Miranda Cherkas Sherrill
Antitrust Writing Competition
Student Paper Submission 2019

Come at the King, You Best Not Miss:
The Economics of Direct-Purchaser Suits after *Twombly*

CONTENTS

I. INTRODUCTION

When a cartel raises prices unlawfully, antitrust enforcement depends on private parties to monitor, detect, and expose anticompetitive behavior.[1] Forty years ago, in *Illinois Brick v. Illinois*,[2] the United States Supreme Court limited who could have standing to thwart anticompetitive behavior to only a cartel's direct purchasers, the firms who deal most closely with their price-fixing suppliers.

But filing a lawsuit against a powerful supplier is dangerous—because when you *come at the king, you best not miss*.[3] For direct purchasers, bringing an antitrust suit against their

[1] *See* Everette MacIntyre, Comm'r, Fed. Trade Comm'n, Address before the joint meeting of the Antitrust Sections of the Chicago Bar Association and the Illinois State Bar Association at the Antitrust Symposium on Private Antitrust Litigation: The Role of the Private Litigant in Antitrust Enforcement (Jan. 18, 1962) , https://www.ftc.gov/system/files/documents/public_statements/683441/19620118_macintyre_the_role_of_the_private_litigant_in_antitrust_enforcement.pdf (the intent of Congress in allowing private parties to sue for antitrust violations as to "supplement government enforcement in the antitrust field.").
[2] Ill. Brick Co. v. Illinois, 431 U.S. 720 (1977).
[3] *The Wire: Lessons* (HBO television broadcast season 1, episode 8, July 21, 2002). Essentially, this phrase means that an attack on a powerful party must be substantial enough to prevent the powerful party from retaliating against the attacker. Though this phrasing derives from a modern television show, often regarded as one of the best television dramas of all time, *see, e.g.*, Rob Sheffield, *100 Greatest TV Shows of All Time*, ROLLING STONE (Sept. 21, 2016 4:30 PM ET), https://www.rollingstone.com/tv/tv-lists/100-greatest-tv-shows-of-all-time-105998/the-wire-102868/, the same idea appears elsewhere. In the early sixteenth century, Niccolò Machiavelli advised that "the injury that is to be done to a man ought to be of such a kind that one does not stand in fear of revenge." Nicolò Machiavelli, The Prince ch. III *reprinted in* 23 GREAT BOOKS OF THE WESTERN WORLD 3, 4 (Robert Maynard Hutchins ed., W.K. Marriott trans., University of Chicago 1952) (1513). And as a college student, U.S. Supreme Court Justice Oliver Wendell Holmes once wrote an essay criticizing Plato and sent it to Ralph Waldo Emerson, who responded, "I read your piece on Plato. Holmes, when you strike at a king, you must kill him." HARLAN BUDDINGTON PHILLIPS, FELIX FRANKFURTER REMINISCES 59 (1960); *see also* Barry Popik, *"If You're Going to*

suppliers can be akin to biting the hand that feeds them. Even if *Illinois Brick* was correct about a direct purchaser's incentives to sue in 1977, the game has since changed, but no one has yet to analyze how the direct-purchaser rule under *Illinois Brick* is impacted by heightened pleading standards deriving from another critical Supreme Court decision—*Bell Atlantic Corp. v. Twombly* in 2007.[4] In contrast to fairly lax criteria for filing complaints pre-*Twombly*, the Court articulated a new "plausibility" standard requiring plaintiffs to provide factual allegations sufficient to "raise the right to relief above the speculative level."[5] Although the payoff for a direct purchaser to bring suit could be quite substantial—even treble damages—the likelihood of attaining a sizeable damages sum has fallen substantially. If direct purchasers are *not* in the best position to sue after all, then the prospect of bringing a cartel to justice is even darker after *Twombly* than before.

II. Comprehensive Model of Direct Purchasers' Decision to Sue

The relationship between *Illinois Brick* and *Twombly* becomes clear through a theoretical economic model of the direct purchaser's decision to sue a cartelizing supplier. Though direct purchasers weigh the costs and benefits of suing their suppliers, few if any commentators to date have employed a comprehensive economic model to dissect a direct purchaser's decision process. Direct purchasers consider their expected value of recovery as the expected amount of damages they can receive from trial discounted by their expected costs. In order to sue, the amount of money that direct purchasers can expect to recover must be a positive number, which means that expected damages must be more than expected costs.[6]

Shoot the King, Don't Miss", The Big Apple (Apr. 22, 2011), https://www.barrypopik.com/index.php/new_york_city/entry/if_youre_going_to_shoot_the_king_dont_miss (citing numerous sources spanning many centuries for this adage).

[4] 550 U.S. 544 (2007).

[5] *Id.* at 555.

[6] Gregory J. Werden & Marius Schwartz, Illinois Brick *and the Deterrence of Antitrust Violations--An Economic Analysis*, 35 Hastings L.J. 629, 640 (1984) ("We begin with the basic premise that the extent to which private

Expected Value of Recovery = Expected Damages – Expected Costs

To sue, Expected Damages must be > Expected Costs.[7]

Costs to a direct purchaser are significant, including litigation costs, investment into detection, and relationship costs as a result from investigating and filing a complaint. Even the possibility of treble damages is discounted by the reduced probability of ultimately winning those damages at trial post-*Twombly*. The following theoretical equation models these phenomena and will be explained in turn:

$$3 \text{ x Damages } [p(t) \mid I_d)] \; > \; \text{Litigation Costs} + I_d + [R \mid I_d] + R(c).$$

By statute, upon success at trial successful federal antitrust plaintiffs are entitled to treble damages (3 x D).[8] But their costs are also substantial. In addition to litigation costs, direct purchasers must also invest in monitoring and detecting their supplier's anticompetitive conduct. In 1979 Landes and Posner asserted that the possibility that direct purchasers "are bashful about suing their suppliers is . . . unrealistic, almost quaint."[9] But in contrast, Harris and Sullivan framed the direct purchasers' decision to sue in terms of relationship costs: "If the ongoing

treble-damages actions deter a potential price fixer depends on 1) the magnitude of the potential damages award to which the price fixer is exposed if successfully sued, and 2) the likelihood that such damages awards will be made.").

[7] The model described herein assumes that direct purchasers are rational actors who face transaction costs that change their behavior from what might appear to be the most obvious answer financially. "The most important assumption of the model is that potential litigants form rational estimates of the likely decision, whether it is based on applicable legal precedent or judicial or jury bias." [7] George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. L. STUD. 1, 4 (1984). Every rational actor maximizes expected utility within the constraints of their resources. Only for a risk-neutral individual is expected utility equal to expected returns on expected values. *See* ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 392 (6th ed. 2012). That being said, the managers who run these profit-maximizing, risk-neutral firms are also human, each with varying risk tolerances and fears of losing their jobs if a supplier retaliates. The purpose of the model is not intended as an exhaustive undertaking of every variable that could motivate a direct purchaser considering an antitrust suit. Instead, this economic model is merely a tool for helping attorneys, judges, and policymakers grasp the balancing of costs and benefits and to understand the weight of various factors that direct purchasers must consider when deciding whether to seek legal redress from their suppliers for alleged anticompetitive behavior.

[8] A party with antitrust injury "shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee." Clayton Act § 4, 15 U.S.C. § 15 (2012).

[9] William M. Landes & Richard A. Posner, *Should Indirect Purchasers Have Standing to Sue Under the Antitrust Laws?*, 46 U. CHI. L. REV. 602, 614 (1979).

relationship between the direct purchasers and the potential defendant has any value to the direct purchaser (and often it will have), the direct purchaser will to that extent be deterred from suing. (Indeed, even in cases in which the direct purchaser absorbs a significant part of the overcharge, it may often be deterred by the risk of being cut off entirely.)"[10] The risk of retaliation from price-fixing suppliers may deter direct purchasers before they ever invest in detection. Overall, the damage to the relationship is a function of investment into detecting a cartel, denoted as I_d, plus the damage to the relationship based on the decision to sue.

$$I = \text{investment};\ d = \text{detection};\ I_d = \text{the cost of investment into detection}$$

$$R = \text{damage to relationship};\ c = \text{filing a complaint}$$

$$\text{Relationship costs} = [R \mid I_d] + R(c)$$

Yet incurring these relationship costs is necessary to gather enough information that will satisfy *Twombly*'s plausibility requirement. Before *Twombly* was decided in 2007, courts rarely granted motions to dismiss, and plaintiffs' complaints could pass muster even if only speculating conspiracy.[11] But after *Twombly*, plaintiffs need more facts to show that their allegations of conspiracy are not only possible but plausible.[12] The same actions of monitoring and detecting a cartel that create the possibility of winning damages at trial are the same ones that increase relationship costs. Direct purchasers are left with the decision whether to investigate what they perceive as suspicious behavior: Investigating is necessary in order to convince a judge to deny the defendant cartel's motion to dismiss but also may put the direct purchaser at risk of business failure before the day of trial even arrives.

---

[10] Robert G. Harris & Lawrence A. Sullivan, *Passing on the Monopoly Overcharge: A Comprehensive Policy Analysis*, 128 U. PA. L. REV. 269, 352 (1979).
[11] *See Twombly*, 550 U.S. at 558.
[12] *Id.*

For direct purchasers' cost-benefit analysis, the expected value of damages is now equal to treble damages discounted by the probability of prevailing at trial, denoted as p(t), where the probability of prevailing at trial must account for the likelihood of overcoming a motion to dismiss under heightened pleading standards from *Twombly* given the cost of initially detecting (d) a cartel.

$$\text{Damages} = 3D \times p(t \mid I_d) \quad \text{where } p(t) = f(I_d)$$

Recovery is thus a function of the costs that direct purchasers are willing to incur. That means that the variables determining costs, especially I_d, end up on both sides of the equation, both the expected-costs side and the expected-benefits side. The likelihood of receiving damages is dependent upon "1) the probability that potential plaintiffs will detect the collusion, and 2) the conditional probability that, if the collusion, is detected, plaintiffs will be able to prove their case in court."[13] Therefore, if direct purchasers need the expected value of damages to be greater than expected costs, or, in its expanded version,

$$3 \times \text{Damages } [p(t) \mid I_d)] \text{ must be} > \text{Litigation Costs} + I_d + [R \mid I_d] + R(c),$$

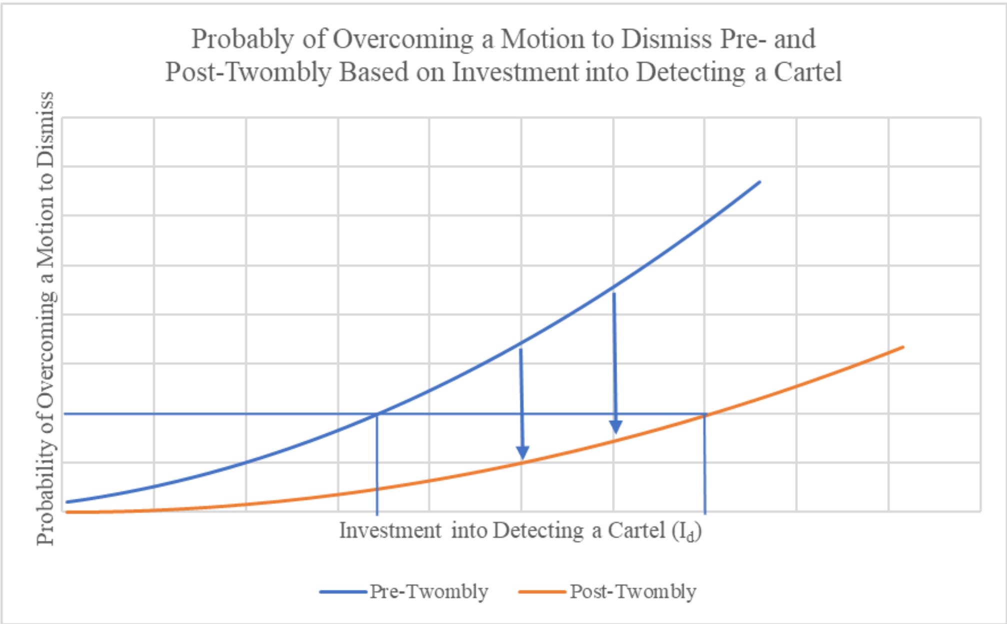
then I_d must be high enough to maximize the probability of getting damages on the left side but not so high as to increase the costs of doing business on the right side past an unreasonable level. That makes recovery more difficult for direct purchasers to calculate. Direct purchasers want to choose an investment into detection, or I_d, that maximizes the probability of overcoming a motion to dismiss, but that maximum level also raises costs, and it is unclear where the tipping point lies. But it is surely more difficult to ascertain the likelihood of winning damages after *Twombly* than it was before the Court tightened pleading standards.[14]

---

[13] Werden & Schwartz, *supra* note 6, at 641.

[14] As the district court in *Twombly* acknowledged, "[d]irect evidence of such an agreement is often impossible to obtain." Twombly v. Bell Atlantic Corp., 313 F. Supp. 2d 174, 179 (2003) (citing Theatre Enters., Inc. v. Paramount Film. Distrib. Corp., 346 U.S. 537, 540 (1954)).

In the graph below, the top line represents the probability of overcoming a motion to dismiss pre-*Twombly* and the bottom line represents post-*Twombly*.[15] Not only are small efforts likely not enough to increase the possibility of overcoming a motion to dismiss generally, but also the introduction of heightened pleading standards makes the same efforts result in even less likelihood of success. A direct purchaser must increase investment into detection post-*Twombly* in order to reach the same pre-*Twombly* probability of overcoming a motion to dismiss (shown in the graph as the line at y=2).



[15] These functions assume that the probability of overcoming a motion to dismiss is dependent on the investment that direct purchasers devote to monitoring and detection. Because more monitoring should lead to more information to support a complaint, the relationship should for the most part be positive. The exact quantitative relationship between investment into detecting a cartel and the probability of overcoming a motion to dismiss is not explored in here, but this paper assumes it is nonlinear and increasing. This means that for small and medium amounts of a direct purchaser's investment on the x-axis, such as one phone call and a few hours spent researching the market, the payoff on the y-axis is small because these few efforts will not likely produce enough information for a judicial complaint to plausibly prove a cartel. When Werden & Schwartz made a similar model, they intended to measure how much a potential plaintiff should invest when trying to detect collusion. Their x-axis represented D for dollars invested, and their y-axis represented a probability of detecting collusion P(D), rather than the probability of proceeding to the discovery phase. Their variables are not the exact variables as presented here but are related. They also hypothesized that the function curves would be different than presented here. "Investing more increases the probability of detection, but it does so at a decreasing rate—i.e., the investment of each additional dollar will cause a positive incremental effect on the probability of detection, but the amount of each incremental effect will decrease as the amount invested increases." Werden & Schwartz, *supra* note 6, at 642.

Therefore, after *Twombly*, the cost of investment into detecting a cartel is higher than it was when the direct-purchaser rule was created. These costs may be too burdensome for direct purchasers to bear, and especially where continuing with the status quo is a realistic or even favorable option, direct purchasers may be disincentivized from attaining or even considering that maximum level of investment into detection. All this is not to mention that overcoming a motion to dismiss and getting to the discovery phase does not with certainty amount to success at trial.[16] A legal battle may drag on for years, and where a direct purchaser can continue to pass on costs to downstream consumers or even survive small financial harm, staying quiet may be the best option. However, where direct purchasers do not sue their price-fixing suppliers, and indirect purchasers cannot,[17] and attorneys general or the federal government may not pursue the case, [18] leaving conspiracies are left free to operate.

III. CONCLUSION

Antitrust defendants have "sole custody" of the relevant information that direct purchasers must know before writing a legal complaint, but "[i]f the operative pleading standard require[s the] plaintiff to allege facts that she cannot reasonably be expected to know at the case's inception, this information asymmetry would in turn prevent proper functioning" of private antitrust enforcement.[19] Therefore, because the act of monitoring and detecting monopolistic behavior is necessary in order to overcome *Twombly* but also increases costs for

[16] Or overcoming summary judgment for that matter. Since *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574 (1986), many antitrust cases have ended in summary judgment. *See* Edward D. Cavanagh, Matsushita *at Thirty: Has the Pendulum Swung Too Far in Favor of Summary Judgment?*, 82 ANTITRUST L.J. 81 (2019).
[17] Andrew I. Gavil, *Thinking Outside the* Illinois Brick *Box*, 76 ANTITRUST L.J. 167, 192 (2009) (claiming that direct purchasers encounter transaction costs that mean "their litigation goals, strategies, and settlement incentives may not align with those of indirect purchasers" and "will lead to suboptimal compensation deterrence.").
[18] William Breit & Kenneth G. Elzinga, Antitrust Penalties and Attitudes Toward Risk: An Economic Analysis, 86 HARV. L. REV. 693 (1973) ("the probability of any given antitrust violator being apprehended and convicted could be raised by increasing the amount of resources devoted to the detection of such behavior.").
[19] Paul Stancil, *Balancing the Pleading Equation*, 61 BAYLOR L. REV. 90, 114 (2009).

potential plaintiffs, antitrust enforcement is ultimately stymied. Within this context of the effort and proof needed to overcome *Twombly*'s heightened standards for pleading, *Twombly* turns out to be an enemy of *Illinois Brick*.

These concerns for effective antitrust enforcement are particularly relevant considering the speculative nature of direct and indirect purchasing relationships among providers and consumers in today's platform economy. Forty years ago, the *Illinois Brick* Court stressed that between direct and indirect purchasers were multiple "separate levels in the chain of distribution."[20] This sort of attenuated relationship separating suppliers from indirect purchasers is not the same for platforms. The United States Supreme Court recently reaffirmed the *Illinois Brick* direct-purchaser requirement in *Apple v. Pepper* but distinguished the economic arrangement in *Apple v. Pepper* from the one in *Illinois Brick* by highlighting the proximity of iPhone users to Apple in contrast to the "two or more steps removed" between brick manufacturers and the purchasers of buildings using those bricks.[21]

But this distinction applies with most if not all platform services, making the *Apple v. Pepper* exception likely the new norm going forward for multi-sided platforms such as Amazon, Uber, YouTube, AirBnB, and eBay. Forty years ago, Harris and Sullivan began their initial critique of *Illinois Brick* with a concern that "[t]echnological development and increasing specialization in the American economy have fostered structural complexity."[22] That structural complexity further complicates the *Illinois Brick* rule, and in light of the economics of the direct purchaser's decision to sue, it is time to reconsider.

[20] Ill. Brick Co. v. Illinois, 431 U.S. 720, 726 (1977).
[21] Apple v. Pepper, 139 S. Ct. 1514 (2019).
[22] Harris & Sullivan, *supra* note 10, at 269.