94-6190

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

UNITED STATES OF AMERICA,

Plaintiff-Appellant,

v.

EASTMAN KODAK CO., a corporation of New Jersey, and EASTMAN KODAK CO., a corporation of New York,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF NEW YORK

REPLY BRIEF FOR THE UNITED STATES

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Over the government's objection, the district court terminated two long-standing antitrust decrees in a large industry important to millions of American consumers. As we showed in our opening brief, the court seriously erred. It misconstrued well-established Supreme Court precedent holding that a judicial decree may not be terminated unless the party seeking relief proves that the purpose of the decree has been fully achieved. It thus failed to perceive the significance of the undisputed proof--based on Kodak's own elasticity of demand--that Kodak's film prices are twice its marginal costs. On this record this proof is a powerful and unrebutted indicator that Kodak still has significant market power. The court also did not accord due significance to its findings that U.S. consumers strongly prefer Kodak film (though it is no better in quality

than rival brands) and that as a result Kodak can charge premium prices here for its film. It is precisely that consumer preference--not shared by foreign consumers--that enables Kodak to exercise power in a U.S. film market, even though such a market might well not exist if U.S. consumers had a different opinion of Kodak film.

Since Kodak still has market power, it is clear that Kodak failed to carry its burden of proof in seeking termination of the decrees. It is also clear that the decrees still serve to protect competition and consumers. The district court's ruling not only wrongly takes away that protection, but it also sends a dangerous message to hundreds of other firms that it is an easy matter to throw off the antitrust decrees that now bind them.

Kodak in its brief ("K. Br.") responds with two basic arguments: a contention that as a matter of law a district court may terminate a consent decree over a party's objection even if the purpose has not been fully achieved (K. Br. 23); and a potpourri of reasons why the district court's findings on Kodak's own elasticity of demand and consumer preferences should be ignored. Id. at 32-36. Kodak is wrong in both respects.

ARGUMENT

1. Kodak Must Show the Decrees' Purposes Have Been Fully Achieved to Secure Termination

The Supreme Court in Board of Education v. Dowell, 498 U.S. 237, 247 (1991), held that a decree should not be terminated "'if the purposes of the litigation as incorporated in the decree . . . have not been fully achieved.'" The language the Court

quoted and made central to its holding came from United States v. United Shoe Machinery, 391 U.S. 244, 248 (1968), which had established the standard for modifying an antitrust consent decree.

Nonetheless, Kodak argues that the district court was free to terminate the decree even if its purposes were not fully achieved, because United Shoe "has been overruled by Rufo [v. Inmates of Suffolk County Jail, 112 S. Ct. 748 (1992)]." K. Br. 23. This contention is plainly wrong.

One will search Rufo in vain for any language that even hints at, let alone states, disapproval of United Shoe. Quite to the contrary, the Court in Rufo cites to United Shoe's reformulation of the Swift standard in terms of full achievement of decree purposes that the Court had relied on just a year earlier in Dowell. Rufo, 112 S. Ct. at 758. Rufo, thus, is also harmonious with Dowell in its reliance on United Shoe. Dowell/United Shoe remains the law, and the district court and Kodak were wrong to think that Rufo in any way changed it.[1]

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[1] Accord Patterson v. Newspaper Deliverers' Union, 13 F.3d 33, 39 (2d Cir. 1993) (decree terminable when it "has served its purpose"); Inmates of Suffolk County Jail v. Rufo, 12 F.3d 286, 293 (1st Cir. 1993) (minimum imaginable standards include showing that violations "have been entirely remedied or remedied to full extent feasible"); United States v. City of Miami, 2 F.3d 1497, 1505 (11th Cir. 1993). See also Vanguards of Cleveland v. City of Cleveland, 23 F.3d 1013, 1020 (6th Cir. 1994) (failure to achieve purposes warrants extending term of decree).

The present case, of course, involves decree termination, and Rufo dealt with decree modification. But the Supreme Court's clear approval in Rufo of the United Shoe standard rebuts Kodak's (continued...)

Thus, the burden in this proceeding was on Kodak to prove that the decrees' purpose was fully achieved. Since the decrees were designed to protect consumers against the dangers of Kodak's market power, Kodak was entitled to termination of the decrees only if it proved that it no longer has significant market power. This it plainly did not do.[2]

2. Kodak Has Failed to Show That It Lacks Significant Market Power in the United States

Two key district court findings, both based on Kodak evidence, undo Kodak's efforts to show that it no longer has significant market power in amateur film.

First, although Kodak film is no better in quality than that of its main rivals (J.A. 48-49, 66, 196; K. Br. 37), U.S. consumers overwhelmingly prefer Kodak: 50% will buy only Kodak film regardless of price; and another 40% prefer

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[1](...continued)
lengthy argument (K. Br. 17-23) that Rufo supersedes United Shoe as to decree modification. Such a contention is particularly out of place in this Circuit where, long before Rufo, the Court in an opinion by Judge Friendly explained that United Shoe states the governing law on decree modification. King-Seeley Thermos Co. v. Aladdin Industries, Inc., 418 F.2d 31, 34-35 (2d Cir. 1969). See also New York State Ass'n for Retarded Children v. Carey, 706 F. 2d 956, 968-69 (2d Cir.), cert. denied, 464 U.S. 915 (1983)(per Friendly, J.).

[2] Kodak briefly argues that the district court nonetheless applied this standard. K. Br. 25. But the court in its discussion of "The Applicable Standard" (J.A. 28-35; 853 F. Supp. 1462-65) obviously and mistakenly believed that Rufo had substantially lightened Kodak's burden of proof. And in applying that standard in the subsequent parts of its opinion, it equally obviously allowed Kodak more lightly to discharge its burden of proof.

Kodak.[3] J.A. 62. Thus, amateur color negative film in the United States is a highly differentiated product, and the powerful consumer preference for Kodak film gives Kodak significant market power. Indeed, no firm can have market power unless consumers sufficiently prefer its product that they are willing to pay significantly more than the marginal cost of producing it. The district court at least once recognized that consumer preference is the source of Kodak's market power, but excused Kodak on the ground that this cannot be "evidence of market power acquired illegally." J.A. 68; 853 F. Supp. at 1477. But the critical issue in this case is whether Kodak still has market power--not how it was acquired. No decision cited by the district court or by Kodak holds that consumer preference cannot give rise to market power.

The district court also found that Kodak has what economists call an own elasticity of demand of two. As the uncontradicted expert economic testimony established, an own elasticity of 2 indicates that Kodak is charging twice its short-run marginal cost. U.S. Br. 19-20. This in turn is strong evidence that Kodak is exercising significant market power, since market power is defined as the ability to price above a competitive level--which level is short-run marginal cost. U.S. Br. 17-20. As we explained in our opening brief, in light of this evidence Kodak

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[3] Kodak objects that this finding is based on consumer surveys (K. Br. 38), but it does not claim that the finding is wrong. Indeed, it could hardly do so, since the district court relied on Kodak surveys. J.A. 319-20.

never came close to carrying its burden of showing that it no longer has significant market power.

In its brief Kodak offers a multiplicity of arguments to avoid the force of the court's finding. It initially argues that this Court should not even consider the matter of own elasticity of demand, saying that unless the Court determines that the district court's earlier and separate finding of a worldwide film market "constitutes an abuse of discretion, there is no need to examine the other issues raised by the government." K. Br. 31. This proposition is wrong as a matter of law. The district court did not agree with it, but instead rightly held that when there are better ways to estimate market power than market share of a defined market, "the court should use them." J.A. 55; 853 F. Supp. at 1472, quoting Ball Memorial Hospital, Inc. v Mutual Hospital Insurance, 784 F.2d 1325, 1336 (7th Cir. 1986).[4] Cf. FTC v. Indiana Federation of Dentists, 476 U.S. 447, 460-61 (1986) (no need to prove market when there is actual proof of detrimental effect on competition in violation of Section 5 of FTC Act). In short, market definition is superfluous when, as here, direct evidence of power over price is available.

Kodak also argues that the Court should not consider the

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[4] Kodak elicited from its own expert the testimony that he did not think that market shares alone were the right way to gauge Kodak's market share, and that there was a "better way." J.A. 360-61. Dr. Hausman continued: "what you need to look at are the demand elasticities . . . . When you look at those, it doesn't depend on exactly what the [market] shares are. It depends on how consumers and how competitors behave." J.A. 361-62.

significance of Kodak's own elasticity of demand because it was not raised below. K. Br. 16, 33, 36. This is plainly wrong. The government's expert economist, Dr. Masson, made precisely the point we now make about the relationship between an own elasticity of two and market power, and he did so at a page cited by Kodak in support of its argument that the point was not made. J.A. 600, cited at K. Br. 33.

Kodak then goes on to argue that our argument is wrong because the formula relating own elasticity of demand with the difference between price and marginal cost applies only in the case of a monopoly.[5] K. Br. 16, 33-34. This is incorrect. The defendant's expert, Dr. Hausman, never made any such claim, nor could he. In an article he recently coauthored, he applies the formula to a firm selling a differentiated product and setting price independently of its rivals. Jerry Hausman, Gregory Leonard, and J. Douglas Zona, "Competitive Analysis with Differenciated Products," 34 Annales d'Economie et de Statistique 159, 173 (1994). That is the relevant model in this case, as Kodak sells film that is objectively very similar to that of its rivals but that is differentiated from that of its rivals as

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[5] Our opening brief cited three authorities for the proposition that an own elasticity of two implies a price twice marginal cost. It is true as Kodak asserts (K. Br. 34) that all three made that statement in the context of a monopoly. They were cited, however, only for the proposition that an own elasticity of two implies a price twice marginal cost. Whether the formula used to make the calculations applies in cases other than that of monopoly is a separate question not directly addressed by these authorities.

indicated by the strong U.S. consumer preference. Needless to say, economists agree with Dr. Hausman and Dr. Masson on this point. As Professor Richard Schmalensee of MIT has written, it applies to a "firm facing a well-defined demand curve and maximizing its short-run profits" independently of rivals. Schmalensee, "Another Look at Market Power," 95 Harv. L. Rev. 1789, 1790 (1982).[6]

Kodak also contends that its high fixed costs undermine the inference of market power ordinarily attributable to prices that are twice marginal costs.[7] Merely by showing that it has substantial fixed costs it claims that it can carry its burden of proof. This is mistaken. To begin with, the district court made no finding about Kodak's fixed costs.[8] This is not surprising,

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[6] As we noted in our opening brief, the formula also applies to a dominant firm (U.S. Br. 19 n.23), which is the case in the Landes-Posner article on which both we and Kodak rely. K. Br. 34-35. William M. Landes & Richard A. Posner, "Market Power in Antitrust Cases," 94 Harv. L. Rev. 937, 958 (1981). Indeed, they assess market power for firms with shares as low as 23%. Landes & Posner, supra, at 958. In economics, their method of analysis is termed the dominant firm-competitive fringe model. Schmalensee, supra, 95 Harv. L. Rev. at 1797.

[7] Fixed costs actually are irrelevant to the determination of market power as that term is conventionally defined--the ability to price above the competitive level, which is short-run marginal cost. As Professors Areeda and Turner explain in their treatise, the proper argument relevant to fixed costs is that even significant market power is not sufficient to trigger antitrust scrutiny if price just covers costs in the long run. 2 Phillip Areeda & Donald Turner, Antitrust Law 338 (1978).

[8] Kodak's reference to the district court's "findings about fixed costs" (K. Br. 45) is unaccompanied by citation, because the district court made no such finding. It made generalized findings about the gross assets of Kodak's competitors (J.A. 51-

(continued...)

since at trial Kodak made no effort to quantify its fixed costs or to demonstrate that they account for all or even most of the difference between its price and marginal cost. This failing is particularly significant, since Kodak could have produced dispositive information on its costs. Kodak suggests that this information would not have been useful, because accounting rates of return are not indicative of monopoly power. But the issue in this case is whether Kodak's cost data are indicative of Kodak's fixed costs. Rates of return were not mentioned until Kodak's brief.[9]

Finally, Kodak mentions two other types of direct evidence on the market power issue, suggesting that they somehow outweigh

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[8](...continued)
52, 70), and in discussing entry it found the necessary capital costs for a new entrant to be hundreds of millions of dollars. J.A. 57. The record is bare, however, regarding Kodak's investment in plant for the production of film, and how many rolls of film can be produced over the life of a plant. Even if Kodak's investment is large, the average cost per roll could be small, particularly given Kodak's output--367 million rolls sold in 1992 in the U.S. alone. J.A. 690.

[9] Kodak in its brief also tries to attribute to the district court the position that Kodak's own elasticity proves that "Kodak cannot profitably raise prices." K. Br. 33. We discern no such position in the district court's opinion. Had it said this, however, it would have made a serious error of law. Our contention is that Kodak is already exercising substantial market power, and whether it could profitably raise its prices further is irrelevant. J.A. 605. More importantly, as the Supreme Court has observed, "the existence of significant substitution in the event of <u>further</u> price increases or even at the <u>current</u> price does not tell us whether the defendant <u>already</u> exercises significant market power." <u>Eastman Kodak Co. v. Image Technical Services, Inc.</u>, 112 S. Ct. 2072, 2084 (1992), <u>quoting</u> Phillip Areeda & Louis Kaplow, <u>Antitrust Analysis</u> ¶ 340(c) (4th ed. 1988) (emphasis in original).

the damaging evidence of own elasticity of demand. Dr. Hausman estimated the cross-elasticity of demand between Kodak film and other brands. K. Br. 9, 32. The district court mentioned this evidence (J.A. 56; 853 F. Supp. at 1473) but did not ascribe any particular significance to it. The court was right not to do so. There is no objective basis for assessing the significance of an estimated cross-elasticity, and neither Kodak nor Dr. Hausman stated otherwise. While courts have often relied on cross elasticities of demand in defining markets, these cross elasticities cannot directly indicate the degree of market power. Kodak also points to the district court's finding that there is an elastic supply of foreign film and its conclusion that this precludes Kodak from exercising market power. K. Br. 9, 26-33, 38, citing J.A. 56; 853 F. Supp. at 1473. This conclusion, however, does not follow as a matter of common sense or law. The court found, after all, that fifty percent of U.S. consumers will never buy foreign film and that forty percent more are reluctant to do so. The fact that foreign firms could increase supplies of film that most U.S. consumers do not want to buy hardly means that they can prevent Kodak from exercising significant market power.[10]

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[10] The overriding importance of product differentiation thus sharply distinguishes the amateur-color-negative-film market from others in which the elasticity of supply for substitutes is a key determinant of market power. Indeed, Landes & Posner--on whom Kodak relies for this point (K. Br. 27-28)--analyze the extreme opposite case of a perfectly homogeneous product. Landes & Posner, supra, 94 Harv. L. Rev. at 965. See also Schmalensee, supra, 95 Harv. L. Rev. at 1797.

3. Kodak Has Failed to Show a World Market

Since the direct evidence of Kodak's current market power is compelling, the Court can reverse without reaching the issue of geographic market. Nonetheless, we wish briefly to address Kodak's erroneous contention that shipments of film by themselves establish the market. K. Br. 27-28. Whatever the general merits of using shipments to define markets, price discrimination makes it possible to exercise market power in only a portion of a market defined on the basis of shipments. United States v. Rockford Memorial Hospital Corp., 717 F. Supp. 1251, 1267 n.12 (N.D. Ill. 1989), aff'd, 898 F.2d 1278 (7th Cir.), cert. denied, 498 U.S. 920 (1990).[11]

Indeed, Kodak does not deny that there is evidence in the record that it engages in price discrimination. Rather, it argues that the evidence was insufficient for various reasons to prove it. K. Br. 29-31. Its argument is that, once it made some showing regarding the relative importance of imports and exports, it was the government's burden to establish that price discrimination made the United States the relevant market. This is an improper allocation of burden of proof. If this were a

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[11] There is authority for the definition of price discrimination markets. Reynolds Metals Co. v. FTC, 309 F.2d 223, 229 (D.C. Cir. 1962)(opinion by Burger, J.); Phillip Areeda & Herbert Hovenkamp, Antitrust Law ¶ 521d (1993 Supp.); U.S. Department of Justice and Federal Trade Commission, 1992 Horizontal Merger Guidelines §§ 1.12, 1.22. Kodak's assertion that "analyzing the market for film under the 1992 U.S. Department of Justice and Federal Trade Commission Guidelines yields a world market" (K. Br. 28) ignores § 1.22 of the Guidelines.

government enforcement action, in which the United States bore the burden of proof, a showing relating solely to imports and exports would not be sufficient (because of the problems of price discrimination and others) to establish either a worldwide market or a U.S. market. Kodak is not entitled to fare any better in this case, where it has the burden of proof, merely by showing significant imports and exports. There was, to be sure, pertinent data that Kodak could have presented that might well have enabled it to carry its burden. It would be a very different case had it shown, for example, that international arbitrage precludes significant price discrimination.[12] But it made no effort to do so.

The only other evidence for a world market cited by Kodak is the elastic supply of foreign film. K. Br. 8, 27. But, as we have already explained, the elastic supply of foreign film cannot overcome the fact that U.S. consumers prefer not to buy it.

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[12] Kodak also could have shown that cost differences justified the international price differences. As Dr. Masson noted, all the available evidence on Kodak's distribution costs is in its possession (J.A. 622), and "the ordinary rule, based on considerations of fairness, does not place the burden upon a litigant of establishing facts peculiarly within the knowledge of his adversary." Campbell v. United States, 365 U.S. 85, 96 (1961). Accord, McCahey v. L.P. Investors, 774 F.2d 543, 550 (2d Cir. 1985).

CONCLUSION

For the reasons stated in this brief and our opening brief, the decision of the district court should be reversed, and the case remanded with instructions to reinstate the 1921 and 1954 decrees.

Respectfully submitted.

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NOVEMBER 1994

CERTIFICATE OF SERVICE

I, Robert J. Wiggers, a member of the bar of this Court, hereby certify that on this 29th day of November, 1994, I caused copies of the foregoing REPLY BRIEF FOR THE UNITED STATES in final form to be served by first class mail upon:

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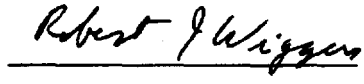

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