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THE EMPEROR'S NEW CLOTHES: WHY IS RECIPROCITY ANTICOMPETITIVE?

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"Tie-ins may also at times be beneficial to the economy."[1]
"The analogy [of reciprocal buying] to a tie-in agreement has impressed all observers."[2]

Having gathered most of the material for this *Symposium*, the Editors of this *Review* asked me to comment briefly on the subject of reciprocity. Time does not permit an exhaustive analysis, much of which has in any event already been done by others.[3] It is a sad but revealing comment on the nature of communication among those who concern themselves with antitrust matters, that the issues raised in the most complete, intelligible and analytically sound pieces so far written on the subject of reciprocity[4] have not been discussed to any significant degree in any of the other articles in this *Symposium*.[5] It seems as though reciprocity is bad because (almost) everyone assumes that it is; it is bad because the folklore, continually affirmed from on High, says so. It is very much like a bad case of the Emperor's New Clothes.

In such a context the hope of getting anyone to meet directly the issues involved may be wan indeed. I shall, nevertheless, try to show, primarily in the context of *FTC v. Consolidated Foods Corp.*,[6] that reciprocity is surely not always anticompetitive. Indeed, it may be positively beneficial to the competitive process, even though, like most aspects of competition, it may discomfort some competitors.

First, what are the evils which, as the mythology of antitrust hands it down, flow from reciprocal dealing? The practice has been denounced as "one of the congeries of anticompetitive practices at which the antitrust laws are aimed."[7] This is apparently so because reciprocity "results in 'an irrelevant and alien factor' . . . intruding into the choice among competing

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1 Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495, 514 n.9 (1969) (White, J., dissenting).

2 Kestenbaum, *Is Reciprocity Illegal, Immoral or Just Fattening?*, 22 RECORD OF N.Y.C.B.A. 576, 579 (1967).

3 *See* Ferguson, *Tying Arrangements and Reciprocity: An Economic Analysis*, 30 LAW & CONTEMP. PROB. 552 (1965); Comment, *Reciprocal Dealing*, 76 YALE L.J. 1020 (1967). *See also* Coase, *Working Paper II: The Conglomerate Merger* (working paper for the Task Force on Productivity and Competition), 2 ANTITRUST LAW & ECON. REV., Spring 1969, at 45; Stigler, *Working Paper IV: Reciprocity*, *id.* at 51.

4 Stigler, *supra* note 3.

5 These pieces are cited and some of the issues they raise are mentioned in Backman, *supra* at p. 90.

6 380 U.S. 592 (1965).

7 380 U.S. at 594.

products, creating at the least 'a priority on the business at equal prices.' "[8] Adumbrators have isolated and identified coercive, contractual and accommodative reciprocity.[9] We are treated to the spectre of "reciprocity effect."[10] Congratulating itself on what it has done already, in the name of protecting "competition," the Antitrust Division announces plans to move against "second-line reciprocity."[11] Finally, and most recently, we are advised that:

> Undoubtedly the most dangerous form of leverage in the concentric merger context is reciprocity. Where the potential to use it is present we may assume that without some form of prevention it will be used. The only question of consequence about reciprocity is how to stop it.[12]

But should reciprocity be stopped in a situation like that involved in *Consolidated Foods?* The facts should be familiar to all by now: the Federal Trade Commission (FTC) attacked a merger of Consolidated Foods, which owned food processing plants and "a network of wholesale and retail food stores,"[13] and Gentry, Inc., which made dehydrated onion and garlic. The Court said that Consolidated was "a substantial purchaser of the products of food processors who in turn purchase dehydrated onion and garlic for use in preparing and packaging their food."[14]

The decision was bottomed on the proposition that Consolidated had buying power which provided both the "leverage" to force those from whom it bought to purchase Gentry's garlic and onions and the power " 'to foreclose competition from a substantial share of the markets for dehydrated onion and garlic.' "[15] In the language of the Commission, adopted by Mr. Justice Douglas, Gentry would have "an unfair advantage over competitors enabling it to make sales that otherwise might not have been made."[16] The merger supposedly increased " 'obstacles to the creation of genuinely competitive conditions in an oligopolistic industry.' "[17]

It seems profitable to focus initially on the nature of the dehydrated onion and garlic market rather than to dwell on the nature of Consolidated's "buying power." In that market, Gentry and its only significant competitor, Basic, accounted for almost 90 percent of total industry sales. At the time there were only two other firms in the industry.[18] Given the structure of the industry it would not strain credulity to assume that in making price

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8 *Id.*

9 *See, e.g.*, Kestenbaum, *supra* note 2, at 579-80.

10 *See, e.g.*, Rigler, *Conglomerate Mergers — Reciprocity, Real and Potential, as a Basis for Attack, infra* at p. 580.

11 So-called "second-line reciprocity" appears to be that situation which exists when a firm trys to convince a supplier to buy from a customer. *See* ANTITRUST & TRADE REG. REP. No. 447, at A-5 (Feb. 3, 1970).

12 Solomon, *The Concentric Merger and Section 7 of the Clayton Act, infra* at p. 559.

13 380 U.S. at 593.

14 *Id.* at 595.

15 *Id.* at 593 (quoting FTC).

16 *Id.* at 597.

17 *Id.* (quoting FTC)

18 *Id.* at 595.

determinations, each firm would take account of the other's reaction. We had, in short, almost the classic duopoly market structure.

Economic analysis of this type of market suggests that the firms will act jointly in an attempt to maximize profits, even in the absence of any cartel agreement.[19] In such a situation prices will almost certainly be higher than costs; supercompetitive profits will be earned even though they may be limited to some extent by the threat of entry.[20] Both Basic and Gentry would most likely be something less than eager to initiate open price cuts, on the theory that their individual demand curves would be highly inelastic below the going price.[21] This is based on the plausible assumption that any *open* price cut by one firm would be almost immediately matched by the other. Because of this the firm initiating such a cut could not realistically expect to increase its market share at the expense of the other. The net result, therefore, of an open price cut by either firm would be a revenue loss to both firms with market shares remaining about the same. Accordingly, we would not expect such open price cuts to be made.[22]

An additional factor militating against an open price cut is that it would have to be granted to all buyers. To determine the effect of any such cut on its net revenue the firm would have to deduct (1) the revenue loss that would result from reducing prices in respect of sales which could have been made at the higher price from (2) the increase in revenue that would result from the additional sales that could be expected to flow from the general reduction in prices.[23] Obviously, at some point the decrease in revenue following any price cut (1) should equal the increase (2). If the firms were behaving rationally we would, of course, expect their price and output to be such that their net revenue position could not be improved either by increasing or decreasing prices across the board, *i.e.*, the decrease (1) and the increase (2) that would result from any price reduction would be equal.[24]

If we are correct so far, we find a pre-merger situation in which the

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[19] *See, e.g.*, R. LEFTWICH, THE PRICE SYSTEM AND RESOURCE ALLOCATION 214-16 (3d ed. 1966); G. STIGLER, THE THEORY OF PRICE 228-29 (rev. ed. 1952).

[20] *See* G. STIGLER, *supra* note 19, at 231-32; Bain, *A Note on Pricing in Monopoly and Oligopoly*, 39 AM. ECON. REV. 448 (1949); Liebeler, *Toward A Consumer's Antitrust Law: The Federal Trade Commission and Vertical Mergers in the Cement Industry*, 15 U.C.L.A.L. REV. 1153, 1175 n.80 (1968).

[21] Sweezy, *Demand Under Conditions of Oligopoly*, 47 J. POL. ECON. 568 (1939); Professor Sweezy's views and the nature of the oligopolist's demand curve are discussed in E. SINGER, ANTITRUST ECONOMICS 103-08 (1968).

[22] This view seems to be generally accepted by the FTC, or at least by its staff. *See* FTC, ECONOMIC REPORT ON MERGERS & VERTICAL INTEGRATION IN THE CEMENT INDUSTRY 59 (1966); BUREAU OF ECONOMICS, FTC, ECONOMIC REPORT ON CORPORATE MERGERS 324 (1969) [hereinafter cited as FTC REPORT].

[23] This is, of course, the basis of the concept of marginal revenue. *See, e.g.*, A. ALCHIAN & W. ALLEN, UNIVERSITY ECONOMICS 109 (2d ed. 1967).

[24] This is only to say that a firm with a downward sloping demand curve could rationally be expected to vary output until marginal cost equalled marginal revenue. *See, e.g.*, *id.* at 111-12.

prices of dehydrated onion and garlic almost certainly exceed their costs of production. There is some competition between Basic and Gentry, probably also involving the two much smaller members of the industry as it then existed, but that competition is primarily in terms of quality, service and the like. Open price competition is severely inhibited because any initial price cut by either major firm would immediately be matched by the other and would have to be given to all buyers.

Gentry (or Basic for that matter) could improve its net revenue position if it could find some way to reduce prices to new customers without affecting the prices it charged to its old customers.[25] Gentry would also be happy if it could make those cuts in such a way that they were not immediately apparent to Basic.[26] Gentry would be happier still if those cuts could be made in such a way that Basic could, even after observing them, not match them without imposing some cost on itself that Gentry did not have to incur in connection with its initial reduction.[27]

It appears that just such a device is provided by reciprocal buying.

To keep matters as simple as possible, let us assume a hypothetical maker of garlicky pickles (GP), who has been buying for $.10 a pound from Basic garlic that it costs both Basic and Gentry $.06 a pound to produce and deliver to him. For simplicity, let us start with the assumption that Consolidated does not exercise any buying power and that GP has been selling his pickles to a competitor of Consolidated for $5.00 per case, the competitive price for all similar delicacies. Assume also that five pounds of garlic go into the manufacture of each case of pickles.

It seems clear that, all other things being equal, Consolidated-Gentry could induce our pickle maker to shift his garlic purchases from Basic to Gentry by offering to pay $5.05 a case for pickles. This is the same thing, of course, as a $.01 reduction in the per pound price of garlic. But making this cut in the price of garlic in the form of higher prices paid for pickles has its advantages as far as Gentry is concerned. Firstly, Gentry has obtained an additional and profitable piece of garlic business. Gentry is selling to GP garlic for $.09 per pound that costs only $.06 a pound to produce and deliver; it still maintains the price of garlic to its other customers at $.10 per pound. In the second place, the open or posted price of garlic remains unchanged. It is thus more difficult for Basic and for other customers of Gentry to observe that in fact the price of Gentry's garlic has been reduced in the case of the sale to GP. This should postpone a response by Basic and, in any event, as noted above, avoids the loss of revenue that would attend an across-the-board cut that included its old customers.[28]

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[25] *See* J. BAIN, PRICE THEORY 403 (1952).

[26] *Id.* at 294. *See also* note 21 *supra* and accompanying text.

[27] Basic's inability to match Gentry's cuts immediately after observing them produces much the same result as a failure to observe those cuts in the first instance. The more "secret" — *i.e.*, unmatchable without imposing additional cost — Gentry's cuts, the more likely Gentry is to make them, the greater the pressure on Basic to respond, and the greater the likelihood that the entire oligopolistic price structure will be disrupted.

[28] *See* J. BAIN, *supra* note 25, at 403.

Perhaps even more interesting, cutting garlic prices by paying higher than competitive prices for reciprocally purchased pickles puts Basic in a difficult position as to what to do *after* it discovers that Gentry has in fact been cutting garlic prices. Basic can attempt to counter the competitive reciprocal buying attack that Gentry has made by trying to do the same thing. It could attempt to find a merger partner like Consolidated, thereby putting itself in the same position as Gentry to engage in reciprocity, *i.e.*, to cut garlic prices on a selective basis. Or it could contract for the purchase of pickles at higher than competitive prices, just as Consolidated-Gentry did, and then sell those pickles in the open market, taking a loss of \$.05 per case, just as Consolidated-Gentry would have to on the resale of pickles it buys from GP.[29]

In the long run it should cost Basic no more to do either of these things than it has cost Gentry.[30] But the response will take time and in that time Gentry will presumably be making hay.[31]

Basic, of course, could respond immediately with an open cut in garlic prices. This would, however, impose the cost of revenue losses on all garlic business which Basic has been doing at \$.10 per pound. We might thus expect Basic to be somewhat reluctant at first, although, depending on the extent to which Gentry pushes this business of reciprocally made price cuts, Basic may eventually be forced to do so.

It is important to note that any open price cut that Basic makes in response to Gentry's selectively made reciprocal buying cuts will force Gentry to follow suit. Should Gentry also respond with more selectively made reciprocity cuts, the point will come where the price of garlic will approximate its production cost, the level we would expect to find under

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29 *See* Comment, *Reciprocal Dealing*, 76 YALE L.J. 1020, 1023 n.16 (1967).

30 There is no reason to believe that Consolidated is the only or the best merger partner in a situation such as this, should Basic try to respond through merger. Nor is there any reason to think that merger is more desirable than the contract situation mentioned in the text. In fact the opposite may be true. *See* Coase, *The Nature of the Firm*, 4 ECONOMICA (NS) 386 (1937), reprinted in 6 AM. ECON. ASS'N, READINGS IN PRICE THEORY 331 (1952). In any event, as the immediately following discussion will show, Basic can solve the whole problem by moving to lower garlic and onion prices at more competitive levels. This would seem to be more appropriate from a social point of view than to complain to the FTC that competition is beginning to break out in the industry and enlisting that agency's aid in stamping it out. (I am only surmising that this is how the FTC became interested in this particular case. I would, however, be willing to bet on the proposition, and in any event the result is the same.)

Of this sort of thing, Professor Posner has said:

> Proceeding against a competitior by way of a complaint to the Trade Commission . . . is a method of imposing the cost of litigation on the competitor at no cost to the complainant. All of the costs of prosecution are borne by the FTC; all of the costs of defense by the respondent. The complainant pays nothing. This arrangement creates an incentive to engage in litigation designed purely to suppress competition, for it enables the complaining party to create a barrier to entry in its exact technical sense: a condition that imposes upon a new entrant a cost not borne by firms already in the market.

REPORT OF THE ABA COMMISSION TO STUDY THE FEDERAL TRADE COMMISSION 108-09 (1969) (statement of Richard A. Posner) (footnote omitted).

31 *See* J. BAIN, *supra* note 25, at 274; Liebeler, *supra* note 20, at 1161.

competitive conditions.[32] Far from reinforcing an oligopolistic market structure, as the Court and FTC claimed it would, reciprocity in this case could well, indeed most likely would, disrupt the oligopolistic price structure and greatly increase competition in the garlic industry.

It is also worth noting that as competitive conditions are approached in the garlic market, the use of reciprocity would decline and tend to disappear entirely.[33] For example, if Gentry used reciprocal buying arrangements to obtain an appreciable amount of Basic's garlic business we would expect Basic eventually to respond with an open price cut of, say, \$.01 per pound of garlic. Gentry would have to follow this cut on all its non-reciprocity business and in addition increase the price it was paying GP for pickles to \$5.10 per case in order to maintain the \$.01 per pound differential with which it had been favoring GP. Assuming no changes in marginal cost,[34] Gentry would now be selling garlic to GP for \$.08 per pound at a cost of \$.06 per pound; the reciprocity arrangement would still pay. But if competition continues to drive the price of garlic down, to its cost of \$.06 per pound, Consolidated-Gentry would become indifferent as to how it made its price cut to GP. There would no longer be any advantage to paying more for

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[32] *See, e.g.*, J. BAIN, *supra* note 25, at 126.

[33] *See* FTC REPORT at 323-24; Comment, *Reciprocal Dealing*, 76 YALE L.J. 1020, 1027 (1967).

[34] Actually we would expect Gentry's marginal costs to rise as it increased output concomitantly with selective price cuts made by reciprocal dealing. This, of course, would tend to hasten the demise of reciprocity, which should theoretically disappear when price and marginal cost come together. A rising marginal cost curve would also limit Gentry's ability to drive Basic from the market, even if it employed ordinary "cross subsidization," "disciplinary-repressive cross subsidization" or even more esoteric devices in its never ending attempt to monopolize the garlic market. *See* FTC REPORT at 398, 421.

It is hard to believe that the FTC staff is still arguing against the legality of conglomerate mergers on the basis of the theory on which the old *A&P* case was based. *See* United States v. New York Great Atlantic & Pacific Tea Co., 173 F.2d 79 (7th Cir. 1949). This so-called cross-subsidization theory has been as thoroughly discredited as any theory could be. *See* Adelman, *The A&P Case: A Study in Applied Economic Theory*, 63 Q.J. ECON. 238 (1949). This whole thing is particularly ironic to one viewing the world from the vantage point of southern California, which was one of the two districts in which the A&P kept operating its stores at a loss — subsidizing their operations, of course, by increasing their margins in Brooklyn and elsewhere. There are no more A&P stores in southern California, or at least none that I can find. Apparently even cross-subsidization has its limits as a device for gaining monopoly power. The possibility that *competition* ever forces anyone to operate at a loss is apparently something that does not occur to some people. In any event, the A&P never did get a monopoly on the grocery business in Los Angeles.

And for those more devoted to idolatry than to rationality, which seems to be more than a few when it comes to antitrust policy, it is worth noting that the absurdity of the *A&P* theory is something on which Professor Galbraith, the Chicago People, Donald Turner, and at least a part of the Supreme Court appear to agree. *Cf.* J. GALBRAITH, AMERICAN CAPITALISM 148 (1952); McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case*, 1 J.L. & ECON. 137 (1958); Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313, 1340 (1965), cited with seeming approval by Mr. Justice Harlan in FTC v. Procter & Gamble Co., 386 U.S. 568, 588 (1967) (Harlan, J., concurring). This in itself is enough to give one pause. . . .

pickles in order to cut garlic prices. Consolidated-Gentry would just as soon sell its garlic to GP for $.06 per pound and buy pickles at the competitive price of $5.00 per case, either from GP or from any other pickle manufacturer who might be interested.

Under our hypothetical, Consolidated-Gentry would never pay more than $5.20 for a case of pickles.[35] After that the usefulness of reciprocity would disappear. This would result, of course, from the competition that was introduced into the garlic market by reciprocity in the first place. We might conclude, therefore, that reciprocity of this type carries the seeds of its own destruction.

The fact that Consolidated may exercise buying, countervailing or monopsony power[36] in the pickle market, or may be buying pickles from GP prior to the institution of reciprocal dealing does not affect the conclusions of the above analysis. Suppose that Consolidated does have such power. It uses it against GP and before reciprocity with respect to garlic is instituted Consolidated is getting pickles for $4.50 per case, rather than the $5.00 it would be paying in the absence of that power. We should be able to assume that Consolidated has exercised all of its power against GP, since it is in its economic interest to do so, and that it is unable to reduce the price of pickles below $4.50 per case. If Consolidated offers $4.49 or tries to impose any other costs on GP in connection with pickle purchases, Consolidated will not get any GP pickles. GP will simply go elsewhere with its pickles, or in the extreme case may stop making them altogether.

As the "leverage" theory would have it, the fact that Consolidated has buying power of some kind gives it the power to impose some *additional* cost on GP, over and above the $.50 reduction in pickle prices it has already obtained with this power.[37] Under this theory this cost is imposed by

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Cost of producing garlic (per lb.)	"Posted" price of garlic (per lb.)	Price Consolidated pays for pickles per case	Net price of garlic to pickle seller	Profit (loss) to Gentry on garlic sales (per lb.)
$.06	$.10	$5.00	$.10	$.04
.06	.10	5.05	.09	.03
.06	.09	5.10	.08	.02
.06	.08	5.15	.07	.01
.06	.07	5.20	.06	.00
.06	.06	5.25	.05	(.01)

A price of $5.20 for a case of pickles would preserve the $.01 cut in garlic prices which Consolidated-Gentry had extended to GP (at the point when the general market price of garlic had dropped to $.07 per pound). Gentry would be earning only a competitive rate of return in respect of sales made at this price ($.06). It presumably would not go below this point, as an out of pocket loss would result.

36 In spite of the happy unanimity described in note 34 *supra*, any discussion of the nature or even of the existence of these phenomena is beyond the scope of this note.

37 The fact that some small pickle makers had gone out of business or merged with

"forcing" GP to buy garlic from Gentry when it would prefer, presumably for good economic reasons, to buy from Basic.

It has been well argued that this cannot be done.[38] There is no obvious way in which Consolidated's acquisition of Gentry can increase its buying power in the pickle market. There is no question, however, that the practice of reciprocity can have much the same effect as a vertical merger between the firms engaging in the practice, in this case Gentry and its pickle-making garlic customer.[39] This will make it possible for Gentry to engage in more flexible pricing practices after its merger with Consolidated, but this has nothing to do with Consolidated's power in the pickle market.

If Consolidated's buying power in the pickle market is not increased by the Gentry acquisition, then the only way Consolidated-Gentry can induce GP to switch its garlic purchases from Basic to Gentry is by cutting garlic prices. The situation is, in short, the same as though Consolidated did not exercise any buying power in the pickle market. The garlic price cut can now be made, of course, by increasing the price Consolidated pays for GP pickles from $4.50 to $4.55 per case, rather than increasing that price from $5.00 to $5.05. Garlic prices are cut, in other words, whenever Consolidated forgoes a lower price for pickles.

Consolidated, of course, can be viewed in such a case as transferring its market (buying) power from the pickle market to the garlic market. While this is true in a sense, it is no more true in the case where Consolidated exercises buying power than in the case where it does not.[40] In our first

larger firms seems to have been the basis of Mr. Justice Stewart's concurrence in *Consolidated Foods*. 380 U.S. at 608. But it would seem that the fact that some pickle makers merged "can rest on so many alternative hypotheses that it is persuasive as to none." *Id.* at 605.

[38] Director & Levi, *Law and the Future: Trade Regulation*, 51 Nw. U.L. Rev. 281, 290 (1956). While, 13 years later, this idea has managed to creep sneakily into a footnote in a dissenting opinion of Mr. Justice White, its implications — which are broad indeed — for antitrust policy are not yet generally recognized. *See* Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495, 512 n.3 (1969) (White, J., dissenting). *See also* Bork, *Antitrust in Dubious Battle*, Fortune, Sept. 1969, at 103, 105. Even if the Gentry acquisition does in some way increase Consolidated's "buying" or "countervailing power" in the pickle market, there is no reason to assume that this will have any anticompetitive effect. Any use of this hypothetically increased power would result in lower input (pickle) prices to Consolidated. Since Consolidated's marginal cost has gone down its output should rise and pickle eaters should be happier. This would be a perfect example of a socially desirable use of "countervailing power," [J. Galbraith, *supra* note 34, at 125], which has in some contexts at least been met with the approval of the FTC. *See* FTC, Economic Report on Mergers & Vertical Integration in the Cement Industry 110 (1966).

[39] Reciprocity is, of course, a contractual vertical merger. The implications of this in terms of output and pricing are particularly interesting when the firms engaging in reciprocity both exercise market power.

[40] *See* Liebeler, *supra* note 20. If output is being restricted in the pickle market, Consolidated-Gentry may have an advantage over Basic and other garlic makers who are not in a short-run position to buy pickles. This advantage would result if the cost imposed on Consolidated-Gentry by shifting (or refraining from shifting) from one pickle supplier to another is less than the advantage gained by a particular pickle maker by increasing (or refraining from reducing) his output as a result of more — or continued — sales of pickles to Consolidated. In such a case the effective reduction in

hypothetical Consolidated had the "power," as did everyone else, to buy pickles for $5.00 per case. When it pays $5.05 a case for pickles, instead of $5.00, we could say that it has transformed its pickle power into garlic power, but we would not have said very much. The same is true if it pays $4.55 for pickles when it could have gotten them for $4.50. In either case, the net result of the reciprocal transaction should be regarded as a reduction in the price of garlic.[41]

Are there any facts, either in the *Consolidated* record or elsewhere, that support this interpretation of reciprocity? There is an almost ancient

garlic prices to the pickle maker (the benefit resulting from the sale of pickles to Consolidated) will be greater than the cost to Consolidated-Gentry of granting such a reduction in garlic prices.

While this could be called "leverage," it has nothing to do with buying power on Consolidated's part; it would exist even if there were perfect competition in the wholesale grocery market, *i.e.*, no "buying power" of any kind in that market. For example, suppose there are only three firms making pickles (*A*, *B* and *C*); parallel pricing practices result in a price of $6.00 per case of pickles which have a marginal cost of $4.50 per case. Suppose that Consolidated has been buying all its pickles from *A* and that it will cost Consolidated $.50 per case more (because of transport or other such factors) to buy from *B* and *C*. Assuming constant marginal costs in pickle making, it seems clear that a shift of some pickle purchases to *B* and *C* will benefit each of those firms to the extent of $1.50 per case; it will cost Consolidated only $.50 per case to effect this benefit.

If *B* and *C* can sell more pickles as a result and only as a result of buying garlic from Gentry, they should realistically regard the $1.50 benefit per case of pickles sold as an effective reduction in the price of garlic. Their shift of garlic purchases from Basic to Gentry will have precisely the same effect as any other indirect reduction in garlic prices, *i.e.*, it will increase the pressures on Basic and other competitors of Gentry to compete more effectively. There is an additional advantage in this situation in that Gentry will be more inclined to engage in reciprocity than if the benefit given to its garlic-buying pickle makers resulted in the imposition of costs on Consolidated that equalled the benefits granted, *i.e.*, in our example, $1.50 per case of pickles. This being the case, competitive conditions should appear in the garlic market sooner rather than later.

It is worth noting that the advantage that Gentry appears to have in the situation described above will tend to disappear as garlic prices approach a competitive level. Unless there are *no* additional costs to Consolidated of doing business with *B* and *C* rather than *A* (a situation that would appear to be unlikely), as the price of garlic goes to marginal cost it will cease to be profitable for Consolidated-Gentry to engage in reciprocity with *B* and *C*. Basic and other competitors of Gentry will then be in a position to compete on the basis of quality, services, *etc.*, as they were before reciprocity was introduced. The only difference will be that garlic prices will be lower, a supposed advantage to consumers which the antitrust laws should encourage rather than prevent.

In spite of the possibilities discussed in this note, the treatment in the text has been confined to the situation where Consolidated actually pays the pickle maker a higher price for pickles. The principles involved seem easier to understand in that context. And in terms of the effect on the garlic and onion market, there is no difference between the two cases: a benefit is being conferred on the pickle maker to induce him to buy Gentry garlic and the benefit seems most sensibly viewed as an indirect reduction in garlic prices.

41 For some reason many apparently otherwise intelligent people seem to have trouble translating increased pickle prices into lower garlic prices. But for this the point would not be worth laboring. Perhaps it is simpler to regard Consolidated's conduct as conferring a net benefit on the firm with which it engages in reciprocal dealing. As the discussion below shows, however, businessmen do not seem to have any difficulty in grasping the point.

indication that firms engaging in reciprocity know that any increase in price on articles purchased is in effect a reduction in price (net return) on the article that is sold as a result of the purchase. The *New York Times*, on November 6, 1932, in recounting the development of reciprocal buying in the early 1930's, stated that:

> As the scheme developed in importance and size and necessitated higher costs . . . it became expedient to turn it over to the purchasing departments. The plan worked smoothly for a while . . . but here again the higher prices paid for goods in reciprocal agreements became a troublesome subject. Recently it was decided by the majority of companies to charge the difference in the cost of products to sales expense when reciprocity was involved. In this manner the extra expense is definitely charged to one department and the added cost brings to sales divisions a realization of their responsibility in making reciprocal agreements.[42]

Another striking example of the awareness of firms that increased prices on articles bought means reduced prices on the articles reciprocally sold appears in an internal memorandum of the United States Rubber Company dealing with possible reciprocal arrangements with the United States Steel Company:

> For several years we have purchased in the neighborhood of $400,000 to $700,000 in merchandise from the U.S. Steel Corporation and subsidiaries. During the same time the United States Rubber Company and subsidiaries (primarily the Mechanical Department) have sold merchandise to the extent of about $300,000 annually. One of the large items in money value purchased by us from the Steel Corporation is sulphate of ammonia for use as fertilizer on our Plantations in the Far East. A situation has arisen this year where the best quotation obtainable for our requirements from the Steel Corp'n is $6,478 in excess of a quotation for a satisfactory fertilizer of German production. . . . Knowing the valuable account Mr. Gussenhoven's Department has with the Steel Corp'n and the close relations he has maintained with them, the Purchasing Department felt that before giving our fertilizer business to a foreign competitor, it was better for the Company to ask Mr. Gussenhoven to consider this question from two angles: first, whether or not he could get the Steel Corp'n to meet the foreign offer and, second, in case he were unsuccessful, Mr. Gussenhoven to decide if the value of his sales account was sufficiently important to warrant his agreeing to absorb the $6,478 difference so as not to penalize the Plantations Company. The so-called machinery to carry this particular example out is now being used, although a definite decision has not been reached. Many other similar situations will arise, in fact, there are several now reported as needing such handling by the Purchasing Department.[43]

One is almost embarrassed to note the comment of a former Chief of the Evaluation Section, Antitrust Division, on all of this. He has characterized the practice of "charging off part of a company's payments in

[42] Stocking & Mueller, *Business Reciprocity and the Size of Firms*, 30 J. Bus. U. Chi. 73, 87 n.64 (1957), quoting N.Y. Times, Nov. 6, 1932, § 4 (Financial & Business), at 8, col. 6.

[43] Stocking & Mueller, *supra* note 42, at 86-87.

purchase of goods as a selling cost of the reciprocal business" as "a curious accounting device."[44] It appears to be "curious" only in the sense that it accurately reflects reality. But then in the world portrayed by much of current antitrust doctrine, that may indeed be the true definition of "curious."

The use of reciprocity as a surreptitious price cutting device can be seen clearly in the early railroad cases involving the routing of meat shipments and the purchase of draft gears. These cases brook no interpretation other than that a selective reduction in rail rates was being granted to large meat shippers by the railroads involved.[45] Reciprocity has also been used to obtain reductions from prices dictated by the uniform commission schedule of the New York Stock Exchange, especially in connection with large transactions executed on behalf of institutional investors.[46] The price cutting aspects involved in the railroad and stock exchange situations are among the clearest examples of how reciprocity is used to reduce prices, because direct or open price cutting is prohibited in those situations respectively, by ICC regulation[47] and the rules of the stock exchanges.[48] Similar restraints on open downward price movement may, however, exist as a result of cartel agreements or of oligopolistic market structures.[49]

Any doubts that might have existed about the fact that reciprocity is used as a device for clandestinely reducing prices by paying higher prices for reciprocally purchased items are removed by the recent FTC *Economic Report on Corporate Mergers*. That *Report* states: "We have seen that companies frequently pay premium prices or accept lower quality when reciprocity is a factor in making a sale."[50] Examples included an excerpt from an Atlantic Richfield trade relations manual which outlined buyers'

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44 Kestenbaum, *supra* note 2, at 578.

45 Mechanical Mfg. Co., 16 F.T.C. 67 (1932); Waugh Equip. Co., 15 F.T.C. 232 (1931); Reciprocity in Purchasing and Routing, 188 I.C.C. 417 (1932).

46 Especially enlightening is Professor Marsh's description of this situation. *See* R. JENNINGS & H. MARSH, SECURITIES REGULATION 694-700 (1968).

47 *See* authorities cited in note 45 *supra*.

48 N.Y.S.E. CONST., art. XV, § 2. Professor Stigler notes that reciprocity "is important chiefly where prices are fixed by the state or a cartel." Stigler, *supra* note 3, at 52.

49 Professor Stigler does not emphasize the importance of reciprocity in oligopolistic market structures, probably because of his persuasion as to the extent to which effective oligopoly pricing can be practiced in the current economy. It is worth noting, however, that if reciprocity is as rampant as some people think, we may learn from that something about the extent to which we are plagued by oligopolistic pricing. In any event, the persistence of reciprocity in an industry should serve as warning flag as to the absence of effective competition. The railroads provide a striking example. It is said that reciprocity is "traditional" on the American railroads. Backman, *supra* at p. 95. It may also be noted that regulatory policy in this area is a national scandal. *See* A. FRIEDLANDER, THE DILEMMA OF FREIGHT TRANSPORT REGULATION (1969); Boies, *Experiment In Mercantilism: Minimum Rate Regulation by the Interstate Commerce Commission*, 68 COLUM. L. REV. 599 (1968). Would it not make more sense to limit or abolish rate regulation, thereby permitting a little competition, rather than to joust with the symptoms?

50 FTC REPORT at 387.

procedures for selecting vendors. According to this manual, buyers were to place business with the bidder offering the lowest cost "unless other factors including trade relations, make it advisable to pay a higher price."[51] In connection with General Tire's selection of a freight carrier, the *Report* advises:

> So firm was the reciprocity basis for General Tire's freight commitments that it was said to favor truck shipments even when they were costlier than rail. As another Southern [Railroad] official described the situation, the lower cost hauler had to provide other advantages in addition to lower freight rates in order to compete with trucking firms for General's shipments. . . . In this instance, reciprocity existed with both potential shipping companies [the railroad and the trucking firms], and although a cost conscious business man might reasonably be expected to choose between its reciprocity suppliers on the basis of the relative cost to him of their services, it is clear from the correspondence that General Tire's decision was based on the trade balance theory.[52]

The General Tire case is more complicated than *Consolidated Foods.* And while the economic analysis of vertical relations provides a very good explanation of why a cost conscious business might be expected to do exactly the opposite of what the above quote suggests,[53] the important point here is that firms apparently *do* at times pay higher prices for reciprocal business than they would have to pay for comparable services from others. If this payment of higher prices is viewed as the equivalent of a selective cut in the price of the items sold by the reciprocal dealing firm as a result of the higher prices it pays on the reciprocal business, it is difficult to understand the argument that reciprocity distorts market processes by intruding " 'an irrelevant and alien factor' . . . into the choice among competing products. . . ."[54]

In another article in this *Symposium,* the Honorable Mary Gardner Jones correctly states that:

> To assess the anticompetitive effect of actual reciprocity, we need to know for a sample of industries where reciprocity is an observed practice whether it brings with it any changes toward a more anticompetitive market structure and worsened economic performance, *e.g.,* [*inter alia*] whether prices have become more rigid or more flexible. . . .[55]

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[51] *Id.* (emphasis omitted).

[52] *Id.* at 390.

[53] *See* Liebeler, *supra* note 20.

[54] FTC v. Consolidated Foods Corp., 380 U.S. 592, 594 (1965).

[55] Jones & Heiden, *Conglomerates: The Need for Rational Policy Making, supra,* at p. 243. While Commissioner Jones seems happy with the results of cases such as *Consolidated Foods,* she also contends that any final judgments on the effects of reciprocity must await further study. The only problem with this is that she seems to have in mind further study by the FTC Staff. The ABA Commission on the FTC was quite blunt on this point, stating that "it will be impossible for it [the FTC] to implement present programs effectively, let alone institute the programs proposed in this report, unless it attracts new personnel of high quality." Summing up, the ABA Commission noted that: "With respect to senior staff, a majority of the present FTC Commissioners

In the context of our argument that reciprocity is many times used to effect indirect price cuts, therefore making prices more flexible (presumably a pro-competitive phenomenon), let us look at what actually happened in the dehydrated onion and garlic market after the Consolidated-Gentry merger and the institution of reciprocity. In his concurring opinion Mr. Justice Stewart pointed out that competition seemed to increase in that market after the merger:

> There is evidence that in the years following 1951, when the merger took place, increased emphasis was placed on solving technical problems which had prevented some processors from relying on dehydrated, rather than raw, onions. The 1950's were a time of flux for the industry. Basic was sometimes the innovator of technological change leading to increased sales; sometimes Gentry had the upper hand. It is possible that this shift to more intensive competition was connected with the merger. Faced with a new competitive situation, Basic may have determined to solve quality control problems which had long been dormant. Indeed, the evidence seems to show that, after the acquisition, the industry reflected the salutary qualities normally associated with free competition. Overall, both Basic and Gentry were furnishing a better product at the end of this period than at the beginning.[56]

Even more significant behavior on Basic's part, which is revealed by an examination of the *Consolidated* record, does not seem to have been much noted in the growing literature on reciprocity. It appears that after Consolidated-Gentry began to engage in reciprocal dealing, Basic opened more warehouses, added to its sales force, improved service to its customers and added new products to its line.[57] It also restructured its price schedules to introduce more flexibility, specifically to meet the increased competition from Gentry.[58] The importance of these facts cannot be overemphasized. It appears that in some way the Consolidated-Gentry merger contributed greatly to increased competition in the dehydrated onion and garlic market.[59]

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advised us that some bureau and division chiefs are incompetent." REPORT OF THE ABA COMMISSION TO STUDY THE FEDERAL TRADE COMMISSION 32-33 (1969). If the recent *FTC Report* is any example, the ABA Commission has understated the problem. In Professor MacAvoy's opinion, the FTC staff *Merger Report* is a "shambles of half-finished arguments and incomplete documentation . . . that can only raise again the questions asked last year about staff quality and administration." ANTITRUST & TRADE REG. REP. NO. 447, at A-8 (Feb. 3, 1970). Other recent efforts of the FTC staff have been little, if any, better. *See* Liebeler, *supra* note 20 [commenting on FTC, ECONOMIC REPORT ON MERGERS & VERTICAL INTEGRATION IN THE CEMENT INDUSTRY (1966)].

56 FTC v. Consolidated Foods Corp., 380 U.S. 592, 604-05 (1965).

57 Record at 303, FTC v. Consolidated Foods Corp., 380 U.S. 592 (1965).

58 *Id.* at 312. It is interesting to note that in its eastern territory, Basic shifted from an f.o.b. plant pricing system to a combination of f.o.b. plant and f.o.b. customer system. This in itself would appear to be a shift toward greater pricing flexibility and may have involved discriminatory price cutting in the form of freight absorption, although it is not possible to tell from the Record.

59 Mr. Robert Sparling, representing the Basic sales office, specifically testified that competition from Gentry had increased after the merger. Record at 303-04. The basic concern of counsel for the FTC seemed to be that Basic had lost some business to Gentry.

We do not know for sure that this resulted entirely from reciprocity-effected price cuts by Gentry, but the evidence is at the very least consistent with this hypothesis. And this hypothesis seems to be a great deal more consistent with the facts than any other that has been offered so far.

If this interpretation of *Consolidated Foods* is correct, reciprocity appears to have had a profoundly pro-competitive effect. It seems to have resulted in disruption of the oligopolistic price structure of the dehydrated onion and garlic market, brought about increased customer service and reduced prices. This is, or should be, precisely the goal of any rational antitrust policy.

I am not prepared to say that reciprocity is socially desirable in any and all situations. The subject needs a great deal more investigation in terms of its effect in different market situations. Additional analysis by way of analogy to the vertical merger situation needs to be made. It seems more than safe to say, however, that those who glibly assume the practice to be an unmitigated evil are doing us precious little service indeed. In the meantime we would do well to halt the march against conglomerate mergers on the basis of the supposed anticompetitive effects of reciprocity.

If this is enough to outlaw a merger, as it almost seems to be, then we really are in trouble.