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RECENT DEVELOPMENTS

A Door in the *Illinois Brick* Wall—A Functional Equivalent to the Cost-Plus Contract Exception

I. INTRODUCTION

In *Illinois Brick Co. v. Illinois,*[1] the Supreme Court held that, with narrow exceptions, indirect purchasers may not sue alleged price fixers who are remote from them in the distribution chain for treble damages under section 4 of the Clayton Act.[2] This decision was, according to the Court, the logical outgrowth of its earlier holding in *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*[3] that an antitrust violator may not, as a general matter, assert as a defense to price fixing that the direct purchaser plaintiff was not injured because it passed on any illegal overcharges to its customers. *Illinois Brick* has been criticized, however, as a serious obstacle to private antitrust enforcement, and there have been continuing efforts to overrule it legislatively.[4] Nevertheless, the Court's reluctance to adjudicate passing-on[5] issues stands as a key consideration in antitrust actions alleging price fixing in a multilevel distribution system. As a result, an indirect purchaser or seller victimized by a price-fixing conspiracy must fit his complaint within "the narrow

1. 431 U.S. 720 (1977).

2. Section 4 of the Clayton Act, 15 U.S.C. § 15 (1976), provides:

> Any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States in which the defendant resides or is found or has an agent, without respect to the amount in controversy, and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee.

3. 392 U.S. 481 (1968).

4. On legislative efforts to overturn *Illinois Brick,* see Handler, *Antitrust—1978,* 78 COLUM. L. REV. 1363, 1424-27 (1978); Note, *Treble Damages and the Indirect Purchaser Problem: Considerations for a Congressional Overturning of* Illinois Brick, 39 OHIO ST. L.J. 543 (1978).

5. Stated simply, "passing-on" is the "process whereby a businessman who has been overcharged adjusts his own price upward to reflect the overcharge." McGuire, *The Passing-On Defense and the Right of Remote Purchasers to Recover Treble Damages Under* Hanover Shoe, 33 U. PITT. L. REV. 177, 181 (1971). The practical effect of passing-on is that a buyer other than the original purchaser in a multilevel system of distribution pays part or all of the initial overcharge.

Passing-on analysis is not, however, limited to suits by purchasers alleging illegal overcharges. For example, sellers may pursue buyers one or more steps removed in the vertical distribution chain if the former have been injured by the latters' conspiracy to depress prices, provided that their transactions fall within one of the exceptions adumbrated in *Illinois Brick.* Note, *Scaling the* Illinois Brick *Wall: The Future of Indirect Purchasers in Antitrust Litigation,* 63 CORNELL L. REV. 309, 311 n.11 (1978). *See* Part IV *infra.*

scope [the Court] intended for any exception to its rule barring pass-on"[6] claims, or continue to suffer the injury until a direct purchaser or seller brings suit and prevails.

To date, the only exception to the bar against offensive or defensive assertion of passing-on[7] permitted by the Supreme Court[8] is when an overcharged buyer has a preexisting "cost-plus" contract. Because such a contract makes it easy to prove that the buyer has not been damaged, the Court has determined that the considerations requiring that the passing-on defense not be permitted are not present.[9] Two recent circuit court decisions reveal, however, that the scope of this exception is unsettled. In *Mid-West Paper Products Co. v. Continental Group, Inc.*,[10] the Third Circuit took the position that it would "not extend the exception beyond the limited circumstances recognized by the Supreme Court."[11] Accordingly, the court held that the use of passing-on theory is impermissible unless its proponent can show preexisting, fixed-quantity, cost-plus contracts at every level of the distribution chain, with the result that he absorbed the illegal overcharge in its entirety.[12] In *In re Beef Industry Antitrust Litigation*,[13] however, the Fifth Circuit declared that if the exception is confined to "cases involving literal cost-plus contracts," then it "is a narrow one indeed."[14] Rejecting such a rigid construction, the court held that the exception is also applicable when allegations of rigid formula pricing by middlemen and structural inelasticity of short term supplies[15] compel recognition of a

6. 431 U.S. at 736.

7. Although the Court in *Illinois Brick* did not explicitly address the question of whether these exceptions applied to both offensive and defensive passing-on theory, the Court's reasoning indicates that if the facts of a particular case facilitate proof of passing-on, the purpose underlying such proof would he immaterial. Note, *Recovery by Indirect Purchasers and the Functions of Antitrust Treble Damages*, 55 TEX. L. REV. 1445, 1454 (1977).

8. In its discussion of possihle exceptions in *Illinois Brick*, the Court added in a footnote that "[a]nother situation in which market forces have been superseded and the pass-on defense might he permitted is where the direct purchaser is owned or controlled by its customer." 431 U.S. at 736 n.16. That situation, however, would present a unity of interest not present in the typical pass-on case since the indirect customer could compel the direct purchaser (a proper plaintiff) to sue in any event.

9. Hanover Shoe, Inc. v. United Shoe Mach. Corp., 392 U.S. 481, 494 (1968).

10. 596 F.2d 573 (3d Cir. 1979).

11. *Id.* at 577 n.9.

12. *Id.* at 577.

13. 600 F.2d 1148 (5th Cir. 1979).

14. *Id.* at 1166 (citing Mid-West Paper Prods. Co. v. Continental Group, Inc., 596 F.2d 573 (3d Cir. 1979)).

15. The case presented allegations of inverted passing-on. Specifically, cattlemen alleged that retail grocers had conspired to depress heef prices and that packers "passed-on" these wholesale price depressions to the ranchers and feeders. Because fattened cattle must he sold within three weeks of reaching choice grade, the cattlemen must accept the packers' quoted price. The supply of fat cattle is therefore inelastic in the short term. 600 F.2d at 1154.

"functional equivalent" of the cost-plus contract.[16] This Recent Development examines the conflict between the circuits in light of the principles underlying the *Hanover Shoe-Illinois Brick* rule to determine the feasibility and implications of recognizing a functional equivalent to the cost-plus exception.

II. THE REJECTION OF PASSING-ON THEORY

A. *Evolution of the Rule—* Hanover Shoe *and* Illinois Brick

Hanover Shoe, Inc. v. United Shoe Machinery Corp.[17] was a treble damages action against a manufacturer of shoe machinery under section 4 of the Clayton Act by a lessee of the machinery. The plaintiff claimed that United's practice of leasing, rather than selling, the machinery resulted in illegal overcharges in violation of section 2 of the Sherman Act.[18] United contended, however, that Hanover had sustained no damages since it had passed on any illegal overcharges to its customers in the form of higher retail prices.[19] Thus, the question presented was whether an antitrust violator may avoid liability by showing that its direct purchaser passed on its added costs and hence suffered no injury from the violation.

In affirming the trial court's refusal to hear such evidence, the Supreme Court noted that " '[t]he general tendency of the law, in regard to damages at least, is not to go beyond the first step.' "[20] The Court rejected United's argument that economic principles compelled recognition of the defense when the overcharge both caused and enabled the buyer to pass on the full amount to his customers. The Court reasoned that

> [a] wide range of factors influence a company's pricing policies. Normally the impact of a single change in the relevant conditions cannot be measured after the fact; indeed a businessman may be unable to state whether, had one fact been different (a single supply less expensive, general economic conditions more buoyant, or the labor market tighter, for example), he would have chosen a different price. Equally difficult to determine, in the real economic world rather than an economist's hypothetical model, is what effect a change in a company's price will have on its total sales. Finally, costs per unit for a different volume of total sales are hard to estimate. Even if it could be shown that

16. *Id.* at 1166. The Fifth Circuit also rejected the Third Circuit's holding in *Mid-West* that a direct purchaser from a nonconspiring competitor lacks standing to sue the conspirators for treble damages. *Id.* at 1166 n.24. Both courts agreed, however, that the *Illinois Brick* rule has no application to claims for injunctive relief under section 16 of the Clayton Act, 15 U.S.C. § 26 (1976).

17. 392 U.S. 481 (1968).

18. 15 U.S.C. § 2 (1976).

19. 392 U.S. at 487-88.

20. *Id.* at 488 n.6 (quoting Southern Pac. Co. v. Darnell-Taenzer Lumber Co., 245 U.S. 531, 533 (1918)).

> the buyer raised his price in response to, and in the amount of, the overcharge and that his margin of profit and total sales had not thereafter declined, there would remain the nearly insuperable difficulty of demonstrating that the particular plaintiff could not or would not have raised his prices absent the overcharge or maintained the higher price had the overcharge been discontinued. Since establishing the applicability of the passing-on defense would require a convincing showing of each of these virtually unascertainable figures, the task would normally prove insurmountable.[21]

In short, the Court viewed any attempt to reconstruct the subjective dynamics of a past pricing decision as a practical impossibility because of the multiplicity of factors that come to bear in the marketplace.

Finally, the *Hanover Shoe* Court expressed concern that recognition of a passing-on defense would substantially reduce the effectiveness of the treble damages action as an antitrust deterrent. By precluding recovery by direct purchasers, the defense would place enforcement of the antitrust laws in the hands of ultimate consumers who "have only a tiny stake in a lawsuit and little interest in attempting a class action."[22] Consequently, the Court feared that violators would retain their illegal profits because no one would be available to sue them.[23] In this regard, Professor Posner admits that the amount of the overcharge was indeed greater than the actual damage suffered, but notes that the Court was forced to choose between overcompensating the plaintiff and underdeterring the defendant. The Court's preference for the former, he continues, "is consistent with the view that the primary purpose of antitrust damage actions is to deter violations of law."[24]

Having rejected the defensive use of passing-on except in limited circumstances, the Court in *Illinois Brick Co. v. Illinois*,[25] adopted a rule of symmetry with respect to offensive passing-on by barring indirect purchasers from suing whenever the remote seller is precluded from asserting the passing-on defense against his direct purchaser. In *Illinois Brick*, the State of Illinois and 700 local government entities brought a treble damages action alleging that defendants, manufacturers of concrete blocks,[26] had engaged in a

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21. 392 U.S. at 492-93.

22. *Id.* at 494.

23. A survey of relevant cases indicates that direct purchasers have in fact been "the backbone of private antitrust enforcement." Handler, *supra* note 4, at 1425-26; Handler, *Changing Trends in Antitrust Doctrines: An Unprecedented Supreme Court Term—1977*, 77 COLUM. L. REV. 979, 1001 (1977).

24. R. POSNER, ANTITRUST CASES, ECONOMIC NOTES, AND OTHER MATERIALS 149 (1974).

25. 431 U.S. 720 (1977).

26. The block manufacturers sold to masonry contractors, who in turn sold to general contractors, from whom plaintiffs purchased the blocks in the form of completed masonry structures.

price-fixing conspiracy in violation of section 1 of the Sherman Act.[27] The Court argued that, unless the rule regarding passing-on in treble damages actions applied equally to plaintiffs and defendants, defendants would be subjected to a serious risk of multiple liability. Therefore, since *Hanover Shoe* allows a direct purchaser to recover the full amount of any overcharge regardless of passing-on, the indirect purchaser should not, by proving passing-on, recover the same amount. Such overlapping recoveries would, according to the Court, be certain to result from a rule that presumes "that one plaintiff (the direct purchaser) is entitled to full recovery while preventing the defendant from using that presumption against the other plaintiff."[28]

More importantly, the Court drew heavily on *Hanover Shoe's* assessment of the uncertainties and difficulties in analyzing price and output decisions in the real economic world,[29] emphasizing that these factors had been the most compelling reason for rejecting the passing-on defense.[30] In fact, the Court reasoned that the evidentiary complexities and uncertainties would be multiplied in an offensive passing-on case brought by a plaintiff several steps removed from the defendant in the distribution chain because passing-on proof would have to be repeated at each point at which the price-fixed goods changed hands.[31] Section 4 of the Clayton Act was, the

27. 15 U.S.C. § 1 (1976).

28. 431 U.S. at 730. It has been argued, however, that the multiple liability problem can be overcome by means of numerous procedural devices. For example, a plaintiff's recovery could be placed in an interest-bearing escrow account until the statute of limitations becomes a bar to further claims, with the fund accessible only to those who sue within the statutory period and establish damages. Schaefer, *Passing-On Theory in Antitrust Treble Damage Actions: An Economic and Legal Analysis,* 16 WM. & MARY L. REV. 883, 926 n.175. Alternatively, a court might require the original claimant to post bond sufficient to satisfy any future actions by aggrieved parties. Note, *supra* note 7, at 1449.

29. *See* text accompanying note 21 *supra.*

30. 431 U.S. at 731-32. The Court concluded that the "effective enforcement" rationale, *see* text accompanying notes 22-24 *supra,* was of only secondary importance in light of *Hanover Shoe's* recoguition of a cost-plus contract exception to the passing-on bar. A cost-plus contract will not increase an indirect purchaser's stake (and hence, his incentive to sue) in a lawsuit, but it does ease the complicated task of demonstrating that the direct purchaser did not absorb the overcharge. 431 U.S. at 732 n.12.

31. *Id.* at 732-33. The Court conceded, however, that offensive passing-on cases are simpler in one respect than defensive passing-on cases brought by direct purchasers. In the latter, even if the defendant could show that the direct purchaser increased his price by the full amount of the overcharge, the direct purchaser could still claim injury due to reduced sales volume caused by higher prices. The reduced volume injury is not present in suits by final purchasers, however, because the only issue is whether plaintiff paid a higher price due to the initial overcharge. Nonetheless, the Court concluded that "the difficulty of reconstructing the pricing decisions of intermediate purchasers at each step in the chain beyond the direct purchaser generally will outweigh any gain in simplicity from not having to litigate the effects of the passed-on overcharge on the direct purchaser's volume." *Id.* at 733 n.13.

Court conceded, designed to compensate antitrust victims as well as to deter violators and deprive them of their ill-gotten gains. Nevertheless, the Court could not countenance "carry[ing] the compensation principle to its logical extreme by attempting to allocate damages" throughout the chain of distribution[32] because it "question[ed] the extent to which such an attempt would make individual victims whole for actual injuries suffered rather than simply depleting the overall recovery in litigation over pass-on issues."[33] Before turning on to the exception to the passing-on rule, it is necessary to examine the economic considerations underlying *Hanover Shoe* and *Illinois Brick.*

B. *The Economics of Passing-On*

The ability of an intermediate purchaser to pass an overcharge along the distributive chain[34] depends greatly upon the relative elasticities of supply and demand for his product, or, in other words, "the responsiveness to price changes of quantities supplied and demanded."[35] The full overcharge that results from an antitrust violation can be passed on to indirect purchasers only when demand is perfectly inelastic—when buyers will purchase a specified quantity regardless of price fluctation.[36] The assumption of perfect inelasticity, however, is unrealistic, because demand always exhibits some sensitivity to price in real economic markets.[37]

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32. In this connection, Professor Posner admonishes that the compensation rationale could logically be extended beyond the immediate chain of distribution, limited only by considerations of proximate cause and, ultimately, common sense:

> The troublesome question is where to draw the line. Everyhody's economic welfare is bound up with everybody else's. Why stop with the ultimate consumer? If he is forced to pay a higher price for a product, his demand for other products will fall and this may hurt the suppliers of those products, and the suppliers' suppliers, and so on ad infinitum.

R. POSNER, *supra* note 24, at 149.

33. 431 U.S. at 746-47. In support of this "deterrence before compensation" rationale, see Landes & Posner, *Should Indirect Purchasers Have Standing to Sue Under the Antitrust Laws? An Economic Analysis of the Rule of* Illinois Brick, 46 U. CHI. L. REV. 602, 605 (1979).

34. This discussion will focus on the straight passing-on situation. The same considerations, however, apply in general to inverted passing-on cases, *see* note 15 *supra*, as does the *Illinois Brick* rule. [1977] ANTITRUST & TRADE REG. REP. (BNA) No. 822, at B-5.

35. Schaefer, *supra* note 28, at 887. Elasticity is an economic concept used

> to compare the responsiveness of one variable to a given change in another variable while avoiding problems posed by the arbitrariness of the economic dimensions in which either variable is stated. Elasticity of supply, for example, measures the responsiveness of the quantity of a commodity supplied to changes in the price of that commodity without reference to either units of output or dollars.

Id. at 887 n.22.

36. Note, *supra* note 5, at 312 n.14.

37. R. POSNER, *supra* note 24, at 148. *See generally* P. SAMUELSON, ECONOMICS 379-86 (1973).

Herein lies the crux of the passing-on problem. Real market forces prevent any seller from fully avoiding injury from anticompetitive activity by passing the entire overcharge along the chain of distribution:[38] he must either absorb part of the overcharge himself or, if he raises his price by the full amount of the increase, suffer a corresponding reduction in sales volume, and hence a net decrease in profits. Assuming profit-maximizing behavior, each actor in the chain of distribution will seek to determine the price at which it can pass on the maximum percentage of the overcharge without depressing the market for its product.[39] It is precisely this business decision that the Supreme Court in *Hanover Shoe* said involved such "a wide range of factors" that proving the specific figures calculated therein "would normally prove insurmountable."[40] Aside from the practical impossibility of proving the factors contributing to a company's pricing decisions there remains the problem of demonstrating the point elasticities that come to bear on the volume of sales issue. Although economic techniques are available that can be used to *estimate* point elasticities, the practical shortcomings of such estimations would merely augment the guesswork inherent in proving passing-on.[41] This doubtless helps to explain why no antitrust court has attempted to estimate an elasticity of supply or demand.[42] Indeed, the totality of these factors has led one authority to conclude that "conducting litigation of [such] dimension . . . either would be impossible as a practical matter or would be so expensive that the goal of compensation would be totally frustrated. There are no short-cuts for resolving pass-on issues on a mass scale."[43] Thus, an assessment of these economic factors is essential in framing any exception to the passing-on rule.

III. The Cost-Plus Contract Exception

A. *Basis for the Exception*

As noted,[44] the Supreme Court in *Hanover Shoe* and *Illinois Brick* carved out an exception to the rule barring passing-on claims

38. Note, *supra* note 5, at 312 n.14. The converse is also true, namely, an intermediate puchaser will rarely he compelled to absorb the entire overcharge himself. R. Posner, *supra* note 24, at 148.

39. The ratio of the overcbarge absorbed by the indirect and direct purchaser, respectively, equals the ratio of the elasticities of supply and demand in the market in which the product is sold. Note, *supra* note 7, at 1450 n.34.

40. 392 U.S. at 492-93. *See* text accompanying note 21 *supra.*

41. Landes & Posner, *supra* note 33, at 619.

42. *Id.*

43. Handler, *supra* note 23, at 1002.

44. *See* text accompanying note 9 *supra.*

for situations involving preexisting, cost-plus contracts.[45] Read literally, these cases require: (1) a preexisting contract,(2) specifying a fixed quantity of products to be sold, (3) with the price per unit to be determined by adding an agreed-upon markup to the seller's own cost. Thus defined, the exception contemplates a situation that rarely occurs.[46] The net effect of such an arrangement is to make the purchaser's demand for the particular commodity completely inelastic; he is committed to buy the same quantity at any price and thus bears the full amount of the initial overcharge.[47] This occurs, however, only if the contract fixes the quantity to be purchased; otherwise, remote purchasers would be free[48] to vary the amount of their purchases according to changes in price. This freedom would in turn necessitate a determination of the relative elasticities of supply and demand in the resale market to assess the extent, if any, of the direct purchaser's injury.[49] *Hanover Shoe* and *Illinois Brick,* however, indicate that an antitrust litigant cannot force this inquiry to be made.[50]

Aside from the fixed-quantity requirement, it must be stressed that a preexisting cost-plus contract, and not simply adherence to cost-based price setting, is necessary to invoke the exception. In *Illinois Brick*, for example, the Court refused to recognize an excep-

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45. Under a cost-plus contract a customer pays a specified markup above the seller's own cost for the product. Elaborating on the "narrow scope" of the cost-plus contract exception, the Supreme Court in *Illinois Brick* noted that

> [i]n such a situation, the purchaser is insulated from any decrease in its sales as a result of attempting to pass on the overcharge, because its customer is committed to buying a fixed quantity regardless of price. The effect of the overcharge is essentially determined in advance, without reference to the interaction of supply and demand that complicates the determination in the general case.

431 U.S. at 736.

46. [1977] ANTITRUST & TRADE REG. REP. (BNA) No. 822, at B-6.

47. Schaefer, *supra* note 28, at 917. Such a result does not mean, however, that the direct purchaser necessarily escapes injury; he may still have a cause of action to the extent that the overcharge prompts potential customers to purchase elsewhere, thus diminishing his total profits. Note, *supra* note 5, at 329 n.87.

48. This statement assumes, of course, that buyer demand will never be perfectly inelastic. *See* text accompanying note 37 *supra.*

49. Schaefer, *supra* note 28, at 917-18. Arguably, a direct purchaser might force this evaluation to be made even when he did sell under a fixed quantity arrangement, *see* note 47 *supra,* although the issue has apparently not arisen to date. *See* text accompanying note 96 *infra.*

50. The Court in *Illinois Brick* conceded that reduced sales volume would not be at issue in suits by final purchasers against remote sellers. *See* note 31 *supra.* Therefore, an indirect purchaser arguably need not show that his cost-plus contract also specified a fixed quantity to be purchased. The problem with this argument, however, is that the direct purchaser in such case would, presumably, also allege injury from his reduced volume of sales, in which event the court would still be called upon to reconstruct the direct purchaser's pricing decisions. The court, however, apparently will not engage in such inquiry. *But see* Part IV *infra.*

tion based on the fact that contractors[51] *purported* to charge a fixed percentage above their costs. Such "cost-based rules of thumb"[52] are not, according to the Court, adhered to rigidly; rather, "the extent of the markup (or the allocation of costs) is varied to reflect demand conditions. . . . The intricacies of tracing the effect of an overcharge on the purchaser's prices, costs, sales, and profits thus are not spared the litigants."[53] Moreover, even assuming that a particular market or industry exhibits "generally accepted" markups, variations from these rules of thumb occur in a fashion similar to secret price shaving within a cartel.[54] One authority has explained the phenomenon as follows:

> Two problems underlie the tendency for informal price-fixing and output-restricting agreements to break down. First, the parties to the conspiracy may have divergent ideas about appropriate price levels and market shares, making it difficult to reach an understanding which all will respect. Second, when the group agrees to fix and abide by a price approaching monopoly levels, strong incentives are created for individual members to cheat—that is, to increase their profits by undercutting the fixed price slightly, gaining additional orders at a price which still exceeds marginal cost.[55]

In practical terms, any attempt to classify various market situations as "resembling," and hence paralleling, cost-plus contracts invariably leads to the same evidentiary problems that the passing-on rule sought to avoid.[56]

B. *Precedents*

The decisions of the lower federal courts—most of which, unfortunately, predate *Illinois Brick*—have done little to clarify the parameters of the cost-plus exception. Several cases that have allowed indirect purchaser suits have noted the exception but failed to base their decisions solely on the presence of a cost-plus contract.[57] Other courts, however, have been more bold. In *Standard Industries, Inc. v. Mobil Oil Corp.*,[58] for example, plaintiffs, general construction

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51. *See* note 26 *supra* and accompanying text.

52. In general, pricing rules of thumb "typically involve some variant of the full-cost or cost-plus pricing principle, in which a 'normal' or desired profit margin or percentage return on invested capital is added to estimated unit costs to calculate the product price." F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 173 (1970).

53. 431 U.S. at 744 (citation omitted).

54. Note, *supra* note 5, at 330 n.91.

55. F. SCHERER, *supra* note 52, at 160.

56. 431 U.S. at 745.

57. *See, e.g., In re* Western Liquid Asphalt Cases, 487 F.2d 191 (9th Cir. 1973), *cert. denied,* 415 U.S. 919 (1974); Boshes v. General Motors Corp., 59 F.R.D. 589 (N.D. Ill. 1973); *In re* Master Key Antitrust Litigation, [1973-2] Trade Cas. (CCH) ¶ 74,680 (D. Conn. 1973), *appeal dismissed,* 528 F.2d 5 (2d Cir. 1975).

58. 475 F.2d 220 (10th Cir. 1973).

contractors, had purchased liquid asphalt from certain of the defendants, who contended that the plaintiffs had passed on any overcharges and hence had suffered no damage. On appeal the Tenth Circuit approved the lower court's instruction to the jury that the passing-on defense "is generally available only to a 'cost-plus' contractor *or* to a middleman who buys a product then resells same in unchanged form to a consumer under such condition that the original cost and handling charges can be traced with a fair degree of certainty."[59] This instruction hardly confined the exception to the narrow boundaries noted above. The fact that the instruction was merely intended to enlighten the jury, however, coupled with the appellate posture of the case, suggest that its value as an expansive precedent is limited at best.

The Second Circuit considered the cost-plus exception in *West Virginia v. Chas. Pfizer & Co.*,[60] an action by wholesalers, retailers, government purchasers and ultimate consumers against a drug manufacturer who had charged illegally high prices. Certain wholesale and retail plaintiffs argued, on the basis of *Hanover Shoe,* that ultimate consumers should not have been allowed to share in the 100 million dollar settlement fund because the complexities of passing-on precluded their proving specific injury.[61] Rejecting this argument, the Second Circuit responded that the ultimate consumers had in fact borne part of the overcharge since the retailers had generally sold the excessively priced drugs on the basis of fixed percentage markups analogous to preexisting cost-plus contracts.[62] Again, however, the precedential value of this case must be discounted because it was a settlement proceeding in which a majority of each class had agreed to the resolution.[63]

Two other pre-*Illinois Brick* cases deserve mention because of their divergent treatment of the reduced volume issue[64] in passing-on analysis. In *Obron v. Union Camp Corp.*,[65] plaintiff was a wholesaler who solicited orders for mesh window bags produced by defendant; in a practice known as "drop shipping," plaintiff forwarded its orders to defendant, who shipped the goods directly to plaintiff's

59. *Id.* at 224 n.1 (emphasis supplied).

60. 440 F.2d 1079 (2d Cir. 1971), *cert. denied,* 404 U.S. 871 (1971).

61. 440 F.2d at 1084-86.

62. *Id.* at 1088. Interestingly, some of the direct purchasers admitted in the district court that they had suffered no injury and did not want to share in the recovery. West Virginia v. Chas. Pfizer & Co., 314 F. Supp. 710, 746 (S.D.N.Y. 1970).

63. Comment, *In the Face of Uncertainty—The Passing-On Concept in Civil Antitrust Litigation,* 27 ARK. L. REV. 83, 128 (1973).

64. *See* notes 38-39 & 47-49 *supra* and accompanying text.

65. 355 F. Supp. 902 (E.D. Mich. 1972), *aff'd,* 477 F.2d 542 (6th Cir. 1973).

customers. The parties operated under a pricing arrangement by which Obron purchased the bags at five percent below list price and then resold at list price. Responding to Obron's claim that defendant had conspired to create a monopoly in the manufacture and sale of such bags by maintaining and enforcing an invalid patent, Union urged that this pricing arrangement enabled plaintiff to pass on any overcharges and hence to avoid injury. The court allowed Union's defense, reasoning "that if there is not a 'pre-existing "cost-plus" contract' present here the situation is so strikingly similar to such a contract as to dictate the allowance of the 'passing-on defense.' "[66] The court claimed to restrict the defense to "situations which are easily provable,"[67] but failed to consider the effect of the overcharge on plaintiff's overall sales volume. The evidence offers no indication that Union sold the bags under preexisting contracts that fixed the quantity to be purchased. Thus, it is likely that plaintiff did in fact sustain some damage as a result of the alleged violation.[68]

In contrast to *Obron* is the Fifth Circuit's decision in *Yoder Brothers v. California-Florida Plant Corp.*,[69] an action involving a claim for infringement of twenty-one chrysanthemum plant patents and counterclaims under sections 1 and 2 of the Sherman Act.[70] Yoder sought to assert the passing-on defense to the antitrust counterclaims, alleging that its arrangement with the plant corporation fell within the cost-plus exception. The Fifth Circuit determined, however, that Yoder had not overcome "the almost 'insurmountable' burden of showing that the factors that led the Supreme Court to reject the pass-on defense do not apply."[71] Even assuming that the impact of the overcharge could be measured after the fact, that the plant corporation would not otherwise have raised or maintained its higher price, and that alternative plaintiffs would be readily available to vindicate the antitrust laws, the court nevertheless concluded that Yoder had not shown the effect of the overcharge on total sales and costs per unit for a different volume of total sales.[72] "Simple economics," the court noted, "suggests that sales would have increased at lower prices," and "[s]ince the difference

66. 355 F. Supp. at 906.

67. *Id.* at 907.

68. Schaefer, *supra* note 28, at 926. This conclusion assumes, of course, that the demand for mesh window bags was not perfectly inelastic. *See* text accompanying note 36 *supra*. *But see* text accompanying notes 100-01 *infra*.

69. 537 F.2d 1347 (5th Cir. 1976) (Goldberg, J.), *cert. denied*, 429 U.S. 1094 (1977).

70. 15 U.S.C. §§ 1-2 (1976).

71. 537 F.2d at 1375.

72. *Id.*

in total sales is an uncertain figure, the breakdown of that figure into cost per unit plus profit is equally uncertain."[73] Thus, *Yoder* avoided the problem that the *Obron* court failed to recognize in a way that seems consistent with *Hanover Shoe.*[74] Despite its apparent logic, however, the Fifth Circuit no longer believes *Yoder's* treatment of the passing-on issue is viable.[75]

IV. THE COST-PLUS EXCEPTION AFTER *Illinois Brick*—A FUNCTIONAL EQUIVALENT

A. *Recent Decisions*

In the wake of *Illinois Brick,* two circuits have considered the cost-plus exception to the rule barring passing-on claims and have reached irreconcilable results. The first of these decisions, *Mid-West Paper Products Co. v. Continental Group, Inc.,*[76] dealt with a series of private antitrust actions instituted in response to a grand jury indictment charging five corporations and seven individuals engaged in the manufacture of consumer bags[77] with price-fixing in violation of section 1 of the Sherman Act.[78] The *Mid-West* court's strict formulation of the exception foreshadowed its ultimate holding: the court declared that indirect purchaser-plaintiffs[79] must show "a pre-existing, fixed-quantity, cost-plus contract" at every point in the distribution chain at which the goods changed hands.[80] The plaintiffs claimed they were entitled to further discovery in order to fit their cases within the exception. The court, however,

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73. *Id.* at 1375-76.

74. *See* notes 67-68 *supra* and accompanying text.

75. *In re* Beef Industry Antitrust Litigation, 600 F.2d 1148, 1164 n.20 (5th Cir. 1979). *See* Part IV *infra.*

76. 596 F.2d 573 (3d Cir. 1979). The case came to the Third Circuit on appeal from an order of the District Court for the Eastern District of Pennsylvania granting defendant's motions for summary judgment on the basis of *Illinois Brick* and dismissing the suits in their entirety.

77. Consumer bags are "single or multilayered paper bags that may also contain linings or coatings made from other materials and that are employed to prepackage products then marketed in them." *Id.* at 575. Designed for capacities of less than twenty-five pounds, the bags often have printed exterior designs describing their contents, which include such products as pet food, cookies, tea, coffee, and chemicals. *Id.*

78. *See* United States v. Continental Group, Inc., 456 F. Supp. 704 (E.D. Pa. 1978). Only the corporations were named as defendants in the private civil action, however.

79. Three categories of plaintiffs sued for treble damages and injunctive relief: first, supermarkets and retail grocery stores that did not purchase bags directly, but purchased products packaged therein for resale; second, a grocery store that sold packaged products and also purchased empty bags from middlemen and wholesalers in which it packaged its own brand of ice cream; and third, a middleman that purchased bags for resale to automobile manufacturers who put machine parts in the bags. 596 F.2d at 575-76. This Recent Development is concerned only with the first group—the indirect purchasers.

80. *Id.* at 577.

rejected this request as a mere attempt to delay the inevitable.[81] First, the court declined plaintiffs' invitation to delete the "fixed-quantity" requirement, reasoning that *Illinois Brick* demands that the direct purchaser alone be awarded the full recovery in a variable quantity situation. Absent such a requirement the court would be forced to analyze the terms of each transaction to determine whether the direct or indirect purchaser was damaged.[82] Second, the court summarily rejected plaintiff's contention that the exception should include "informal arrangements and patterns of cost-plus pricing"[83] and instead adhered to the Supreme Court's rejection of "cost-based rules of thumb."[84] Thus, the Third Circuit's decision in *Mid-West* represents a strict reading of the already narrow cost-plus exception.

Less than five months later, however, the Fifth Circuit in *In re Beef Industry Antitrust Litigation*[85] recognized a "functional equivalent" to the cost-plus exception. A thorough review of the complex facts is necessary to understand the court's holding. Plaintiffs, cattlemen, ranchers, and feeders, contended that defendants, twenty-five retail food chains, a wholesale grocer, the retail chains' national trade association, and a beef industry price reporting publication, had conspired to fix at artificially low levels the price at which beef was purchased from meat packers and slaughterhouses in violation of sections 1 and 2 of the Sherman Act. The resulting price depressions were allegedly passed up the distribution chain to the producer-plaintiffs.[86] On this basis, plaintiffs sought treble damages and injunctive relief under sections 4 and 16 of the Clayton Act.

More specifically, plaintiffs alleged that during any given week, the retail chains in a particular geographical area were able to set the wholesale price for beef by wielding monopsony or oligopsony power.[87] A designated chain in each area would buy its beef at wholesale early in the week; the prices offered by leading purchasers across the nation were then reported in the "National Provisioner Daily Market and News Service" and other retail chains followed

81. *Id.* at 580.

82. *Id.* at 577-78 n.9. *See* notes 47-49 *supra* and accompanying text.

83. 596 F.2d at 577 n.9.

84. *See* notes 52-53 *supra* and accompanying text.

85. 600 F.2d 1148 (5th Cir. 1979) (Wisdom, J.). The case involved thirteen private antitrust actions assigned to the District Court for the Northern District of Texas for coordinated or consolidated pretrial proceedings. *In re* Beef Industry Antitrust Litigation, 419 F. Supp. 720 (Jud. Pan. Mult. Lit., 1976).

86. This phenomenon is known as inverted passing-on. *See* note 15 *supra.*

87. "Monopoly" refers to price fixing by sellers. "Monopsony" and "oligopsony" refer to price fixing by a single purchaser or by a group of purchasers respectively. 600 F.2d at 1154 n.3.

the price established by the regional leader in purchasing their requirements. The chains' monopsony or oligopsony power, coupled with the packers' inability to withhold the beef for long terms,[88] allegedly facilitated this control over wholesale prices. Finally, plaintiffs claimed they had no choice but to accept the packers' depressed prices due to the inelasticity of the fat cattle supply in the short term.[89] The packers' prices were allegedly derived directly from quotations in the trade publication—and hence from the action of defendants—with the result that "the allegedly artificially low wholesale prices established by the retail chains' combination translate directly into artificially low prices for fat cattle."[90]

The district court, basing its decision on *Illinois Brick,* dismissed the complaints for failure to state claims upon which relief could be granted.[91] The Fifth Circuit initially rejected plaintiffs' "ambitious contention" that *Illinois Brick* had no application to price-fixing suits brought by sellers against indirect purchasers.[92] The court also refused to recognize an exception based on plaintiffs' suggestion that the packers had conspired with the retailers, with the result that the latter "controlled" the former within the meaning of footnote sixteen of *Illinois Brick.*[93] The court did, however, permit the plaintiffs to pursue their claims in light of allegations that brought them within the cost-plus exception.

Judge Wisdom initially conceded that "the Court meant the scope of the exception to be narrow," but added that "it did not

88. The packers allegedly had no long-term storage facilities. *Id.* at 1154.

89. *See* note 15 *supra.* If they were to withhold their supply, the plaintiffs claimed the cattle would become over-fattened and hence less valuable. 600 F.2d at 1154.

90. *Id.* at 1154-55.

91. *Id.* at 1153.

92. *Id.* at 1158. The plaintiffs argued that the harm suffered by sellers in such cases is much greater than that suffered by indirect purchasers in straight passing-on situations, and thereby justifies tackling the proof and multiple liability problems that the *Illinois Brick* rule was desigued to avoid. The plaintiffs claimed that a purchaser in a monopolistic market can seek substitutes elsewhere, whereas a seller faced with monopsony or oligopsony price-fixing must accept the depressed price or refuse to sell at all. The court initially responded by noting that both situations give rise to "restrictions in industry output and the consequent reallocation of resources to less valuable uses." *Id.* (footnote omitted). More importantly, the court reasoned that any incremental harm that might flow from unremedied monopsony or oligopsony price-fixing schemes would not warrant creating an exception to *Illinois Brick,* even assuming, as plaintiffs did, that the Supreme Court had balanced the deterrence and compensation rationales against considerations of judicial economy and fairness to defendants and concluded that some price-fixing schemes must go unremedied by private damage actions. *Id.* at 1158-59.

93. *See* note 8 *supra.* The court responded that this co-conspiracy theory was not set forth in plaintiffs' complaints. Further, it declared that "[i]f the act of passing-on sufficed to brand the intermediary as a co-conspirator the asserted exception would wholly swallow the *Hanover Shoe-Illinois Brick* rule." 600 F.2d at 1161.

imply that only cases involving cost-plus contracts qualify."[94] In short, the court reasoned that *any* situation in which the impact of an overcharge on a middleman's pricing decisions can be determined without reference to the interactions of supply and demand would avoid the economic uncertainties and potential multiple liability that prompted the *Hanover Shoe—Illinois Brick* rule. More significantly, however, the court went beyond this general proposition to repudiate its earlier rationale in *Yoder Brothers v. California-Florida Plant Corp.*,[95] and to rely on a new argument as the essential justification for its holding:

> Functional equivalence is not lost simply because the proponent of passing-on theory cannot demonstrate that the middleman suffered no loss in volume as the result of raising the price to his customers. In the cost-plus contract case itself, the middleman is likely to have suffered a loss of volume and hence profits as a result of the overcharge. His higher selling price will likely have caused potential customers to forego his product. . . . The middleman's loss of volume and the indirect purchaser's absorption of the overcharge are wholly separable items of damage.[96]

Underlying this conclusion was the court's view that cases like *Yoder*, which required proof that the intermediary suffered no harm as a prerequisite to assertion of the passing-on defense, rested on the erroneous premise that vigorous enforcement of private treble damages actions was of paramount concern to the *Hanover Shoe* Court. *Illinois Brick* made clear, however, that the difficulty of proof problem, not the antitrust enforcement interests, was the underlying concern in *Hanover Shoe.*[97] Absent such evidentiary problems, "the policy in favor of vigorous antitrust enforcement must sometimes give way [and the passing-on defense be permitted] in face of the risk of overpunishing antitrust violators."[98] The converse is also true—that offensive use of passing-on must be permitted, notwithstanding any impact of an overcharge on a direct purchaser's sales volume, so long as the fact of passing-on can be proved without reference to the interactions of supply and demand.

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94. *Id.* at 1163. The court went on to say that "any situation in which [the impact of] the overcharge is essentially determined in advance 'without reference to the interactions of supply and demand' would function in the same way." *Id.* at 1164 (quoting Note, *supra* note 5, at 331 n.93). Interestingly, the only example of such a situation posed in the quoted Note is that in which a single buyer sues for an overcharge on a single purchase passed on by an intermediary using cost-based rules of thumb. Note, *supra* note 5, at 330 n.93. That the facts in the instant case present infinitely more complex problems of proof should be apparent.

95. 537 F.2d 1347 (5th Cir. 1976), *cert. denied,* 429 U.S. 1094 (1977); *see* text accompanying notes 69-73 & 75 *supra.*

96. 600 F.2d at 1164.

97. *See* note 30 *supra* and accompanying text.

98. 600 F.2d at 1164 n.20.

B. *Analysis*

The holding of *Beef Industry* is analytically sound insofar as it separates the question of reduced sales volume from the issue of passing-on. Indeed, the Court in *Illinois Brick* seems to have recognized this severability, but simply failed to admit it.[99] Moreover, allowance of the cost-plus exception is itself tantamount to recognition of the severability of volume issues from passing-on per se; as the Fifth Circuit noted, even when the quantity to be purchased is fixed in the indirect purchaser's contract, the direct purchaser may still be injured to the extent his higher prices caused potential customers to purchase elsewhere.[100] To deny the logic of *Beef Industry*, therefore, is to deny an essential premise underlying the cost-plus exception.

It is unfortunate, however, that the Fifth Circuit chose such an uncomfortable fact situation in which to clarify the sales volume/passing-on dichotomy. Careful to emphasize that the dismissal below had been on the pleadings, the court nevertheless made broad concessions to the plaintiffs by allowing them to "firm up" their proof in the pretrial stage.[101] The cattlemen alleged that the packers had set their prices for live cattle by strictly applying certain formulae to the wholesale price reported in the trade publication. Given this allegation, the court concluded that if a plaintiff could prove both "what the competitive wholesale price *would have been* for a given grade of beef in a given region at a given time" and that the intermediary to whom he sold strictly applied a formula to the trade publication price for the particular sale, then the plaintiff would be entitled "to damages in the amount of the difference between the price he actually received on that sale of fat cattle and the price he would have received absent price-fixing (computed by applying the packer's formula to the constructed competitive wholesale price)."[102] Such proof would, in the court's view, provide the functional equivalent of a cost-plus contract.

It is difficult to reconcile this analysis with the court's prior emphasis on difficulty of proof as the principle justification for the *Illinois Brick* rule.[103] Judge Wisdom rejected defendants' contention that the packers' pricing mechanisms were analogous to the "cost-

99. *See* note 31 *supra*.

100. *See* text accompanying note 96 *supra*. *See also* note 47 *supra*.

101. Compare the Third Circuit's approach in *Mid-West*, in which the court held that "plaintiffs may not, consonant with the summary judgment procedure, insist upon taking a roundabout, lengthy, and costly discovery route before submitting to the inevitable conclusion that their actions for treble damages cannot prevail." 596 F.2d at 580.

102. 600 F.2d at 1165 (emphasis supplied).

103. *See* text accompanying notes 97-98 *supra*.

based rules of thumb" specifically rejected by the Supreme Court as exceptions to the passing-on rule.[104] He noted that, whereas the *Illinois Brick* plaintiffs alleged that the middlemen *purported* to charge a fixed percentage markup, the allegation here was that the packers *in fact* engaged in formula pricing.[105] The court reasoned that if a packer absorbed any part of the loss resulting from the wholesale price depression, it would be readily detectable because the packer would have either changed his purchasing formulae or paid a higher price for choice cattle than he would have paid had he adhered to his customary formulae.[106] Given the multiplicity of factors that come to bear on a middleman's pricing decisions,[107] however, such formulae would seem less reliable "in the real economic world rather than an economist's hypothetical model."[108] The court's acceptance of these formulae would therefore appear to conflict with the express language of *Illinois Brick.*[109] Finally, although the court admitted that it might be classifying market situations according to the likelihood of passing-on and its susceptibility to proof,[110] it argued that "the Supreme Court itself engaged in such a process in suggesting exceptions to its bar against the use of passing-on theories."[111] Albeit a question of semantics, such an argument does not sufficiently reconcile the court's analysis with the teaching of *Illinois Brick.* It is one thing to describe a *mechanism,* such as the cost-plus contract, that will give rise to the exception; it is quite another to compile a number of business and economic factors that collectively parallel that mechanism. Thus, to the extent that it was fashioning an economic analogue to the cost-plus contract, the court should have admitted that it was tracking on new ground.

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104. *See* notes 52-53 *supra* and accompanying text.

105. 600 F.2d at 1165. Judge Wisdom may, however, have raised a distinction without a difference. As the authority relied upon hy the Supreme Court observed:

> Virtually all the recent evidence on full cost pricing practices shows that firms do not in fact apply rigid profit margins, regardless of demand conditions. They vary the margin to suit the product: the more elastic the demand, the lower the margin. Or in some bizarre cases . . . , they applied fixed margins, but juggled their cost allocations to achieve the same result.

F. SCHERER, *supra* note 52, at 176.

106. 600 F.2d at 1165. Additionally, the court observed that packers purportedly have no reason to depart from their purchasing formulae in the short run due to the short-term inelasticity of the fat cattle supply. *Id.*; *see* note 15 *supra.*

107. *See* text accompanying notes 39-40 & 53-55 *supra.*

108. 392 U.S. at 493.

109. *See* text accompanying notes 52-54 *supra.*

110. *See* text accompanying note 56 *supra.*

111. 600 F.2d at 1166.

V. Conclusion

Speaking for the majority in *Illinois Brick,* Mr. Justice White observed that, "as we understand the dissenters' argument, it reduces to the proposition that because antitrust cases are already complicated, there is little harm in making them more so. We disagree."[112] Although the Supreme Court properly identified the competing policies necessary to evaluate the legal and practical implications of passing-on, by raising a nearly absolute bar to the assertion of such claims, the Court may have been too short-sighted.[113] The Fifth Circuit implicitly recognized this shortcoming when it pointed out the severability of passing-on claims from those relating to reduced sales volume. In addition, the Fifth Circuit apparently has responded to Mr. Justice White's admonition by noting that although "the proposed proof of damages is far from simple . . . this is a complexity born of quantity. The *kinds* of proof that will be involved . . . are not new to courts, and certainly not to antitrust courts."[114] However regrettable the factual context in which it arose, the *Beef Industry* holding should prompt a reconsideration of the scope of the cost-plus exception and will doubtless provide important guidance in future passing-on litigation.

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112. 431 U.S. at 743 n.27.
113. Note, *supra* note 5, at 311.
114. 600 F.2d at 1167.