicago Has Overshot the Mark

By Steven C. Salop

Few antitrust issues are less contentious than the analysis of exclusionary vertical conduct and anticompetitive allegations of leverage and foreclosure. These concepts can occur in a wide variety of conduct — tying, exclusive dealing, vertical mergers, refusals to deal, and so on. The Chicago School revolution really began with its analysis of exclusionary vertical restraints and there has been continued controversy ever since.

The Chicago School argument is that the antitrust concepts of anticompetitive foreclosure and anticompetitive leverage are empty and illogical and do not hold up to economic analysis. As for exclusives, the associated argument is that competition for exclusive relationships benefits consumers, just as do other forms of competition. In short, exclusionary vertical conduct is either benign or procompetitive. Thus, the law regarding exclusionary vertical conduct should be very permissive or even *per se* legal. Judge Posner has suggested the use of a very permissive legal standard, the equally efficient entrant standard, which flows from the Brooke Group standard for predatory pricing.

Here, I do not review the case law on this set of issues. Instead, I examine the economic foundations of the controversy as a way to inform the debate. In my view, the strong economic foundations claimed by Chicago School commentators like Robert Bork do not hold up to economic analysis. The concepts of anticompetitive foreclosure and leverage are not empty and illogical. Competition for exclusives is not a panacea for all vertical exclusion claims. Nor is the predatory pricing paradigm the appropriate framework for analyzing exclusionary vertical conduct. Instead, a more refined analysis must be applied. This analysis implies that the better legal approach would be the rule of reason with its focus on consumer harm, not a proxy rule like the equally efficient entrant standard.

In the section that follows, I analyze anticompetitive foreclosure and the view that competition for exclusives can resolve all concerns about vertical exclusion. At the end, I discuss the issue of the two paradigms for exclusionary vertical conduct and show the fundamental economic flaw in the equally efficient entrant standard.

Vertical Integration and Anticompetitive Foreclosure

Conservative commentators have criticized the concept of anticompetitive foreclosure in the older cases like *Brown Shoe*. Bork suggested that the foreclosure alleged to occur from vertical mergers was nothing more than a remixing of supplier-customer relationships. As he cleverly put it, competition would be better served if the FTC had held an industry social mixer instead of bringing an antitrust action to enjoin a vertical merger. Those cases did not explain how foreclosure would lead to market power.

However, uncritical acceptance of this critique of foreclosure leads to an overly permissive view of vertical mergers and other exclusionary vertical conduct and restraints, and an overly skeptical view of antitrust allegations based on anticompetitive foreclosure concerns. Modern economic analysis has drawn the logical linkage between foreclosure and market power. In particular, vertical mergers can lead to real foreclosure that creates market power in either the upstream or downstream market under certain identifiable circumstances.

A vertical merger can lead to market power in the downstream market. Suppose that after the merger, the upstream division of the integrated firm refuses to deal with or raises the input price charged to unintegrated downstream competitors. Suppose that these unintegrated competitors lack equally cost-effective alternative sources of the input. Or, suppose that they only have one or two other alternative suppliers, and that those suppliers realize that the behavior of the now-integrated firm increases their market power over the unintegrated firms. In these circumstances, the merged firm may have the incentive to raise prices or refuse to deal, and that conduct will raise the cost of their integrated rivals. If there is insufficient remaining competition in the downstream market among integrated firms or other unintegrated firms that have cost-effective alternative sources of supply, then the downstream price may increase, leading to consumer injury.

Judge Posner's opinion in *JTC Petroleum* suggested a variant of this foreclosure analysis. In that case, Posner analyzed the case of a downstream cartel that prevents disruptive competition by a maverick by agreeing with input suppliers to refuse to deal with the maverick. The downstream cartel members compensate the input suppliers by paying a supracompetitive price for the inputs they bought, thereby sharing the cartel profits with those suppliers. Thus, the input suppliers enforce the downstream cartel. In this

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example, there is no actual vertical integration. Instead, there is anticompetitive “integration by contract.”

A vertical merger also can lead to market power in the upstream market. Suppose that after the merger, the downstream division of the integrated firm were to refuse to purchase from unintegrated input suppliers and instead began to purchase all of its input needs from the upstream division. If the downstream division of the integrated firm represented a large share of the market, withholding its purchases might drive one or more upstream competitors to exit from the market or be forced into a higher cost niche position. Either way, that might give the upstream division of the integrated firm the power and incentive to raise the prices it charges its other competitors.

Leverage theories of tying discussed earlier also may be applied to foreclosure analysis. For example, suppose that there were a purely vertical merger of an upstream monopolist and a downstream monopolist. (In terms of complementary products, the analogy would be a merger among the monopolistic producers of two complementary products, for example, hot dogs and hot dog buns.) That merger could be procompetitive by giving the two firms the incentive to reduce their prices. This is the well-known efficiency benefit of “eliminating double-marginalization.” Before the merger, a price decrease by one of the firms to a level slightly below the monopoly price would decrease its own profits slightly. At the same time, it would increase the demand for the product and the profits of the other firm. The joint profits of the two firms would rise, but in the pre-merger world that opportunity would not be taken unilaterally. After the vertical merger, this mutual benefit of lower prices would be taken into account and would lead to the incentive to reduce prices of both products.

However, this vertical merger also could be anticompetitive by reducing or eliminating the potential for entry. Before the merger, each firm would have the incentive to cooperate with firms who were trying to enter the market of the other firm. Competition into the other market would lead to lower prices in that market and, therefore, higher demand and profits for the complementary product. Indeed, each firm might be a potential entrant into the market of the other firm. In contrast, this incentive to facilitate independent entry would disappear. As a result, entrants would need to enter both markets simultaneously. This requirement of two-level entry may raise barriers to entry and lead to higher prices, even after taking the elimination of double marginalization benefit into account.

Competition for Exclusives

It has been argued in a number of recent influential anti-trust cases that competition for exclusives can prevent anti-competitive harm. Confidence in the constraining power of competition for exclusives has led a number of U.S. courts to take a very permissive approach to exclusives with a short contractual duration.

However, in my view, the real competitive constraints created by competition for exclusives should not be overestimated when there is a dominant firm or the market is highly concentrated. This process differs from competition in the sale of goods and services in a number of significant ways that can limit its benefits to consumers. To begin with, when a firm pays a supplier, distributor or customer to deal exclusively with it, it is not simply paying to obtain an additional supply source, or channel of distribution, or customer for itself. It also is paying for the right to exclude rivals from that supply source or channel of distribution or customer. In fact, exclusion may be the sole or primary function of the exclusivity.

This is not to say that exclusives are always anticompetitive. Exclusives can eliminate free riding, improve coordination or create other efficiency benefits. However, efficiency benefits are not inherent in exclusives. Exclusives instead might reduce competition by destroying rivals' efficient access to key inputs, make experimentation more difficult and raise switching costs. Stated most simply, the firm may be purchasing market power as well as a channel of distribution, source of supply or additional customer.

There are a number of other reasons to be skeptical of the consumer protection provided by competition for exclusives. First, in some situations, there may not be real competition for the exclusives. An incumbent firm may obtain long-term exclusives before there is another competitor on the horizon. By the time the entrant is poised to enter, the key input suppliers may be tied up in long-term exclusive contracts. For the reasons discussed later on, one cannot count on the suppliers to make decisions that adequately protect the interests of consumers in these circumstances.

Second, even where competition for exclusives does occur, it may not take place on a level playing field. The exclusives tend to be worth more to a dominant incumbent than undoing the exclusive is worth to an equally efficient entrant. This is because the entrant can earn only the (more competitive) duopoly return, whereas a dominant incumbent may earn the monopoly return if entry is deterred or

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significantly constrained. For example, suppose that the incumbent could earn \$200 if it gets the exclusive and so is able to maintain its monopoly. If the entrant gets distribution and breaks the monopoly, suppose that the entrant and incumbent each would earn \$70, for a total of \$140. Because competition transfers wealth from producers to consumers, the total profits fall from competition (e.g., from \$200 to \$140). In this case, the entrant would be willing to bid up only to \$70 to obtain distribution, an amount equal to its profits from entry. In contrast, the incumbent would be willing to bid up to \$130 for an exclusive that prevents the entry, an amount equal to the reduction in its profits from competition. The incumbent thus would win the bidding against an equally efficient entrant and maintain its monopoly. The monopolist would continue to charge the monopoly price for its output, harming consumers. The only difference is that now the distributors would obtain a share of the monopoly profits.

This result does not depend on unusual conditions. We assumed that the entrant was equally efficient. The monopoly result occurs whenever and because aggregate market profits fall from competition. This is a very general condition when the entrant is equally efficient. This example also shows why competition for exclusives cannot be assumed to reach the efficient outcome.

This is not a “deep pocket” argument about the incumbent having more wealth or better access to the capital market. The incumbent’s bidding advantage comes from the fact that it has already sunk the costs of entry, together with the fact that monopoly profits exceed the profits in the more competitive post-entry market. Entry barriers are raised because the entrant’s need to outbid the incumbent artificially raises its costs of entry. The bidding disadvantage faced by the entrant is “artificial” in the sense that the exclusivity does not have real and direct efficiency benefits in the example, but instead has the sole effect of raising barriers to entry.

Third, exclusives increase switching costs and eliminate the ability of suppliers or consumers to experiment by devoting only a portion of their business to the entrant. This in turn raises their risk of switching. For the entrant, this decreases the likelihood that entry will succeed. This increased difficulty of coordination and the resulting barriers to entry and expansion are reinforced if the exclusive contracts are long-term and have “staggered” expiration dates. These factors extend the period before the entrant

can achieve viability. They also reinforce the consumers’ or suppliers’ expectations that the entry will not succeed, which will in turn make them less willing to take the risk of forgoing the exclusive in order to remain available to the entrant. As a result, they will require larger inducements to switch to the entrant, thus raising entry costs still further.

This analysis of experimentation and switching costs suggests another reason why the entrant may face a bidding disadvantage. The retailers may not find the entrant’s product adequate as its only offering, whereas the incumbent’s product may be sufficient. In this situation, the entrant does not desire (nor could it practically obtain) an exclusive. Instead, it wants only to maintain nonexclusivity. In some situations, the distributor might be able to substitute a number of independent brands for the incumbent. But, in a bidding situation, these independent firms would face coordination problems in bidding against the dominant incumbent.

Fourth, even if exclusives are terminable at will or embedded in short-term contracts, they still erect a difficult coordination problem for an entrant. This increases the risk that the entrant will be unable to get enough distributors or enough customers to rapidly achieve minimum viable scale and maintain adequate investment incentives. Bidding still does not take place on a level playing field. It may be difficult for an entrant (or entrants collectively) to convince enough suppliers or consumers to switch at the same time. As a result, the exclusives also can lead retailers to expect entry to fail, raising the fees the entrant must offer.

This is not to say that competition for exclusives has no constraining effects at all. It can constrain the attempt to maintain a monopoly to some extent. This is because the need to purchase exclusives also is costly to the incumbent firm. This cost of buying exclusives can act as somewhat of a deterrent. However, the constraint is limited and does not eliminate competitive concerns. Nor would short duration exclusives legitimately provide the basis for an exemption from antitrust scrutiny. Even with short duration exclusives, the entrant(s) will face certain coordination problems. The more important question is whether the exclusives create real procompetitive efficiency benefits and whether those benefits will be passed on to consumers in a competitive output market. This is only likely when exclusives are divided up among several viable competing firms in the output market.

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This last point raises the question of why a retailer or consumers ever would cooperate by agreeing to an exclusive that might allow a dominant firm to achieve market power. However, this result can occur because an individual distributor or consumer ignores the effect of its decision on others. As a result, the dominant firm can compensate the retailer or consumer for its own harm and still earn money from the incremental power gained with respect to others. In addition, if a retailer or consumer believes that the entrant likely will fail because others are granting exclusives, then it would not require significant compensation to grant exclusivity as well. Both these reasons flow from the same point: *competition is a public good*.

Thus, simply because entrants and smaller competitors have the theoretical potential to outbid a monopolist for distribution or shelf space should not be treated as sufficient defense in an antitrust case. The theoretical ability to compete for exclusives may not be a practical ability, and the competition may not take place on a level playing field or in a way that consumer welfare and efficiency will be protected. Similarly, exclusive dealing should not be per se legal.

Excluding Less Efficient Competitors: The Equally Efficient Entrant Standard

The analysis of exclusionary conduct and competition for exclusives is related to the question of whether antitrust should apply an equally efficient entrant (“EEE”) standard, usually tied to conservative analysis, in antitrust exclusion cases other than predatory pricing. That is, are entrants and other competitors that are less efficient than the excluding firm deserving of the protection of the antitrust laws?

The use of an EEE standard often is motivated by a concern with administrability. That is, a rationale for the use of the Brooke Group below-cost pricing prong for predatory pricing is that this price level is the only one that is practically administrable by antitrust courts. This is a controversial issue and deserving of further analysis. But, for the purposes of this paper, the proper rules for predatory pricing are beyond the scope of the analysis. Instead, the analysis here will focus on the question of whether the EEE standard is appropriate for vertical RRC exclusion cases. In my view, it is not.

The predatory pricing paradigm and its price/cost comparison motivates the EEE standard. It is argued that if

the dominant firm is pricing above its costs, then an equally efficient competitor would not be forced to exit from the market. In this sense, the below-cost pricing standard for predatory pricing is said to protect equally efficient competitors from being excluded from the market. This prong of the antitrust standard in principle could be mechanically applied to all exclusionary conduct, including RRC conduct. For example, Judge Posner has suggested applying this standard to all exclusionary conduct, not just predatory pricing. Under the equally efficient competitor standard, the plaintiff would need to prove that the conduct “is likely in the circumstances to exclude from the defendant’s market an equally or more efficient competitor.”

The equally efficient entrant standard is a very permissive standard with respect to exclusionary vertical conduct, even *naked* RRC behavior. For example, suppose that exclusionary conduct would only be condemned if it would cause the exit or deter the entry of an equally efficient firm. That is, the conduct would only be condemned if it leads the dominant firm to set a price below its costs — a price that could not be profitably matched by equally efficient competitors.

For example, under this standard, payments to input suppliers to induce them to refuse to deal with rivals would be allowed unless the payments were so large that the defendant’s overall profits turned negative. This would be true even if the sole purpose of the payments were to raise the costs and marginalize competitors. As shown in the competition for exclusives numerical example, the winning bid for the monopolist would place the entrant at a loss if it wins, but would not place the monopolist at a loss if it wins.

Similarly, burning down a rival’s factory would not violate the antitrust laws as long as the arsonist’s fee was modest and the predator charged such a high output price that its price remained above its costs. Conduct that was used to maintain an existing monopoly would be treated more permissively than conduct used to achieve dominance because the defendant’s initial price would be at the more highly profitable monopoly level.

The fundamental flaw in applying the equally efficient entrant standard to RRC conduct is that the unencumbered (potential) entry of less efficient competitors often raises consumer welfare and efficiency. For example, consider the simplest example of limit pricing by a monopolist that has obtained its monopoly legitimately with superior skill, fore-

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sight, and industry. Suppose that this monopolist has variable costs of \$20, and initially charges the unconstrained monopoly price of \$50, because the monopolist faces no threat of entry.

Now suppose that there is a new entry threat by a *less efficient firm*, for example, a firm with variable costs of \$40. Facing this threat, the monopolist would have the incentive to reduce its price to the “limit price” of \$39 in order to deter the entry into the monopolized market. This limit pricing conduct clearly benefits consumers. Even though the potential entrant does not produce any output itself, it serves as a *perceived potential entrant* and constrains the monopolist’s price by waiting in the wings. Its potential for entry reduces price, increases market output, and raises both consumer welfare and total economic welfare.

Suppose instead that the monopolist engages in naked RRC conduct that raises the entrant’s costs above the unconstrained monopoly price of \$50. For example, suppose that it raises the entrant’s costs by \$12 to a cost of \$52. As a result, the entrant would no longer have the ability to constrain the monopolist from charging the monopoly price of \$50. Consumers would be harmed by this RRC conduct, and total economic welfare would fall too.

But, no antitrust liability would attach to this RRC conduct under the EEE standard. This is because a \$12 cost increase would not deter an equally efficient potential entrant (i.e., an entrant with costs of \$20). If the monopolist were to maintain its price at the \$50 monopoly price, such an equally efficient entrant would still be able to enter successfully even if its costs increased from \$20 to \$32.

The fact that the EEE standard fails to catch and deter this obvious type of anticompetitive conduct demonstrates the fundamental flaw in the standard. The idea that a perceived potential entrant can constrain the pricing of a monopolist is a central idea in the analysis of entry barriers, potential competition and market power. If the EEE standard fails in this simple RRC example, then it obviously also would be deficient for other, more complex non-price exclusionary conduct.

This analysis also means that using the EEE standard would underdeter anticompetitive conduct. A better antitrust standard would be one that found liability when the following two prongs both are satisfied: (1) when the defendant’s conduct significantly raises the costs of competitors — even less efficient competitors — for example, when the

competitors do not have access to cost-effective alternatives; and (2) when, as a result, the exclusionary conduct permits the defendant to achieve or maintain monopoly power. Of course, if the conduct leads to consumer and efficiency benefits as well as these harms, then the net effect on consumers must also be evaluated. This type of analysis can be carried out in the context of a rule of reason analysis that does not include an EEE prong.

A policy of adopting a standard that finds liability for conduct that harms consumers by raising the costs of competitors, whether or not they are equally efficient, is not one that is at odds with the view of all Chicago School commentators. As discussed earlier, Robert Bork explicitly took the position that eliminating competitors’ access to the most efficient distribution pattern could be viewed as anticompetitive. That section of the *Antitrust Paradox* has been cited with approval in *Aspen Ski*. And, a similar formulation was used in *Microsoft*.

Conclusion

In light of this analysis, it is clear that the strong economic foundations — and economic implications — claimed by Chicago-school commentators like Robert Bork do not hold up to careful economic analysis. The concepts of anticompetitive foreclosure and anticompetitive leverage are not empty and illogical. Competition for exclusives is not a panacea for all vertical exclusion claims. Nor is the predatory pricing paradigm the appropriate framework for analyzing and judging exclusionary vertical conduct. Instead, a more refined analysis must be applied. This analysis implies that the better legal standard would be the rule of reason with its focus on consumer harm, not a proxy rule like the equally efficient entrant standard.