Even if predation is possible, does intense price competition harm consumers?

The Perverse Effects of Predatory Pricing Law

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The theory of predatory pricing is as old as the Sherman Act. Among the evils attributed to John D. Rockefeller and Standard Oil was underpricing rivals to maintain a monopoly in oil production. In the early years of the Sherman Act, courts frequently used conclusory epithets such as "ruinous competition," "predatory intent," and "below-cost pricing" to condemn price-cutting by dominant firms without undertaking any meaningful inquiry into whether the challenged behavior was beneficial or harmful to consumers.

During the 1970s, the law-and-economics movement revolutionized antitrust law, showing that many practices once condemned were in fact socially beneficial. Predatory pricing law received a thorough scrubbing, first at the hands of prominent academics and then in the federal courts. During the mid-1980s and early 1990s, the Supreme Court cast doubt on the viability of most predatory pricing claims, opining that predatory pricing happens rarely, if at all, and that recognizing a claim based on price-cutting threatens to chill vigorous competitive behavior by large firms.

Despite this attitudinal reversal in the academy and the courts, hundreds of predatory pricing cases have been filed in the past decade. Most of the cases are brought by competitors alleging that a rival's low prices threaten to put the plaintiff out of business.

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Although very few plaintiffs succeed in winning a favorable judgment given the strict rules imposed by the Supreme Court, the tone in the academy is beginning to change. Drawing on advances in game theory and behavioral economics, recent scholarship argues that predatory pricing may be more common than the Supreme Court believed. Prominent economists and law professors have proposed new, more restrictive rules on price competition by dominant firms.

The new learning is finding its way into the courts as well. In a 2003 predatory pricing case, the U.S. Court of Appeals for the Tenth Circuit declared that, in light of the recent scholarship, it would no longer approach predation claims with the skepticism that once prevailed. Predatory pricing theories, once discredited, are regaining respectability.

Whether or not the new scholarship has made a convincing case that predatory pricing is a real monopolistic threat, one insight from the law-and-economics literature of the 1970s and 1980s remains unrebutted: punishing excessively low prices is paradoxical because the very objective of the antitrust laws is to secure low prices for consumers. As more and more cases of alleged predatory pricing are filed and new theories of liability based on price discounting gain popularity, the risk grows that predatory pricing law will result in higher prices to consumers—the very antithesis of what antitrust law is supposed to achieve.

WHY ALL OF THE PREDATION CLAIMS?

As noted, the Supreme Court has made it very difficult for plaintiffs to win predatory pricing claims. Yet hundreds of such claims have been filed since the restrictive Supreme

Court decisions. Why would plaintiffs spend the significant time and money it takes to file predatory pricing claims if such claims are usually futile? A substantial part of the answer is that predatory pricing plaintiffs can "win without winning" if the mere fact of the lawsuit coerces the defendant to soften its price competition.

The predatory pricing cause of action is a most suggestive tool for an inefficient firm to forestall price cuts by a more efficient rival. For several reasons, a plaintiff can strategically misuse a predatory pricing lawsuit to force price increases by the defendant even if the lawsuit has very little chance of succeeding on the merits.

For instance, the plaintiff can raise the defendant's costs just by initiating expensive litigation. Defending against a predatory pricing lawsuit is often an extremely costly proposition. Frank Easterbrook once reported that, during the 1980s, AT&T spent $100 million per year just to defend against predation claims. It is not uncommon for a single predation lawsuit to cost the defendant tens of millions of dollars to litigate.

Of course, the litigation will cost the plaintiff something as well, but it will almost always be much more expensive for the defendant. The plaintiff may be able to hire lawyers on contingency, whereas the defendant must pay its lawyers on an hourly basis. The defendant will often be required to produce more documents to the plaintiff than vice versa because the focus of the lawsuit will be on the defendant's pricing practices. Defendants will feel compelled to hire the most expensive lawyers and invest heavily in the defense of even an unmeritorious case because the effects of an adverse treble damages award on the defendant's stock price would be disastrous. Plaintiffs, by contrast, face few such pressures.

In addition to raising rivals' costs through litigation expenses, inefficient firms can use the threat of predatory pricing litigation to coerce price increases from competitors because the expected cost to the defendant of an adverse judgment is so large. Although plaintiffs rarely win predatory pricing judgments, when they do, the numbers are often staggering.

To illustrate, MCI won a jury verdict against AT&T that, with trebling, would have amounted to a $1.8 billion judgment in 1980 dollars. In 2003, Kinetic Concepts won a jury verdict against Hillenbrand Industries in a case that involved predatory pricing claims. The jury awarded $173.6 million in damages, which would have been automatically trebled to $520.8 million pursuant to the Clayton Act. To put that in perspective, Hillenbrand's net income in the year preceding the judgment was $153 million—less than a third of the amount of the judgment. Largely from the $250 million settlement resulting from the judgment, Hillenbrand's net income fell to $44 million the following year.

Further, prevailing plaintiffs are automatically entitled to recover their attorney fees from the defendant, which can add tens of millions of dollars to the price tag of an adverse judgment. (There is no similar provision for defendants to recover attorney fees from unsuccessful plaintiffs).

It is not hard to see that the threat of a predatory pricing lawsuit could cause a firm to forgo a perfectly innocent price-cut. Litigation is an inherently unpredictable activity and there is always a chance that the lawsuit will survive summary judg-

MORGAN BALLARD

ment and the jury will award an erroneous verdict. Suppose that the chance that a frivolous predation claim will succeed on the merits is 10 percent, that the defendant firm would have to incur $50 million to litigate it, and that an adverse judgment (including trebling and attorney fees) would amount to $500 million. From the *ex ante* perspective, the expected cost of the price-cut is $100 million (the expected cost of an adverse judgment is $50 million and it will cost $50 million to defend the lawsuit regardless of the outcome). If the expected profit increase from the price cut is less than $100 million, the firm would forgo it and stick with higher prices. By threatening predatory pricing litigation, a less efficient firm may be able to prevent price cuts by a more efficient rival.

DAVID V. GOLIATH

Even in a world in which the rate of error in adjudication was low, firms might sometimes decide to forgo price cuts because the cost of even an improbable finding of liability was so high. The chilling effects of predatory pricing law are compounded by the fact that the error rate is probably not only high but directionally tilted toward false-positive errors.

The chief cause of this directional bias is the fact that juries are the ultimate fact-finders in any case that makes it to trial. It would be surprising to find that jurors actually understand the substance of predatory pricing law when the very definition of predation and its elements have long been, and continue to be, debated by the brightest economic and legal minds.

A study by Case Western law professor Arthur Austin is telling. Austin interviewed jurors in four antitrust trials, including *Brooke Group v. Brown & Williamson*, the latest predatory pricing case decided by the Supreme Court. Austin's interviews revealed that "the jurors were overwhelmed, frustrated, and confused by testimony well beyond their comprehension.... [A]t no time did any juror grasp—even at the margins—the law, the economics, or any other testimony related to the allegations or defense." Austin reports,

> At no time have I encountered a juror who had the foggiest notion of what oligopoly, market power, or average variable cost meant, much less how they applied to the case.... Typical is the response I received when I asked a juror whether he remembered average variable cost. The juror replied, "Yes, explain it to me. I still don't know what it means."

Mind you, the jury found that Brown & Williamson engaged in predatory pricing, which required a finding that it had priced below average variable cost. If the jury did not understand the legal test, on what basis did it award a $148.8 judgment against Brown & Williamson? Based on his study of the *Brooke Group* jury, Austin concluded that its verdict for Liggett was based upon populist sentiments inflamed by "smoking gun" documents from Brown & Williamson's files "in which B&W executives made comments like 'bury them' and 'put a lid on Liggett.'"

If jurors are unable to understand the legal-economic requirements of predatory pricing law, then they are largely left with a morality play between a dominant firm, often with superior resources and files full of "smoking gun" documents that Judge Richard Posner calls "compelling evidence of predatory intent to the naïve," and a smaller, often younger firm that has been damaged by the dominant firm's behavior. Although the "damage" may have resulted from socially beneficial price competition or the new entrant's comparative inefficiency, all the jurors may understand or care about is that the defendant was a large corporation that damaged a smaller corporation through a series of tactical price cuts. In the jury box, it is *David v. Goliath*.

This systematic jury bias against price-cutting by dominant firms contributes to the chilling effect on price competition of predatory pricing law. A firm considering a price cut in the face of a rival's litigation threat must take into account not just the possibility of expensive litigation, but the prospect of facing a jury that may not understand the relevant law or the economics, but will decide the case nonetheless.

TACIT COLLUSION

The strategic misuse of predatory pricing law is not limited to inefficient firms seeking to create a protective pricing floor. Efficient firms can partake of the opportunity afforded by predatory pricing law to sustain higher prices in the market. In particular, rent-seeking sellers can use claims of predatory pricing to facilitate tacit collusion schemes in concentrated markets.

To see how this can happen, imagine a seller operating in an oligopoly with four dominant firms. Suppose that the market is characterized by fungible goods and high barriers to entry. Sellers in such a market will often be able to price above competitive levels, but achieving the maximum price requires some coordination, tacit or explicit, among the firms. From the perspective of the oligopolists, the ideal solution would be an explicit agreement on prices and output, and elaborate policing mechanisms to ensure compliance. That, of course, is illegal, so sellers in such markets often try to coordinate prices in less explicit ways using tools such as information exchange programs and subtle policing mechanisms to ensure compliance with the tacit agreement. Antitrust cases have condemned such cooperation as unlawful price-fixing, even though the firms never explicitly agreed on price.

Now imagine how a predatory pricing lawsuit could be used to help organize the tacit collusion scheme in a legally privileged way. The plaintiff firm, unhappy with price cuts by a rival, files a complaint detailing exactly what is wrong with the defendant's price cuts and what reasonable prices would be. Then follows a prolonged period of discovery—often years—in which the parties exchange reams of sensitive competitive documents and senior executives testify about their pricing strategies, business plans, productive capacity, costs, and many more pieces of business information that will come very handy to both sides when considering future pricing and output decisions. While discovery and trial takes place, a judge will be closely scrutinizing the parties' pricing behavior and perhaps even enjoining the defendant from lowering its prices during the pendency of the lawsuit. Several judges have issued injunctions against defendants, prohibiting them from lowering their prices until a final adjudication of the case. So there we have several ingredients of a successful tacit collusion scheme: price signaling, information exchange, policing mechanisms, and

even sanctions for deviating from supracompetitive prices.

PIE IN THE SKIES Do firms actually use predatory pricing lawsuits to raise each other's costs or facilitate tacit collusion schemes? It is hard to answer that question categorically because antitrust litigation tends to be quite complex and a plaintiff's motivations are rarely reducible to a single category. It is not difficult, however, to find examples of predatory pricing lawsuits that were rejected on the merits and yet apparently contributed to higher prices.

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Consider the airline industry. Since deregulation in 1978, the airline industry has seen several high-profile charges of oligopolistic collusion. A well-known episode of attempted price-fixing involved a 1982 price-war between American Airlines and Braniff in which the Justice Department obtained a tape recording of a conversation between Robert Crandall, CEO of American, and Howard Putnam, CEO of Braniff, in which Crandall encouraged Putnam to raise prices by 20 percent. In 1992, the Justice Department sued American, Continental, Northwest, TWA, United, and USAir, alleging that they had engaged in price signaling by disseminating future price information in a variety of ways. The case ended in a consent decree in which the airlines agreed to cease a number of the challenged practices. In 2004, the Justice Department filed a show cause petition alleging that American had violated the consent decree by publishing future first travel dates, apparently in order to signal price increases to competitors.

During the same period that the airline industry has ostensibly been a hotbed of oligopolistic cooperation to price at supracompetitive levels, different airlines have allegedly been engaged in predatory pricing. American has faced predatory pricing claims by Continental and Northwest in 1992 and the Justice Department in 1999. Virgin Atlantic sued British Airways on what amounted to predatory pricing charges in 1993. Other post-deregulation predation suits include Laker against Sabena and KLM in 1983 and Laker against PanAm in 1985. Further, several low-cost carriers have reportedly complained to the Department of Transportation about predatory pricing by larger airlines, including ValuJet against Delta, Frontier against United, and Reno Air against Northwest.

What is interesting about the airline cases is that at least one of the alleged dates of predatory pricing corresponded with periods in which the predator and prey were supposedly engaged in oligopolistic collusion. The government's 1992 price signaling case against American, Continental, and Northwest (and others) concerned the same time period as American's alleged predatory pricing campaign against Continental and Northwest. For both of those allegations to be true, American would have to be predating against Contintental and Northwest at the same time as it was colluding with them. Although a predatory pricing campaign to discipline rivals into collusion may be plausible, the Justice Department charged that American, Continental, and Northwest were already colluding at the time that Continental and Northwest alleged that American launched its new, allegedly predatory, pricing scheme. American cannot have been both predating against, and colluding with, the same competitors at the same moment because predation involves pricing below cost and collusion involves pricing at supracompetitive levels.

It is possible that one or both of the claims were mistaken—indeed, the jury found that American was not predating. It is also possible that the allegations of collusion were correct and that the predatory pricing case itself reinforced a tacit collusive scheme. Northwest and Continental may have facilitated a resumption of consciously parallel, lockstep pricing by using the predatory pricing lawsuit as a price signal and information exchange device, combined with a punitive raising of American's costs through expensive litigation.

If so, the strategy seems to have worked. American announced the challenged pricing plan on April 9, 1992, and other major carriers quickly matched or beat American's price cut. Between April and June, fares remained relatively flat. Then Continental filed its predatory pricing lawsuit in early June of 1992 and Northwest filed its parallel suit a few days later. A few days after filing suit, Northwest announced a 10 percent price increase. American and Continental soon followed with price increases of their own. Between July and the end of the year, while the predatory pricing case progressed, the major airlines reportedly raised prices seven times, albeit with many false starts, retreats, and delays as the oligopolistic discipline frayed by American's April price cuts was restored. In December, while announcing another round of price increases, Continental reported publicly that its "objective is to get back to the fare levels that prevailed in early April, which are fair, market-based competitive fares." Such overt price-signaling through media comments frequently accompanied the upward pricing movements following the filing of the predatory pricing suits. A headline about the September fare increases in *Tour and Travel News* reported (apparently without conscious irony), "Airlines Agree on Fare-Increase Date."

There is little doubt that the airline fare war that began with American's price cuts in April ended within weeks after North-

west and Continental filed their predatory pricing suits. How significant a role the predatory pricing suit played in deterring aggressive price competition and restoring lockstep price increases is uncertain. The predatory pricing lawsuit was not the only strategic tool available or utilized by competitor airlines. The competitors also took their complaint to the Senate Transportation Committee and engaged in unabashed price signaling through the media. The predatory pricing lawsuit, however, may have offered a unique combination of coercive opportunities to complement other strategic tools, including raising a rival's costs through litigation expense, the threat of a substantial adverse judgment, and detailed information exchange in discovery.

And the predatory pricing case may have taught American a lesson. After the jury returned a verdict for American in the predatory pricing case in the summer of 1993, American CEO Robert Crandall—the same CEO caught on tape encouraging Braniff to raise its prices—stated publicly that American "probably won't be attempting that type of leadership again."

MULTIPRODUCT DISCOUNTING: THE NEXT FRONTIER

Just as conventional predatory pricing theories are being rehabilitated, a new theory of anticompetitive exclusion through price discounting is becoming popular in antitrust circles. A number of recent lawsuits and academic papers have explored the possibility that a diversified firm could offer customers discounts contingent upon the purchase of goods in multiple markets and thereby exclude a single-product firm that sold only one of the products covered by the package discount.

The case that defines this theory for the moment is *LePage's v. 3M*. 3M is a diversified manufacturer of various household and industrial products. LePage's competes with 3M for sales of private-label transparent tape—a generic equivalent of 3M's well-known Scotch tape brand. In 1995, 3M began a rebate program called the Partnership Growth Fund (PFG) that incentivized 3M's customers, large retailers like Staples, Wal-Mart, and Target, to purchase minimum quantities from six 3M divisions. In order to receive the maximum 2 percent rebate, a customer needed to increase its overall purchases from 3M as well as its purchases in a minimum number of specified product categories.

LePage's alleged that, as a result of the 3M program, it lost private-label transparent tape sales (even though it still had a 67 percent market share in the private-label side of the transparent tape market) and was in danger of being forced out of business. In 2002, a Philadelphia jury found that 3M had used the program unlawfully to maintain a monopoly in the transparent tape market, and awarded LePage's $22,828,899 in damages (before trebling).

In an initial three-judge decision in 2002, the U.S. Court of Appeals for the Third Circuit reversed, finding that LePage's had not shown that 3M's bundled rebates were anticompetitive. Among other things, the two-judge majority noted that LePage's had not shown that it would have had to price below cost in order to compensate customers for the 3M rebates they would lose if they purchased private label transparent tape from LePage's instead of 3M.

The original panel's way of assessing the bundled discount program was quite reasonable. Under ordinary predatory pricing rules, the plaintiff must show that the defendant priced below its cost in order to establish liability. If the plaintiff is as efficient as the defendant, then if the defendant prices above cost, the plaintiff cannot be driven out of business because the plaintiff could profitably match the defendant's prices. The same logic should follow in a case involving discounts spread across multiple product lines.

Suppose that, for litigation purposes, the following exercise was undertaken: Calculate the total discounts that a customer would forgo from the defendant on all product lines if it bought from the plaintiff. Reallocate those discounts to the single market in which the plaintiff operates. Finally, inquire whether, after deducting all of the forgone discounts, the effective price in the competitive market was below cost. If the answer is no—if the effective price in the competitive market was still above cost— then there is no reason to impose liability for the bundled discount any more than there would be to impose liability for an above-cost price cut in a single market. An equally efficient competitor should still be able to compete.

Regrettably, in a 2003 *en banc* decision, the full Third Circuit saw it differently. In a 7–3 decision, the court affirmed the jury verdict. Critically, the court found it irrelevant that the exercise described in the preceding paragraph had been undertaken and it was shown that 3M had not priced below cost even if all of the discounts on other product lines were reallocated to the transparent tape market. According to the court, multiproduct bundling is completely different from single-market predatory pricing and the cost/revenue comparisons required in predatory pricing cases are not required in cases involving discounts across multiple markets.

So what is the standard of illegality for bundled discounts? In the Third Circuit, at least, the answer is completely murky. As the Solicitor General pointed out in an *amicus curiae* Supreme Court brief, "the court of appeals failed to explain precisely why the evidence supported a jury verdict of liability in this case, including what precisely rendered 3M's conduct unlawful."

The *LePage's* decision has caused well-founded alarm in the business community. Bundled discounting—what economists call mixed bundling—is ubiquitous and generally beneficial to consumers. If liability can be imposed on dominant firms that offer bundled discounts without any clear rules for when such discounts will be found exclusionary, sellers will need to be concerned about potential exposure from offering such discounts.

Not surprisingly, given the allure of treble damages awards, *LePage's* has created a cottage industry of lawsuits in the Third Circuit involving claims of bundled discounts, including AMD's heavily publicized monopolization lawsuit against Intel and Broadcom's lawsuit against Qualcomm. A number of other mixed bundling cases, some of which predate the *LePage's* decision, are pending. Bundled discounting, it is fair to say, is under heavy attack as a commercial practice.

So not only is single-market predatory pricing being revitalized as an antitrust theory, but new theories of ill-defined liability are being opened for price discounting. And, just as with single-market predation claims, there is evidence that at least some of the recent bundled discounting claims are strategic

efforts to prevent aggressive price competition by larger rivals. Tellingly, in virtually none of the recent bundled discounting cases was the plaintiff actually excluded from the market. Many of the plaintiffs had very significant market shares in the relevant markets or had experienced growth and profitability despite the existence of the bundled discount program. Unfortunately, the symptoms of strategic misuse of antitrust law to prevent price-discounting are spreading to new frontiers.

RESOLVING THE PARADOX

Over 25 years ago, Frank Easterbrook advocated abolishing the right of action for predatory pricing on the view that, even if predatory pricing sometimes occurs, allowing the legal claim to be asserted does more harm than good. Time has vindicated Easterbrook's claim, yet predatory pricing remains as popular—and strategically misused—a theory as ever. What can be done about this?

Apart from simply disallowing any claim based on excessively low prices, a number of steps could be taken to minimize the abuse of predatory pricing law. One step would be to eliminate competitor standing to assert such claims. Most predatory pricing claims are brought not by injured consumers, but by competitors. Competitors have unique incentives to misuse predatory pricing law to chill price competition. They want to see higher prices both in the short run and in the long run.

The law tolerates a competitor's complaint that the defendant's prices were too low because of the further allegation that the low prices would eventually lead to higher prices. But the law does not require proof of actual higher prices. In an attempted monopolization through predatory pricing case, it is sufficient to prove that a defendant's low prices created a dangerous probability of subsequent higher prices. Thus, a competitor-plaintiff is often in the position of asserting that a defendant's prices were anticompetitively low merely based on the speculation that, left unchecked, the defendant would have driven the plaintiff from the market and raised its prices—even though that never actually happened.

Giving firms standing to challenge their rivals' prices as too low on the theory that higher prices might eventually emerge is like asking the fox to guard the henhouse. Consumers—the intended beneficiaries of antitrust law—have exactly the opposite incentives as competitors. They prefer sustainably low prices and therefore make far better-intentioned predation enforcers than business rivals of the "predator." If predatory pricing were a frequent and successful enterprise, one would expect to see many class-action lawsuits by overcharged consumers. Such lawsuits are rare, which is probably more a testament to the absence of successful predation schemes than to consumers' deficiencies as enforcers.

If competitors are allowed to continue asserting predatory pricing claims, then two simple changes in the law would help deter strategic misuse. First, attorney fee shifting could become bilateral. If unsuccessful plaintiffs were required to pay defendants' attorney fees, filing unmeritorious predatory pricing lawsuits in order to coerce the defendant to raise its prices would become significantly less attractive.

Second, treble damages could be disallowed in predatory pricing cases. The economic rationale for treble damages in antitrust cases is that because many antitrust violations will go undetected, the magnitude of the penalty must be increased in order to deter violations. While that rationale may be sensible with respect to price-fixing cartels, it has no application to predatory pricing. Low prices are easy to spot. Indeed, most of the recent theories that have attempted to rehabilitate the status of predatory pricing as a serious threat have relied on reputational effects from prior acts of predation to discourage new entry in the future. If predatory pricing is supposedly effective because everyone knows that it is not worth entering a price war with the predator, there is little reason to allow treble damages on the theory that the predation might go undetected. Detrebling damages in predatory pricing cases would eliminate some of the potency of predatory pricing claims as means to chill price competition.

CONCLUSION

Frank Easterbrook once remarked that the reason that there are so many theories about what predatory pricing schemes look like is much the same as the reason there were once so many theories about what dragons look like. One need not believe, with Easterbrook, that predatory pricing never occurs to believe that legal efforts to stop predation often do more harm than good.

To be sure, there are market failures that allow firms to obtain monopoly power through undesirable means. But there are also legal failures that allow firms to abuse well-intentioned liability rules to stymie the very competitive forces the rules were intended to support. Much of one's view about the appropriateness of penalties for excessively low prices depends on whether one believes that market failures or legal failures will generally be more harmful. The history of predatory pricing law suggests that, when it comes to price discounts, legal failures have done far more harm than market failures. R

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