THE ENIGMA OF THE SINGLE ENTITY

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INTRODUCTION

The Sherman Act of 1890 allows for the assessment of the competitive

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effects of defendants' activities. Section One of the Sherman Act applies only to agreements between two or more actors. A perplexing aspect of the agreement requirement of Section One is that sometimes two or more actors who are parties to an agreement are classified as one person, a "single entity." Since an agreement requires two or more distinct actors, the single entity fiction precludes finding the required agreement. Therefore, the agreements among actors within an economic unit deemed to be a single entity are invisible for purposes of Section One. Because these agreements within a single entity are deemed not to exist for purposes of Section One, their competitive effects are not assessed. Therefore, the single entity concept controls when the competitive effects of agreements will and will not be subject to Section One scrutiny. This article (1) analyzes the theoretical foundation of the single entity concept and (2) proposes a sequential two-step test for determining when the preclusive effect of the single entity concept is justified.

The first section of this article will examine the structure of the Sherman Act, focusing on the assessment of competitive effects of agreements under Section One. Section II will analyze the efforts of the U.S. Supreme Court to address the limits of the single entity concept. The Court has determined that corporations and their wholly owned subsidiaries are incapable of conspiring for purposes of Section One and that teams forming the National Football League are separate entities unprotected by the single entity concept.

Section III will analyze the impact of two contrasting theories of the firm on the single entity concept. Ronald Coase's groundbreaking 1937 essay, *The Nature of the Firm*, fits neatly with the single entity concept. Coase viewed the firm as consisting of an entrepreneur and his or her employees, and he distinguished activities within the firm from transactions between the firm and other actors. However, the predominant view of the firm for the last several decades has been the "nexus of contracts" concept. The nexus of contracts concept views the firm as a web of explicit and implicit contracts, which includes suppliers of capital, services, and goods together with the purchasers of output. The nexus of contracts approach downplays the distinction between suppliers of services who are employees and suppliers who are not. It also questions whether suppliers of equity capital are "owners" of the firm in any meaningful sense. The nexus of contracts concept rejects the categorical distinction between activity "inside" the Coasean firm and activity "outside" the firm.

Section IV will develop a two-stage test for determining the boundaries of a single entity for the purposes of Section One. The test relies on an analysis of the likelihood of incentives for efficiency. Sharing of net profits creates incentives for efficiency, so parties who share net profits should be part of the single entity. Persons significantly controlled by parties who share net profits should also be included in the single entity. This is because the people who have the incentive to seek efficiency control the people who lack that incentive. Finally, Section V will apply the tests developed in the preceding section to the facts of Supreme Court cases addressing the single entity concept.

I. THE EXISTENCE OF AN AGREEMENT CONTROLS WHETHER THE COMPETITIVE EFFECT OF MOST BEHAVIOR WILL BE ANALYZED

The structure of the Sherman Act prohibits a single inquiry into whether conduct is anticompetitive. The Act is divided into two sections, each of which gives rise to claims with two elements. Section One prohibits all contracts, conspiracies, and combinations which unreasonably restrain trade.[1] The first element of a claim under Section One is the existence of an agreement between two or more actors. Evidence of an express agreement may directly prove an agreement. Express agreements are sometimes contained in written contracts.[2] Express agreements are also contained in rules or bylaws adopted by organizations in order to govern the conduct of their members.[3] Section One cases involving such direct proof of agreements turn on the analysis of whether the uncontroverted agreement is a reasonable one.

However, parties often vigorously contest the existence of an agreement. Courts have struggled with the standard for when conduct of the parties indicates the existence of an agreement.[4] Such conduct can occur both in the context of alleged agreements among competitors[5] and in the context of alleged agreements between buyers and sellers.[6] In resolving

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1. 15 U.S.C. § 1 (2006).

2. *See, e.g.*, Broad. Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1, 2 (1979) (recognizing that agreements can be manifested in the form of blanket license agreements).

3. *See, e.g.*, Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 679 (1978) (holding that a canon of ethics amounts to an agreement among competitors).

4. *Compare* Interstate Circuit, Inc. v. United States, 306 U.S. 208, 226-27 (1939) (stating that knowingly participating in mutually dependent parallel behavior constitutes an agreement), *with* Bell Atl. Corp. v. Twombly, 550 U.S. 544, 553-554 (2007) (determining that interdependent parallel action among telephone companies is not enough, by itself, to constitute an agreement), *and* Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752, 763-66 (1984) (discussing standards for inferring an agreement from communications between manufacturers and distributors), *and* United States v. Colgate & Co., 250 U.S. 300, 306-07 (1919) (holding that a manufacturer's refusals to deal with retailers, who sold its products below a certain price, does not constitute agreements with those retailers).

5. *See, e.g.*, *Interstate Circuit*, 306 U.S. at 214, 221 (alleging an agreement between competitors in the film distribution business); *Twombly*, 550 U.S. at 549, 551 (alleging an agreement between competitors in the telephone service carrier business).

6. *See, e.g.*, *Monsanto*, 465 U.S. at 755-57 (alleging an agreement between a manufacturer of chemical herbicides and the distributers who bought the herbicides); *Colgate*, 250 U.S. at 302 (alleging an agreement between a manufacturer of toiletries and

these cases, courts analyze the reasons that concerted behavior [7] is subject to scrutiny under Section One.

The Supreme Court has noted that:

> The reason Congress treated concerted behavior more strictly than unilateral behavior is readily appreciated. Concerted activity is inherently fraught with anticompetitive risk. It deprives the marketplace of the independent centers of decisionmaking that competition assumes and demands. In any conspiracy, two or more entities that previously pursued their own interests separately combine to act as one for their common benefit. This not only reduces the diverse directions in which economic power is aimed but suddenly increases the economic power moving in one particular direction. Of course, such merging of resources may well lead to efficiencies that benefit consumers, but their anticompetitive potential is sufficient to warrant scrutiny even in the absence of incipient monopoly.[8]

The second element of a claim under Section One of the Sherman Act is that the agreement unreasonably restrain trade.[9] The usual test for determining the legality of an agreement under Section One is called the rule of reason.

The rule of reason is the accepted standard for testing whether a practice restrains trade in violation of § 1:

> Under this rule, the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition. Appropriate factors to take into account include "specific information about the relevant business" and "the restraint's history, nature, and effect." Whether the businesses involved have market power is a further, significant consideration. In its design and function the rule distinguishes between restraints with anticompetitive effect that are harmful to the consumer and restraints stimulating competition that are in the consumer's best

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the wholesale/retail merchants it distributed to).

7. "Concerted behavior" is a conventional shorthand for conduct amounting to an agreement under Section One.

8. Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 768-69 (1984).

9. 15 U.S.C. § 1 (2006). *See also* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 885 (2007) ("Section 1 of the Sherman Act prohibits '[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States.' While § 1 could be interpreted to proscribe all contracts, the Court has never 'taken a literal approach to [its] language.' Rather, the Court has repeated time and again that § 1 'outlaw[s] only unreasonable restraints.'") (quoting 15 U.S.C. § 1; Texaco Inc. v. Dagher, 547 U.S. 1, 5 (2006); State Oil Co. v. Khan, 522 U.S. 3, 10 (1997)).

interest.[10]

Assessing the procompetitive and anticompetitive effects of an agreement under the rule of reason can be burdensome. To limit this burden, courts assess more straightforward agreements without extensive market analysis, under the "quick look" version of the rule of reason.[11]

Some categories of agreements are subject to neither the full-blown nor the quick look version of the rule of reason. Rather, courts deem these agreements illegal *per se*. Agreements subject to *per se* treatment include price fixing agreements by competitors[12] and agreements that allocate markets among competitors.[13] Since the mid-1970s, the Supreme Court has reduced the number of agreements subject to *per se* illegality. It has done this by eliminating *per se* rules or limiting their application.[14] The Court has stated its preference for the rule of reason over *per se* treatment in strong terms:

> Resort to *per se* rules is confined to restraints, like those mentioned, "that would always or almost always tend to restrict competition and decrease output." To justify a *per se* prohibition a restraint must have "manifestly anticompetitive" effects, and

10. *Leegin*, 551 U.S. at 885-86 (citing *Texaco*, 547 U.S. at 5) (quoting Cont'l T. V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 49 (1977); *Khan*, 522 U.S. at 10; *Copperweld*, 467 U.S. at 768; Ill. Tool Works Inc. v. Indep. Ink, Inc., 547 U.S. 28, 45-46 (2006)).

11. *See, e.g.*, Fed. Trade Comm'n v. Ind. Fed'n of Dentists, 476 U.S. 447, 460-61 (1986) (explaining that a lack of elaborate market analysis does not invalidate a finding of a violation of the rule of reason); Nat'l Collegiate Athletic Ass'n v. Bd. of Regents of the Univ. of Okla., 468 U.S. 85, 109, 110 n.39 (1984) (noting that the rule of reason may be applied in the "twinkling of an eye" when anticompetitive effects are obvious); Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 692 (1978) (noting that some agreements are so plainly anticompetitive that an elaborate analysis is not needed). *But see* Cal. Dental Ass'n v. Fed. Trade Comm'n, 526 U.S. 756, 759 (1999) (holding that a quick look analysis is improper where the anticompetitive effects of a given restraint are not intuitively obvious).

12. *See* United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 223 (1940) ("Under the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal *per se*.").

13. *See* United States v. Topco Assocs., Inc., 405 U.S. 596, 608 (1972) ("One of the classic examples of a *per se* violation of § 1 is an agreement between competitors at the same level of the market structure to allocate territories in order to minimize competition.").

14. *See, e.g.*, *Leegin*, 551 U.S. at 893-94 (establishing that *per se* illegality is unwarranted for vertical agreements to fix minimum resale prices because both precompetitive and anticompetitive are possible); *Khan*, 522 U.S. at 18 (concluding that the economic justification for *per se* invalidation of vertical maximum price fixing is insufficient); *GTE Sylvania*, 433 U.S. at 57 (overturning *per se* treatment for vertical non-price restraints); Broad. Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1, 19 n.33 (1979) (limiting application of *per se* treatment only to those alleged restraints with which the court has considerable experience).

> "lack . . . any redeeming virtue[.]"
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> As a consequence, the *per se* rule is appropriate only after courts have had considerable experience with the type of restraint at issue, and only if courts can predict with confidence that it would be invalidated in all or almost all instances under the rule of reason[.] It should come as no surprise, then, that "we have expressed reluctance to adopt *per se* rules with regard to restraints imposed in the context of business relationships where the economic impact of certain practices is not immediately obvious." And, as we have stated, a "departure from the rule-of-reason standard must be based upon demonstrable economic effect rather than . . . upon formalistic line drawing."[15]

The preference for rule of reason treatment over *per se* rules on the question of reasonableness is conceptually related to whether an agreement exists at all. When a court finds an agreement *per se* illegal, it does not reach the question of whether that agreement is reasonable. The Supreme Court's hesitance to cut off an inquiry into the facts regarding the competitive effect of an agreement is understandable. A court will also forego a factual inquiry into the anticompetitive effects of conduct if it determines that an agreement does not exist. As with a *per se* illegality finding, if courts find that no agreement exists under Section One, the reasonableness question is never reached. It would be understandable if courts would be hesitant to cut off an inquiry into the competitive effects of conduct by concluding that an agreement is lacking.

Section Two of the Sherman Act prohibits monopolization and attempted monopolization.[16] A monopolization claim under Section Two has two elements. First, the defendant must have monopoly power. Second, the defendant must have acquired or maintained that power by means that are deemed unlawful under Section Two.[17] While an agreement

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15. *Leegin*, 551 U.S. at 886-887 (quoting Bus. Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717, 723 (1988); Nw. Wholesale Stationers, Inc. v. Pac. Stationery & Printing Co., 472 U.S. 284, 289 (1985); *GTE Sylvania*, 433 U.S. at 50, 58-59; *Khan*, 522 U.S. at 10) (citing Arizona v. Maricopa Cnty. Med. Soc'y, 457 U.S. 332, 344 (1982); *Broad. Music, Inc.*, 441 U.S. at 9; White Motor Co. v. United States, 372 U.S. 253, 263 (1963)). The strength of the Court's preference for the rule of reason over *per se* rules is emphasized by the fact that this quotation comes from a case in which the Court overturned a *per se* rule that had been in existence for almost a century.

16. 15 U.S.C. § 2 (2006). Section Two also prohibits conspiracies to monopolize. *Id.* Such conspiracies to monopolize would also be prohibited as conspiracies in unreasonable restraint of trade under Section One.

17. *See, e.g.*, Pac. Bell Tel. Co. v. Linkline Commc'ns., Inc., 555 U.S. 438, 448 (2009) (stating that the acquisition of monopoly power must have been willful, and not simply a consequence of natural business growth or development, to be a Section Two violation). A claim for attempted monopolization under Section Two generally requires that (1) the defendant be dangerously close to the acquisition of monopoly power, (2) that the defendant engage in conduct condemned under Section Two, and (3) that the defendant have the

between two or more parties is required for a claim under Section One, unilateral conduct is actionable under Section Two. Thus, the structure of the Sherman Act prevents an inquiry into whether conduct is anticompetitive, unless that conduct is either the product of an agreement or is undertaken by a defendant who either has or is dangerously close to acquiring monopoly power. Unilateral conduct undertaken by a defendant, who neither has nor is close to acquiring monopoly power, is legal under the Act without regard to whether that conduct is procompetitive or anticompetitive.

Since relatively few firms have monopoly power or are dangerously close to acquiring it, the agreement question under Section One controls whether courts can assess the competitive effects of business behavior in the vast majority of situations. If an agreement is present, courts typically apply the rule of reason to determine whether challenged behavior is net procompetitive or anticompetitive. In relatively few settings, courts will apply *per se* rules to condemn agreements. If an agreement is not present, a court cannot assess the competitive effects of the challenged behavior under Section One. The presence of an agreement is a threshold that must be crossed before the competitive effects of business behavior can be analyzed under Section One.

A perplexing question arises in the application of the agreement requirement that goes to the heart of the two-section division of the Sherman Act. Are there instances in which the concerted conduct of two or more parties should be deemed that of a single actor and thus shielded from scrutiny under Section One? The behavior could potentially be examined under Section Two, but only if the defendant had or was close to having monopoly power. The law unequivocally allows the fiction of a single entity to shield multiple actors within a firm under Section One. No matter how many shareholders, directors, and employees a single firm has, The Sherman Act treats them as a single person. Their meetings, memoranda, emails, and conversations about the firm's business are deemed unilateral actions automatically lawful under Section One. This conclusion is a legal fiction. Owners, managers, and employees of a firm are distinct natural persons. If they agree together to sell illegal drugs or commit a murder, they are guilty of criminal conspiracy. However, the policy of the Sherman Act protects the competitive consequences of their conduct within the firm from assessment under Section One. This article analyzes the rationale of this rule.

specific intent to monopolize. Spectrum Sports, Inc. v. McQuillan, 506 U.S 447, 456 (1993).

II. THE SUPREME COURT AND THE FICTION OF THE SINGLE ENTITY

The Supreme Court has addressed the single entity fiction in two cases. In one of these cases, the Court concluded that single entity treatment was appropriate, over a vigorous dissent by Justice Stevens. In the other, the Court reached the opposite conclusion in a unanimous decision authored by Justice Stevens.

A. Wholly Owned Subsidiaries Are Part of the Parent Corporation

In *Copperweld Corp. v. Independence Tube Corp.*, a new entrant to a market sued several defendants for conspiring to impede its entry.[18] The defendants included a parent corporation, its wholly owned subsidiary, and a potential supplier to the plaintiff. The jury determined that the potential supplier had not joined the conspiracy.[19] This left the parent corporation and its wholly owned subsidiary as the only two potential participants in the conspiracy. The jury had been instructed that a parent corporation and its wholly owned subsidiary were sometimes capable of conspiring under Section One of the Sherman Act, and the jury concluded that such a conspiracy existed.[20] Thus, the question before the Court on appeal was whether a parent corporation and its wholly owned subsidiary could conspire under Section One.

In an opinion by Chief Justice Burger, the Court acknowledged that earlier rulings indicated that parent corporations and wholly owned subsidiaries were capable of conspiring under Section One. Chief Justice Burger reasoned that this "problem"[21] began with *United States v. Yellow Cab Co.*[22] *Yellow Cab* involved an alleged conspiracy among an individual and several corporations he controlled. The case contains broad language suggesting that the corporate affiliations of alleged conspirators are irrelevant to the question of whether a conspiracy exists.[23] The *Copperweld*

18. Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 755-57 (1984).
19. *Id.* at 757-58.
20. *Id*. at 757-58, 759 n.2.
21. *Id*. at 760.
22. United States v. Yellow Cab Co., 332 U.S. 218 (1947).
23. *See id.* at 227-228 ("The test of illegality under the Act is the presence or absence of an unreasonable restraint on interstate commerce. Such a restraint may result as readily from a conspiracy among those who are affiliated or integrated under common ownership as from a conspiracy among those who are otherwise independent. Similarly, any affiliation or integration flowing from an illegal conspiracy cannot insulate the conspirators from the sanctions which Congress has imposed. The corporate interrelationships of the conspirators, in other words, are not determinative of the applicability of the Sherman Act. That statute is aimed at substance rather than form.

And so in this case, the common ownership and control of the various corporate appellees are impotent to liberate the alleged combination and conspiracy from the impact

Court acknowledged *Yellow Cab*'s suggestion, but found that corporate affiliation was only irrelevant when considering the original acquisition of a corporation, not its subsequent operation:

> It has long been clear that a pattern of acquisitions may itself create a combination illegal under § 1, especially when an original anticompetitive purpose is evident from the affiliated corporations' subsequent conduct. The Yellow Cab passage is most fairly read in light of this settled rule. In Yellow Cab, the affiliation of the defendants was irrelevant because the original acquisitions were themselves illegal.24

The Court in *Copperweld* found that subsequent cases expanded *Yellow Cab*'s holding, thereby supporting the broader proposition that parent corporations and their wholly owned subsidiaries were capable of conspiring under Section One beyond the potentially illegal original acquisition:

> The ambiguity of the Yellow Cab holding yielded the one case giving support to the intra-enterprise conspiracy doctrine. In Kiefer–Stewart Co. v. Joseph E. Seagram & Sons, Inc., the Court held that two wholly owned subsidiaries of a liquor distiller were guilty under § 1 of the Sherman Act for jointly refusing to supply a wholesaler who declined to abide by a maximum resale pricing scheme. The Court offhandedly dismissed the defendants' argument that "their status as 'mere instrumentalities of a single manufacturing-merchandizing unit' makes it impossible for them to have conspired in a manner forbidden by the Sherman Act." With only a citation to Yellow Cab and no further analysis, the Court stated that the "suggestion runs counter to our past decisions that common ownership and control does not liberate corporations from the impact of the antitrust laws" and stated that this rule was "especially applicable" when defendants "hold themselves out as competitors."
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> Unlike the Yellow Cab passage, this language does not pertain to corporations whose initial affiliation was itself unlawful.[25]

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of the Act. The complaint charges that the restraint of interstate trade was not only effected by the combination of the appellees but was the primary object of the combination. The theory of the complaint, to borrow language from United States v. Reading Co., 253 U.S. 26, 57, is that 'dominating power' over the cab operating companies 'was not obtained by normal expansion to meet the demands of a business growing as a result of superior and enterprising management, but by deliberate, calculated purchase for control.' If that theory is borne out in this case by the evidence, coupled with proof of an undue restraint of interstate trade, a plain violation of the Act has occurred.") (internal citation omitted)).

24. *Copperweld*, 467 U.S. at 761 (internal footnote omitted).

25. *Id.* at 763-764 (internal footnote and citation omitted).

However, the Court concluded that *Yellow Cab*, *Kiefer-Stewart*, and other cases involving alleged conspiracies among affiliated corporations[26] did not prevent reconsideration of the issue: "In short, while this Court has previously seemed to acquiesce in the intra-enterprise conspiracy doctrine, it has never explored or analyzed in detail the justifications for such a rule; the doctrine has played only a relatively minor role in the Court's Sherman Act holdings."[27]

The Court began reconsidering whether parent corporations and their wholly owned subsidiaries were capable of conspiring under Section One by describing the difference between the two sections of the Sherman Act. "The Sherman Act contains a 'basic distinction between concerted and independent action.' The conduct of a single firm is governed by § 2 alone and is unlawful only when it threatens actual monopolization."[28] The Court explained that limited coverage of unilateral conduct under the Act was motivated by a concern over false positives; in other words, courts would erroneously proscribe procompetitive conduct:

> In part because it is sometimes difficult to distinguish robust competition from conduct with long-run anticompetitive effects, Congress authorized Sherman Act scrutiny of single firms only when they pose a danger of monopolization. Judging unilateral conduct in this manner reduces the risk that the antitrust laws will dampen the competitive zeal of a single aggressive entrepreneur.[29]

The Court explained its stricter assessment of concerted behavior in a well-known passage setting forth the reasons concerted behavior raises competitive concerns:

> The reason Congress treated concerted behavior more strictly than unilateral behavior is readily appreciated. Concerted activity inherently is fraught with anticompetitive risk. It deprives the marketplace of the independent centers of decisionmaking that competition assumes and demands. In any conspiracy, two or more entities that previously pursued their own interests separately are combining to act as one for their common benefit. This not only reduces the diverse directions in

26. *See, e.g.*, Timken Roller Bearing Co. v. United States, 341 U.S. 593, 597-98 (1951) (holding that agreements providing for an aggregation of trade restraints are illegal under the Act and the fact that the agreement was created pursuant to a joint venture will not save it); Perma Life Mufflers, Inc. v. Int'l Parts Corp., 392 U.S. 134, 141-42 (1968) (holding that even common ownership cannot save the parties from the legal obligations imposed on separate entities).

27. *Copperweld*, 467 U.S. at 766.

28. *Id.* at 767 (citing Monsanto Co. v. Spray-Rite Serv. Corp., 465 U.S. 752, 761 (1984)) (internal footnote omitted).

29. *Id.* at 767-68.

> which economic power is aimed but suddenly increases the economic power moving in one particular direction. Of course, such mergings of resources may well lead to efficiencies that benefit consumers, but their anticompetitive potential is sufficient to warrant scrutiny even in the absence of incipient monopoly.[30]

The Court went on to address whether officers and employees of a corporation represent separate actors. The Court reasoned that the language of Section One does not foreclose treating officers and employees of a single firm as actors capable of conspiracy. But the Court found that such a reading was not supported by the policy underlying the Sherman Act:

> Nothing in the literal meaning of [Section One] excludes coordinated conduct among officers or employees of the *same* company. But it is perfectly plain that an internal "agreement" to implement a single, unitary firm's policies does not raise the antitrust dangers that § 1 was designed to police. The officers of a single firm are not separate economic actors pursuing separate economic interests, so agreements among them do not suddenly bring together economic power that was previously pursuing divergent goals.[31]

Under this view, officers and employees of a single firm are not capable of conspiring because they are pursing the interests of the firm rather than their own interests. The Court went on to explain that a corporation that groups its officers and employees into unincorporated divisions does nothing to alter this result.[32]

The Court then addressed whether it should treat wholly owned subsidiaries differently. The Court concluded that it would not:

> A parent and its wholly owned subsidiary have a complete unity of interest. Their objectives are common, not disparate; their general corporate actions are guided or determined not by two separate corporate consciousnesses, but one. They are not unlike a multiple team of horses drawing a vehicle under the control of a single driver. With or without a formal "agreement," the subsidiary acts for the benefit of the parent, its sole shareholder. If a parent and a wholly owned subsidiary do "agree" to a course of action, there is no sudden joining of economic resources that had previously served different interests, and there is no justification for § 1 scrutiny.[33]

30. *Id.* at 768-69.
31. *Id*. at 769.
32. *Id.* at 770-71.
33. *Id.* at 771.

Thus, although Section One authorizes scrutiny of mergings of interests, further scrutiny is forbidden once those interests are merged.

Justice Stevens, joined by Justices Brennan and Marshall, dissented in *Copperweld*. He cautioned against overturning precedent and argued that the majority had erroneously minimized the holdings of earlier cases.[34] Justices Stevens also relied on the breadth of the statutory language addressing the agreement requirement.[35] He argued that the statutory language reflected a common law context in which legally separate persons were capable of conspiring together.[36] The statute's expressed concern with trusts also informed his position, because that concern also addressed affiliated corporations.[37]

Justice Stevens concluded that a parent and subsidiary are capable of conspiring under Section One by relying on policy that distinguishes between two different types of internal agreements: those which solely eliminate competition between agreeing parties and those which tend to exclude competitors. Price fixing is an example of the first type of

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34. *See id.* at 783 (Stevens, J., dissenting) ("Thus, the rule announced today is inconsistent with what this Court has held on at least seven previous occasions.").

35. *See id.* at 784-785 ("The language of § 1 of the Sherman Act is sweeping in its breadth: 'Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, . . . is declared to be illegal.' This Court has long recognized that Congress intended this language to have a broad sweep, reaching any form of combination: '[I]n view of the many new forms of contracts and combinations which were being evolved from existing economic conditions, it was deemed essential by an all-embracing enumeration to make sure that no form of contract or combination by which an undue restraint of interstate or foreign commerce was brought about could save such restraint from condemnation. The statute under this view evidenced the intent not to restrain the right to make and enforce contracts, whether resulting from combination or otherwise, which did not unduly restrain interstate or foreign commerce, but to protect that commerce from being restrained by methods, whether old or new, which would constitute an interference that is an undue restraint.'") (quoting 15 U.S.C. § 1; Standard Oil Co. v. United States, 221 U.S. 1, 59–60 (1911)).

36. *See id.* at 785-86 ("Since the statute was written against the background of the common law, reference to the common law is particularly enlightening in construing the statutory requirement of a 'contract, combination in the form of trust or otherwise, or conspiracy.' Under the common law, the question whether affiliated corporations constitute a plurality of actors within the meaning of the statute is easily answered. The well-settled rule is that a corporation is a separate legal entity; the separate corporate form cannot be disregarded. The Congress that passed the Sherman Act was well acquainted with this rule. Thus it has long been the law of criminal conspiracy that the officers of even a single corporation are capable of conspiring with each other or the corporation. This Court has held that a corporation can conspire with its employee, and that a labor union can 'combine' with its business agent within the meaning of § 1.") (internal citation and footnotes omitted).

37. *See id.* at 787 ("Holding that affiliated corporations cannot constitute a plurality of actors is also inconsistent with the objectives of the Sherman Act. Congress was particularly concerned with 'trusts,' hence it named them in § 1 as a specific form of 'combination' at which the statute was directed. Yet 'trusts' consisted of affiliated corporations.").

agreement.[38] Boycotts[39] and exclusive dealing arrangements[40] are examples of the second type. Justice Stevens argued that agreements eliminating competition between a parent corporation and its subsidiary should be legal:

> The Court's reason for rejecting the concept of a combination or conspiracy among a parent corporation and its wholly owned subsidiary is that it elevates form over substance — while in form the two corporations are separate legal entities, in substance they are a single integrated enterprise and hence cannot comprise the plurality of actors necessary to satisfy § 1. In many situations the Court's reasoning is perfectly sensible, for the affiliation of corporate entities often is procompetitive precisely because, as the Court explains, it enhances efficiency. A challenge to conduct that is merely an incident of the desirable integration that accompanies such affiliation should fail.[41]

However, Justice Stevens argued that an agreement between a parent corporation and its subsidiary that tends to exclude rivals should potentially be illegal under Section One. He used the *Copperweld* facts to demonstrate his point:

> In this case, it may be that notices to potential suppliers of respondent emanating from Copperweld carried more weight than would notices coming only from Regal. There was evidence suggesting that Regal and Copperweld were not integrated, and that the challenged agreement had little to do with achieving procompetitive efficiencies and much to do with protecting Regal's market position. The Court does not even try to explain why their common ownership meant that Copperweld and Regal were merely obtaining benefits associated with the efficiencies of integration. Both the District Court and the Court of Appeals

38. Arizona v. Maricopa Cnty. Med. Soc'y, 457 U.S. 332, 347 (1982) ("We have not wavered in our enforcement of the *per se* rule against price fixing.").

39. *See* Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207, 212 (1959) ("Group boycotts, or concerted refusals by traders to deal with other traders, have long been held to be in the forbidden category. They have not been saved by allegations that they were reasonable in the specific circumstances, nor by a failure to show that they 'fixed or regulated prices, parcelled out or limited production, or brought about a deterioration in quality.' Even when they operated to lower prices or temporarily to stimulate competition they were banned. For, as this Court said in *Kiefer-Stewart Co. v. Seagram & Sons*, 'such agreements, no less than those to fix minimum prices, cripple the freedom of traders and thereby restrain their ability to sell in accordance with their own judgment.') (internal citations omitted).

40. *See* Standard Oil Co. of Cal. v. United States, 337 U.S. 293, 314 (1949) ("Standard's use of the [exclusive requirement] contracts creates just such a potential clog on competition as it was the purpose of § 3 [of the Clayton Act] to remove wherever, were it to become actual, it would impede a substantial amount of competitive activity.").

41. *Copperweld,* 467 U.S. at 789 (Stevens, J., dissenting) (internal citation omitted).

> thought that their agreement had a very different result — that it raised barriers to entry and imposed an appreciable marketwide restraint. The Court's discussion of the justifications for corporate affiliation is therefore entirely abstract — while it dutifully lists the procompetitive justifications for corporate affiliation, it fails to explain how any of them relate to the conduct at issue in this case. What is challenged here is not the fact of integration between Regal and Copperweld, but their specific agreement with respect to Independence. That agreement concerned the exclusion of Independence from the market, and not any efficiency resulting from integration. The facts of this very case belie the conclusion that affiliated corporations are incapable of engaging in the kind of conduct that threatens marketwide competition.[42]

Justice Stevens believed that the Court improperly adopted a rule of *per se* legality for agreements between parent corporations and their subsidiaries. He argued that the rule of reason could separate procompetitive integration from anticompetitive exclusion.[43]

B. Teams in a Professional Sports League Are Separate Actors

In *American Needle, Inc. v. National Football League*, the members of the National Football League ("NFL") argued that they were a single entity for purposes of Section One and were therefore incapable of conspiring with each other.[44] The NFL is an unincorporated association of thirty-two independently owned teams.[45] Each of these firms owns the intellectual

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42. *Id.* at 795-96.

43. *See id.* at 778 ("It is safe to assume that corporate affiliates do not vigorously compete with one another. A price-fixing or market-allocation agreement between two or more such corporate entities does not, therefore, eliminate any competition that would otherwise exist. It makes no difference whether such an agreement is labeled a 'contract,' a 'conspiracy,' or merely a policy decision, because it surely does not unreasonably restrain competition within the meaning of the Sherman Act. The Rule of Reason has always given the courts adequate latitude to examine the substance rather than the form of an arrangement when answering the question whether collective action has restrained competition within the meaning of § 1.

Today the Court announces a new *per se* rule: a wholly owned subsidiary is incapable of conspiring with its parent under § 1 of the Sherman Act. Instead of redefining the word 'conspiracy,' the Court would be better advised to continue to rely on the Rule of Reason. Precisely because they do not eliminate competition that would otherwise exist but rather enhance the ability to compete, restraints which enable effective integration between a corporate parent and its subsidiary — the type of arrangement the Court is properly concerned with protecting — are not prohibited by § 1. Thus, the Court's desire to shield such arrangements from antitrust liability provides no justification for the Court's new rule.").

44. (Am. Needle II) 130 S. Ct. 2201, 2207 (2010).

45. *Id.* at 2207.

property in their team names and trademarks. For many years, teams licensed their intellectual property separately. In 1963, the members of the NFL formed National Football League Properties ("NFLP") to license the intellectual properties owned by the teams.[46] Each team has the power to withdraw from NFLP. The revenue generated by NFLP is shared by the teams equally or given to charity.[47] Until 2000, NFLP licensed the intellectual property of the teams to multiple apparel manufacturers, allowing the licensees to use the team marks on various products. NFLP had granted American Needle one of these licenses. In 2000, the members of the NFL voted to change the licensing policy of NFLP. Instead of granting multiple nonexclusive licenses to apparel vendors, the members voted to cause NFLP to grant a series of exclusive licenses. Pursuant to this policy, NFLP granted an exclusive ten-year license to Reebok International Ltd. to manufacture hats using the trademarks of the NFL team members.[48] Since the license to Reebok was exclusive, NFLP could not renew American Needle's license to manufacture hats.

American Needle sued, alleging violations of Section One and Section Two of the Sherman Act. The district court granted summary judgment for the defendants, concluding that the NFL was a single entity with respect to the challenged conduct.[49] In doing so, the court discussed the various procompetitive reasons that could justify the NFL's decision to use a joint licensing entity. The court recognized "that supposed efficiencies in economic arrangements are more the stuff of the rule of reason than of distinguishing between single entities and joint ventures."[50] However, rather than analyze these efficiencies under the rule of reason, the court concluded that American Needle's Section One claims should be summarily disposed of by accepting the single entity argument made by the NFL.

The Supreme Court disagreed. In a unanimous opinion written by Justice Stevens, the Court held that the members of the NFL were not protected by the single entity concept, but rather were separate actors capable of conspiring for purposes of Section One.[51] In his analysis, Justice Stevens returned to the history of the intra-enterprise conspiracy doctrine that he had found so persuasive in his dissent in *Copperweld*.[52] He concluded that the majority in *Copperweld* focused on substance rather

46. *Id.*
47. *Id.*
48. *Id.*
49. Am. Needle, Inc. v. New Orleans La. Saints (Am. Needle I), 496 F. Supp. 2d 941, 944 (N.D. Ill. 2007).
50. *Id.* at 944.
51. *Am. Needle II*, 130 S. Ct. at 2212.
52. *Id*. at 2210-11.

than form.[53]

In searching for a test for conspiracy under Section One, Justice Stevens turned to language from *Copperweld* that focused on whether the decisionmakers were "separate" and "independent":

> The key is whether the alleged "contract, combination. . . , or conspiracy" is concerted action — that is, whether it joins together separate decisionmakers. The relevant inquiry, therefore, is whether there is a "contract, combination . . . or conspiracy" amongst "separate economic actors pursuing separate economic interests," such that the agreement "deprives the marketplace of independent centers of decisionmaking," and therefore of "diversity of entrepreneurial interests," and thus of actual or potential competition[.][54]

Justice Stevens also drew from *Copperweld* a concern about the separateness and independence of the decision makers and the separateness of the economic interests and sources of economic power:

> Thus, while the president and a vice president of a firm could (and regularly do) act in combination, their joint action generally is not the sort of "combination" that § 1 is intended to cover. Such agreements might be described as "really unilateral behavior flowing from decisions of a single enterprise." Nor, for this reason, does § 1 cover "internally coordinated conduct of a corporation and one of its unincorporated divisions," because "[a] division within a corporate structure pursues the common interests of the whole," and therefore "coordination between a corporation and its division does not represent a sudden joining of two independent sources of economic power previously pursuing separate interests[.]" Nor, for the same reasons, is "the coordinated activity of a parent and its wholly owned subsidiary" covered. They "have a complete unity of interest" and thus "[w]ith or without a formal 'agreement,' the subsidiary acts for the benefit of the parent, its sole shareholder." . . .
>
> The question is whether the agreement joins together "independent centers of decisionmaking."[55]

Applying a standard based on separateness of decision making, economic power, and objectives, Justice Stevens concluded that the members of the NFL were capable of conspiring for purposes of Section

53. *Id*. at 2211.

54. *Id*. at 2212 (quoting Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 769 (1984); Fraser v. Major League Soccer L.L.C., 284 F.3d 47, 57 (1st Cir. 2002)) (citing Freeman v. San Diego Assn. of Realtors, 322 F.3d 1133, 1148-49 (9th Cir. 2003)).

55. *Am. Needle II*, 130 S. Ct. at 2212 (quoting *Copperweld*, 467 U.S. at 767, 770-71).

One:

> The NFL teams do not possess either the unitary decisionmaking quality or the single aggregation of economic power characteristic of independent action. Each of [the teams] is a substantial, independently owned [and] independently managed business, whose "general corporate actions are guided or determined" by "separate corporate consciousnesses," and whose "objectives are" not "common."[56]

The Court found that the league members were at least potential competitors in licensing the teams' trademarks and that in licensing they were pursuing their separate economic interests.[57]

The NFL made a series of arguments contending that the teams had integrated their operations sufficiently to justify single entity treatment. The Court rejected each of these arguments. Although the league members' common goal in promoting the NFL brand partially aligned their interests, the Court noted that "the teams still have distinct, potentially competing interests."[58] The NFL argued metaphorically that NFLP was the driver of a promotional vehicle pursuing the common interests of league members. The Court rejected this argument as well, responding that "illegal restraints often are in the common interests of the parties to the restraint, at the expense of those who are not parties."[59] Justice Stevens noted that a history of cooperation may merely manifest an anticompetitive agreement.[60] The NFL argued that cooperation was essential to the creation of the product being sold. But the Court responded that while the necessity of cooperation should be included in the analysis of an agreement under the Rule of Reason, it does not necessarily justify single entity treatment.[61]

Justice Stevens acknowledged that decisions made by NFLP were not exactly the same as decisions made directly through agreements among the league members, especially since NFLP had its own management and the league members shared NFLP's revenues.[62] However, Justice Stevens reasoned that each league member owned its separate trademarks and, without the cooperative activity coordinated through NFLP, each of the teams was a potential competitor in the licensing of their trademarks.[63]

56. *Am. Needle II*, 130 S. Ct. at 2212 (quoting *Copperweld*, 467 U.S. at 771).
57. *Am. Needle II*, 130 S. Ct. at 2213.
58. *Id*.
59. *Id*.
60. *Id*. at 2213-14.
61. *Id*. at 2214.
62. *Id*.
63. *See id.* at 2214-15 ("Nevertheless we think it clear that for the same reasons the 32 teams' conduct is covered by § 1, NFLP's actions also are subject to § 1, at least with regards to its marketing of property owned by the separate teams. NFLP's licensing

While courts usually treat actors in a single corporation as a single entity, Justice Stevens believed that single entity treatment was inappropriate in this case because each of the teams were acting to further their separate interests:

> Agreements made within a firm can constitute concerted action covered by § 1 when the parties to the agreement act on interests separate from those of the firm itself, and the intrafirm agreements may simply be a formalistic shell for ongoing concerted action.
>
> For that reason, decisions by the NFLP regarding the teams' separately owned intellectual property constitute concerted action. Thirty-two teams operating independently through the vehicle of the NFLP are not like the components of a single firm that act to maximize the firm's profits. The teams remain separately controlled, potential competitors with economic interests that are distinct from NFLP's financial well-being.[64]

Justice Stevens believed that a joint venture in which the participants shared profits and losses could merely be a way of running a cartel of potential competitors:

> If the fact that potential competitors shared in profits or losses from a venture meant that the venture was immune from § 1, then any cartel "could evade the antitrust law simply by creating a 'joint venture' to serve as the exclusive seller of their competing products." "So long as no agreement," other than one made by the cartelists sitting on the board of the joint venture, "explicitly listed the prices to be charged, the companies could act as monopolies through the 'joint venture.'" (Indeed, a joint venture with a single management structure is generally a better way to operate a cartel because it decreases the risks of a party to an illegal agreement defecting from that agreement).[65]

III. THEORIES OF THE FIRM AND THE SINGLE ENTITY CONCEPT

The conceptual division of labor between the two sections of the Sherman Act depends on a reliable distinction between acts of a single firm (Section Two) and the coordinated actions of multiple firms (Section One).

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decisions are made by the 32 potential competitors, and each of them actually owns its share of the jointly managed assets. Apart from their agreement to cooperate in exploiting those assets, including their decisions as the NFLP, there would be nothing to prevent each of the teams from making its own market decisions relating to purchases of apparel and headwear, to the sale of such items, and to the granting of licenses to use its trademarks.").

64. *Id*. at 2215 (internal footnote and citations omitted).

65. *Id.* (quoting Major League Baseball Props., Inc. v. Salvino, Inc., 542 F.3d 290, 335 (2d Cir. 2008) (Sotomayor, J., concurring in judgment)).

This distinction requires a definition of what constitutes a single firm. Generations of economists and business associations scholars, including Ronald Coase, Michael Jensen and William Meckling, have struggled to formulate this definition.

A. Coase Views the Firm as Distinct From the Market

In his famous 1937 essay *The Nature of the Firm*,[66] Nobel laureate Ronald Coase pondered what constitutes a firm and why firms exist. His conclusions provide a meaningful foundation for the conceptual division between Section One and Section Two of the Sherman Act. Coase began by asking why firms exist at all. If market transactions allow individuals to exchange goods and services at market clearing prices, why do groups of individuals exist as firms? Coase states:

> An economist thinks of the economic system as being coordinated by the price mechanism and society becomes not an organisation but an organism. The economic system "works itself." This does not mean that there is no planning by individuals. These exercise foresight and choose between alternatives. This is necessarily so if there is to be order in the system. But this theory assumes that the direction of resources is dependent directly on the price mechanism. Indeed, it is often considered to be an objection to economic planning that it merely tries to do what is already done by the price mechanism.[67]

Within a firm, resources are allocated by direction rather than by market transactions. Goods move from worker to worker on an assembly line without negotiation as to quantity, quality, and price. No offer or acceptance occurs. Different workers provide services to accomplish the firm's goals without service contracts between those workers. Factory workers, sales associates, accountants, and in-house lawyers all coordinate their efforts without contracting with each other. This stands in stark contrast to a classical market as the intermediary between economic actors.

> Within a firm, the [market transaction] description does not fit at all. For instance, in economic theory we find that the allocation of factors of production between different uses is determined by the price mechanism. The price of factor *A* becomes higher in *X* than in *Y*. As a result, *A* moves from *Y* to *X* until the difference between the prices in *X* and *Y*, except in so far as it compensates for other differential advantages, disappears. Yet in the real world, we find that there are many areas where this does not apply. If a workman moves from department *Y* to department *X*,

66. R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).
67. *Id*. at 387 (internal footnotes omitted).

> he does not go because of a change in relative prices, but because he is ordered to do so. Those who object to economic planning on the grounds that the problem is solved by price movements can be answered by pointing out that there is planning within our economic system which is quite different from the individual planning mentioned above and which is akin to what is normally called economic planning. The example given above is typical of a large sphere in our modern economic system.[68]

The first task Coase undertakes is to explain why firms exist if market transactions are available.[69] Coase then goes on to explain what determines the size of each firm.[70] In explaining why firms exist, Coase identifies the costs of using market transactions. The first cost he identifies "is that of discovering what the relevant prices are."[71] Moving goods and services within a firm avoids this cost by avoiding market transactions, and therefore avoiding the need to determine a market price. The second cost of market transactions Coase identifies is the cost of negotiating each contract.[72] Here, Coase acknowledges that contracts exist within firms as well as outside of them. For example, suppliers of labor contract with the firm by agreeing to follow the direction of the purchaser, subject to certain limits. Within these limits, the purchaser may direct the activities of the supplier and by this mechanism coordinate the activities of the firm.[73]

Coase analyzes the possibility of using long-term supply contracts as an alternative to forming a firm. Like forming a firm, long-term supply

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68. *Id.* at 387-388.

69. *See id.* at 388 ("But in view of the fact that it is usually argued that co-ordination will be done by the price mechanism, why is such organisation necessary? Why are there these 'islands of conscious power'? Outside the firm, price movements direct production, which is co-ordinated through a series of exchange transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator, who directs production. It is clear that these are alternative methods of co-ordinating production. Yet, having regard to the fact that if production is regulated by price movements, production could be carried on without any organisation at all, well might we ask, why is there any organisation?").

70. *See infra* text accompanying notes 78-86.

71. Coase, *supra* note 66, at 390 (internal footnote omitted).

72. *Id.* at 390-391.

73. *See id.* at 391 ("It is true that contracts are not eliminated when there is a firm but they are greatly reduced. A factor of production (or the owner thereof) does not have to make a series of contracts with the factors with whom he is co-operating within the firm, as would be necessary, of course, if this co-operation were as a direct result of the working of the price mechanism. For this series of contracts is substituted one. At this stage, it is important to note the character of the contract into which a factor enters that is employed within a firm. The contract is one whereby the factor, for a certain remuneration (which may be fixed or fluctuating), agrees to obey the directions of an entrepreneur *within certain limits*. The essence of the contract is that it should only state the limits to the powers of the entrepreneur. Within these limits, he can therefore direct the other factors of production.").

contracts reduce transaction costs by reducing the number of contracts to negotiate and form. Coase's assessment of this possibility speaks to the idea of bounded rationality, which states, among other things, that at the time of contract formation, the parties do not know what the future holds. [74] Coase addresses the possibility that, in the future, the purchaser might want to specify which of several courses of action the seller should take:

> Now, owing to the difficulty of forecasting, the longer the period of the contract is for the supply of the commodity or service, the less possible, and indeed, the less desirable it is for the person purchasing to specify what the other contracting party is expected to do. It may well be a matter of indifference to the person supplying the service or commodity which of several courses of action is taken, but not to the purchaser of that service or commodity. But the purchaser will not know which of these several courses he will want the supplier to take.[75]

Coase identifies one solution to this problem, noting that the contract may allocate to the purchaser the power to specify later how the seller is to perform.[76] Coase then notes that as the power of control contractually allocated to the purchaser increases, a firm comes into existence: "When the direction of resources (within the limits of the contract) becomes dependent on the buyer in this way, that relationship which I term a 'firm' may be obtained. A firm is likely therefore to emerge in those cases where a very short term contract would be unsatisfactory."[77]

Coase then asks why any market transactions exist in a world where firms can reduce or eliminate the cost of those transactions.[78] What is the point at which a firm decides to use a market transaction rather than coordinate one more activity within the firm? In modern terms, when will Toyota decide to buy sparkplugs rather than make them, or retain a law firm for a legal matter rather than use its in house legal staff? Coase discusses three reasons why the scope of a firm could be limited, even if all tasks that need to be accomplished were of the same type.[79] First, as a firm

74. Herbert Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99 (1955).

75. *Id.* at 391.

76. *Id.* at 392.

77. *Id.* (internal footnote omitted).

78. *See id.* at 394 ("A pertinent question to ask would appear to be . . . . why, if by organising one can eliminate certain costs and in fact reduce the cost of production, are there any market transactions at all? Why is not all production carried on by one big firm?").

79. Coase acknowledges that market transactions are highly variable. *Id.* at 396. This of course means that some types of transactions might be cheaper to organize within a firm, while others are especially suited to market transactions. Coase notes that this would explain the division of tasks between intra-firm coordination and market transactions. However, he further notes that it would not explain why more than one firm coordinating tasks suitable to intra- firm coordination would exist. *Id.*

attempts to coordinate more transactions, the cost per transaction may increase.[80] If an entrepreneur has to pay attention to more and more steps in production, the cost of coordinating incremental steps may rise. Second, as a firm attempts to coordinate more transactions with the firm, it may become less effective.[81] The entrepreneur may make more mistakes when paying attention to more steps in production. Finally, as a firm gets larger, suppliers of inputs, whose activities need to be coordinated within the firm, may raise their prices.[82] These suppliers may charge more if their activities are part of the purchasing firm than if they are purchased in a market transaction. This is because suppliers of these inputs may prefer to operate their own firms rather than be controlled by a larger firm.[83]

Coase suggests variables that would alter the costs of intra-firm coordination compared to market transactions. He explains that geographic distance, task variability, and market price volatility would all increase the cost of organizing transactions with a firm.[84] Technological innovation could affect the relative costs of intra-firm coordination versus market transactions. Coase notes the telephone and telegraph as inventions that reduced the cost of a firm organizing tasks at a great distance.[85] Coase would likely agree that today's email, video conferencing, and remote computer file access do the same. Coase makes the point that inventions can affect both the cost of intra-firm coordination and market transactions. It is the relative size of these effects that impacts the optimally efficient size of the firm.[86] For example, computer-aided manufacturing allows cheaper coordination within a firm by decreasing the variability of transactions. It allows a high level of confidence that repetition of a manufacturing process will be uniform. However, computer-aided manufacturing allows cheaper market transactions for the same reason. A buyer of a manufactured part can look at a sample of the part for sale by a supplier and have a high degree of confidence that the parts delivered will be of the same quality.

Thus, Coase's explanations of why firms exist at all and why they are not infinitely large still hold true in the modern world. Firms exist because coordination within a firm avoids costs associated with market transactions. Firms are not infinitely large because coordination within a firm costs more as the firm gets larger. Firms increase in size until the point where the costs of market transactions equal the costs of coordinating more

80. *Id.* at 394.
81. *Id.* at 394-395.
82. *Id.* at 395.
83. *Id.* at 395, n.1.
84. *Id.* at 397.
85. *Id.*
86. *Id.* at n.3.

transactions with the firm.[87]

Coase limited his task to explaining why firms exist and how large they become. In doing so, he assumed that an entrepreneur ran the firm. Thus, the Coasean firm consists of the entrepreneur and his or her employees. It excludes suppliers and customers with whom the firm interacts in markets. Although this construction of the firm focuses on the boundary between the firm and the market, it does not try to explain the boundaries of the firm when more than one individual assumes the functions of the entrepreneur. The modern nexus of contracts construction of business associations both questions the boundary between the firm and the market and attempts to explain the fracture of the entrepreneurial functions.

B. The Nexus of Contracts Concept Denies the Separation of the Firm From the Market

The entrepreneur-owner performs multiple functions. He or she supplies the capital, bears the risk of losing the capital,[88] receives any profits the business earns, and manages the business. There is no reason why only one person must assume these tasks. In a partnership, more than one person shares each of these tasks.[89] Partnership default rules provide that the partners share financial risks, benefits, and management responsibilities.[90] In a corporation, financial risks and benefits are allocated to the shareholders while management tasks are allocated to the directors and officers.[91] The modern law of business associations defines and controls these different roles. For the past several decades, the prevailing explanation of business associations has been the nexus of contracts theory.[92] The nexus of contracts theory does not conceive of the firm as an entity separate from the market. Rather, it views people performing the various parts of the entrepreneurial function along with suppliers,

87. For a comparison of the decision to form a firm to the decision to form a joint venture between firms from a Coasean perspective, *see* 13 HERBERT HOVENKAMP, ANTITRUST LAW 5-7 (2d ed. 2005).

88. In a sole proprietorship, the entrepreneur also bears the risk of losing his or her assets in addition to the invested capital.

89. Similarly, in a member-managed limited liability company, members who also manage the firm share financial risks and benefits.

90. Uniform Partnership Act §§ 401, 807, 6 U.L.A. 1 (2001).

91. Model Business Corporation Act § 801 (2010). Of course, the same individual may, but need not, be a shareholder, a director, and an officer.

92. For examples of works that advance this theory, see, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-39 (1991); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 391 (2000); and William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982).

employees, and customers as participating in a nexus of explicit and implicit contracts.

The nexus of contracts approach originated in a famous article by Michael Jensen and William Meckling. In *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*,[93] Jensen and Meckling address how explicit and implicit contracts affect cooperation in production.[94] Cooperation in production takes the form of one person acting for another, including situations where two or more people act for their joint benefit. Jensen and Meckling use the term "agency" for this concept and address the cost of agency relationships:

> We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.[95]

Jensen and Meckling note that agency relationships and agency costs exist in many settings.[96] The focus of their article is on the agency relationship between owners and managers of corporations. As a foundation for addressing this subset of agency issues, the authors discuss the nature of the firm as a nexus of contracts: "Contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc. The problem of agency costs and monitoring exists for all of these contracts. . . ."[97] Jensen and Meckling emphasize that the fictional personhood of a business organization should not distract from seeing the web of explicit and implicit contracts among members of the cooperating group:

> It is important to recognize that most organizations are simply legal fictions, *which serve as a nexus for a set of contracting*

93. 3 J. FIN. ECON. 305 (1976).
94. *Id.* at 307-310.
95. *Id.* at 308.
96. *See id.* at 309 ("The problem of inducing an 'agent' to behave as if he were maximizing the 'principal's' welfare is quite general. It exists in all organizations and in all cooperative efforts — at every level of management in firms, in universities, in mutual companies, in cooperatives, in governmental authorities and bureaus, in unions, and in relationships normally classified as agency relationships such as those common in the performing arts and the market for real estate. The development of theories to explain the form which agency costs take in each of these situations (where the contractual relations differ significantly), and how and why they are born will lead to a rich theory of organizations which is now lacking in economics and the social sciences generally.") (internal footnotes omitted).
97. *Id.* at 310.

> *relationships among individuals*. . . . The private corporation or firm is simply one form of *legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals*. While this definition of the firm has little substantive content, emphasizing the essential contractual nature of firms and other organizations focuses attention on a crucial set of questions — why particular sets of contractual relations arise for various types of organizations, what the consequences of these contractual relations are, and how they are affected by changes exogenous to the organization. Viewed this way, it makes little or no sense to try to distinguish those things that are "inside" the firm (or any other organization) from those things that are "outside" of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material, and capital inputs and the consumers of output.[98]

The final two sentences distinguish the nexus of contracts approach from Coase's theory of the firm.[99] Coase explicitly sets out to distinguish the inside of the firm from the outside of the firm. Inside the firm, the entrepreneur directs the activities of the employees. Outside the firm, market transactions take place between the firm and other actors. The nexus of contracts approach rejects the categorical distinction between actors inside the firm and actors outside the firm. Instead, it posits that suppliers of goods, money, risk bearing, management, and labor, together with purchasers of the output, are part of a web of explicit and implicit contracts.

Jensen and Meckling agree with the earlier work of Armen Alchian and Harold Demsetz in rejecting a focus on the entrepreneur's control of employees as the distinguishing characteristic of a firm.[100] In *Production, Information Costs, and Economic Organization*,[101] Alchian and Demsetz develop a theory of the firm that focuses on the role of the entrepreneur as the supplier of capital and management. The entrepreneur is the center of a

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98. *Id*. at 310-311 (internal footnotes omitted, emphasis in original).

99. On the distinction between the Coasean approach to the firm and the nexus of contracts theory, see Charles R. T. O'Kelley, *Coase, Knight, and the Nexus-Of-Contracts Theory of the Firm: A Reflection on Reification, Reality, and the Corporation as Entrepreneur Surrogate*, 35 SEATTLE U. L. REV. 1247, 1256-1264 (2012).

100. *See* Jensen & Meckling, *supra* note 93, at 310 ("Alchian and Demsetz . . . object to the notion that activities within the firm are governed by authority, and correctly emphasize the role of contracts as a vehicle for voluntary exchange.").

101. 62 AM. ECON. REV. 777 (1972).

group of contracts and monitors the relative value of each of the inputs.[102] As a foundation for this analysis, the authors deny the importance of an employer's control over the employee:

> It is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market. This is delusion. The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people. I can "punish" you only by withholding future business or by seeking redress in the courts for any failure to honor our exchange agreement. That is exactly all that any employer can do. He can fire or sue, just as I can fire my grocer by stopping purchases from him or sue him for delivering faulty products. What then is the content of the presumed power to manage and assign workers to various tasks? Exactly the same as one little consumer's power to manage and assign his grocer to various tasks. The single consumer can assign his grocer to the task of obtaining whatever the customer can induce the grocer to provide at a price acceptable to both parties. That is precisely all that an employer can do to an employee. To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer continually is involved in renegotiation of contracts on terms that must be acceptable to both parties. Telling an employee to type this letter rather than to file that document is like my telling a grocer to sell me this brand of tuna rather than that brand of bread.[103]

Thus, Alchian and Demsetz, as well as Jensen and Meckling, reject treating the employee/employer relationship as categorically different from relationships of others in a web of contracts because of the control exercised by the employer. In this way, the nexus of contracts approach is different from Coase's theory of the firm.[104]

The nexus of contracts approach differs from the Coasean approach in another respect as well. Coase viewed the firm as consisting of entrepreneur and his or her employees. He did not address the boundaries of the firm where multiple individuals assume the entrepreneurial functions. The entrepreneur provides capital, risk bearing, and management. In 1980, Eugene Fama responded to the work of Jensen, Meckling, Alchian, and Demsetz by arguing that they did not pay enough

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102. *Id.* at 778.

103. *Id.* at 777.

104. *See also* O'Kelley, *supra* note 99, at 1262 (explaining that the nexus of contracts approach includes, within the firm, more actors than the Coasean approach).

attention to the separation of the entrepreneurial functions.[105] Alchian and Demsetz defined the classical firm as:

> a contractual structure with: 1) joint input production; 2) several input owners; 3) one party who is common to all the contracts of the joint inputs; 4) who has rights to renegotiate any input's contract independently of contracts with other input owners; 5) who holds the residual claim; and 6) who has the right to sell his central contractual residual status. The central agent is called the firm's owner and the employer.[106]

Fama argues that it is important to recognize the conceptual separation of items 3 and 4 from items 5 and 6 on the Alchian and Demsetz list:

> To understand the modern corporation, it is better to separate the manager, the agents of points 3 and 4 of the Alchian-Demsetz definition of the firm, from the risk bearer described in points 5 and 6. The rationale for separating these functions is not just that the end result is more descriptive of the corporation, a point recognized in both the Alchian-Demsetz and Jensen-Meckling papers. The major loss in retaining the concept of the entrepreneur is that one is prevented from developing a perspective on management and risk bearing as separate factors of production, each faced with a market for its services that provides alternative opportunities and, in the case of management, motivation toward performance.[107]

Fama argues that the risk bearing function is just one of many inputs of production that are parts of the nexus of contracts. Performing the risk bearing function and being the residual claimant is not the equivalent of owning the firm. "We first set aside the typical presumption that a corporation has owners in any meaningful sense. . . . [T]he two functions usually attributed to the entrepreneur, management and risk bearing, are treated as naturally separate factors within the set of contracts called a firm."[108] Fama exemplifies the nexus of contracts approach by pointing out that owning a firm and owning securities in a firm are distinct concepts:

> [O]wnership of capital should not be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this "nexus of contracts" perspective, ownership of the firm is an irrelevant concept. Dispelling the

105. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980).
106. Alchian and Demsetz, *supra* note 101, at 794.
107. Fama, *supra* note 105, at 291.
108. *Id.* at 289.

> tenacious notion that a firm is owned by its security holders is important because it is a first step toward understanding that control over a firm's decisions is not necessarily the province of the security holders.[109]

In summary, the nexus of contracts theory of the firm differs from that set forth by Coase in two respects. First, Coase focused on a boundary of the firm that separated it from market transactions with others. The entrepreneur and his or her employees were inside the firm. Suppliers and customers were outside the firm. The nexus of contracts theory does not adopt this distinction; instead, it adopts a more complex view of firm inclusion that relies heavily on agency principles. Second, Coase did not address the division of the entrepreneurial functions among separate actors. Therefore, he did not need to determine a boundary for the firm if that firm separated management and risk bearing functions. In the nexus of contracts view, risk bearers, managers, employees, suppliers, and customers are all part of the web of explicit and implicit contracts that make up the firm. No subset of this group is categorically separate from the rest.

C. The Single Entity Concept from Coasean and Nexus of Contracts Perspectives

The single entity concept under Section One of the Sherman Act creates a rule of *per se* legality for agreements between individuals within the firm. An agreement between the firm and another actor, such as a supplier or a customer, is subject to scrutiny under Section One. This categorical separation between agreements among actors within the firm (ignored under Section One) and agreements between the firm and actors outside the firm (assessed under Section One) fits naturally in the Coasean perspective. Of course, Coase was not addressing analysis under Section One of the Sherman Act when he wrote his article. He was instead trying to analyze why firms exist and what determines their size. However, his perspective that there is something conceptually different about conduct within a firm and conduct outside the firm is consistent with the single entity concept of Section One. Both Coase and the single entity concept treat the line between the firm and the market as conceptually sound.

The nexus of contracts approach rejects the importance of the line between actors within a firm and those outside the firm. The nexus of contracts approach treats suppliers and customers as part of the same web of explicit and implicit contracts as stockholders, directors, officers, and employees. Under this approach, the employer's control over the employee

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109. *Id.* at 290.

is not categorically different from the control exercised by any buyer over any seller. Similarly, the firm has no owner who is categorically different from any other actor in the web of explicit and implicit contracts. Stockholders are merely suppliers of capital and risk bearing services. In this sense, they are not categorically different than suppliers of any other input.

Because the nexus of contracts approach rejects the categorical distinction between actors inside and outside the firm, it calls into question the single entity concept. If there is no categorical difference between actors inside and outside the firm, why should agreements among actors "inside" the firm and agreements between the firm and others be treated as categorically different? Why should agreements among actors inside the firm be ignored, while those between the firm and other actors be subject to scrutiny under Section One of the Sherman Act?

Rejecting the single entity concept would take the language of Section One literally. All agreements which restrain trade would be subject to scrutiny under Section One, whether those agreements were among shareholders, directors, officers, and employees of a firm or between the firm and other actors such as suppliers and customers. An assessment of the competitive consequences of the agreements would replace the rule of *per se* legality flowing from the single entity concept. The rejection of that rule would be in accord with the historical trend in which the Supreme Court has reduced the number of *per se* rules.[110]

In such a hypothetical world, the rules governing scrutiny under Section One would need to be substantially revised. An intra-firm agreement among plant managers that the products produced by each plant are to sell at the same price would not be *per se* illegal price fixing. In applying the rule of reason, one of the factors considered would need to be whether the agreement included only actors within a firm. Nevertheless, rejection of the rule of *per se* legality embodied in the single entity concept would substantially increase the number of agreements subject to scrutiny under Section One. Whether this is favorable depends on one's confidence in the rule of reason. While the Supreme Court seems very confident in the rule of reason when it rejects or limits rules of *per se* illegality, it is not at all clear that this confidence should lead to the rejection of the rule of *per se* legality at the foundation of the single entity concept.

One could retain the single entity concept based on one or more of several theoretical foundations. First, one could conclude that Coase was right, that control of employees by an employer is categorically different from other agreements. This conclusion has several difficulties for

110. *See supra* text accompanying notes 13-15 (describing the Supreme Court's reduction in the number of agreements it subjects to *per se* illegality).

purposes of retaining and applying the single entity concept. First, it ignores the power of the intellectual insights found in the nexus of contracts perspective. Second, it leaves unaddressed the issues raised by the separation of various aspects of the entrepreneurial role. It does not help in understanding how one should apply the single entity concept to shareholders and managers of a business entity. These are the very problems posed in cases such as *Copperweld* and *American Needle*.

A second theoretical basis for retaining the single entity concept is to conclude that the nexus of contracts perspective is right, but there are still reasons to retain the single entity concept for purposes of Section One of the Sherman Act. The scholars who developed the nexus of contracts perspective did so for purposes of understanding the economics of business associations and developing rules for their governance. They were not addressing the Sherman Act. The Sherman Act governs competition in markets, but does not expressly address the governance of business associations. It is possible that the nexus of contracts perspective on the firm is correct, but there are still Sherman Act policies that lead to the conclusion that the single entity concept should be retained as a rule of *per se* legality.

Rules established under Section One of the Sherman Act attempt to assess the competitive effects of agreements. The rule of reason explicitly addresses the procompetitive and anticompetitive effects of agreements. Rules of *per se* illegality are based on the conclusion that particular types of agreements are so likely to be net anticompetitive that it is not worth the effort of assessment under the rule of reason. Similarly, the rule of *per se* legality embodied in the single entity concept could be based on the conclusion that certain types of agreements among shareholders, directors, officers, and employees of a corporation are so likely net procompetitive that assessment under the rule of reason is not worth the effort. The question is what would be the basis for such a conclusion.

IV. SHARING NET PROFITS AND EXERTING SIGNIFICANT CONTROL JUSTIFY SINGLE ENTITY TREATMENT

The single entity concept legalizes agreements among owners and employees. The nexus of contracts perspective divides ownership functions into supply of capital, risk taking, and management services. Some suppliers of capital take limited risk and exert limited management because they are holders of debt. Holders of debt take limited risk since they receive a return that does not depend on the venture making a profit.[111]

111. At some point, the insolvency of the venture would affect payment of principal and interest to debt holders.

Holders of debt have a limited role in management. Loan agreements often place limits on the activities of the borrower, but do not usually give the debt holder discretionary power. Owners of equity securities supply capital and take more risk than debt holders take. Owners of equity securities also have more management power than debt holders have. Owners of equity securities in corporations elect directors who oversee management. One question raised by the single entity concept is whether the risk bearing service provided by owners of equity justifies *per se* legality for agreements related to that risk bearing service. This question is analyzed in subpart A.

Owners of equity securities exercise some level of control over managers, and managers exercise extensive control over employees. The nexus of contracts perspective questions whether this level of control is meaningfully different from control exercised by any buyer over any seller. The single entity concept leads to the conclusion that agreements among owners, managers, and employees are *per se* lawful. Subpart B analyzes whether the control exercised over employees justifies this treatment.

A. Sharing Net Profits Induces Cost Savings Sufficient to Justify Single Entity Treatment

Owners of a firm are the residual claimants to the firm's net profits. The default rules for sharing net profits vary among different types of business organizations, and there are various levels of management authority.[112] Private ordering often alters these default rules. Despite the variance in default rules and private ordering, sharing net profits induces cost savings. Net profits are calculated by subtracting expenses from revenue. Actors who share net profits have incentives to increase revenue and decrease costs. These incentives justify single entity treatment.

Actors who are residual claimants to the net profits of a firm are deemed part of a single entity with respect to all activities that give rise to those profits. There is a basic difference between actors who share net profits and those who do not. For example, imagine two actors who want to cooperate in a business venture. One owns the building that the venture will use. The other will provide knowledge and labor to the venture. One possible arrangement would be for the building owner to rent the building to the person providing the labor. The rent could be a fixed dollar amount per month or a percentage of the gross revenue of the business. Another possibility would be for the two actors to form a business organization in

112. Shareholders of corporations have relatively little control. Partners in a general partnership share extensive control. Members of limited liability companies have varying levels of control depending on whether the company is member managed or manager managed.

which they would share profits. This business organization could be a corporation in which they are both shareholders, a limited liability company in which they are both members, or a partnership.

In the landlord/tenant relationship, each of the actors would try to maximize their own returns. Neither the property owner nor the tenant has an interest in increasing the returns of the other.[113] Each would bargain for higher or lower rent. More importantly, each would try to extract the maximum from the other in other terms of performance. The tenant would try to get the highest level of service out the property owner. The property owner would try to provide the cheapest level of service. Neither has an interest in reducing the costs of the other.[114] It is of course possible to try to predict the consequences of this divergence of interest and bargain to an efficient result. However, given the bounded rationality of the actors, such a prediction is sometimes difficult.

The formation of a business organization in which both parties are co-owners alters the interests of the actors in important ways. Both actors will still try to maximize their own returns.[115] However, since they are sharing net profits, they each have an interest in maximizing the revenue produced by the venture, and more importantly, minimizing costs. Unlike the property owner/tenant relationship where costs are borne individually, in the business organization context, the owners deduct costs from revenues before sharing the resulting net profit. Therefore, both parties have an incentive to improve the efficiency by reducing costs.

The property owner/tenant scenario and the business organization scenario merit different treatment under Section One of the Sherman Act, because they have materially different incentives for reducing costs. One way of implementing different treatment would be to say that agreements are present in both scenarios and assess the competitive effects of the agreements under the rule of reason and any *per se* rule if applicable. This would allow and require the trier of fact to determine the competitive effects of the differing incentives for cost reduction on a case-by-case basis. Another way of implementing the different treatment would be to say that an agreement is absent in the business organization scenario and conclude that coordinated behavior is *per se* lawful. This is the approach that the single entity fiction promotes.

Three Supreme Court cases show how Section One has been applied to scenarios involving varying levels of sharing of revenues and profits. Although each of these cases was nominally addressed to whether conduct

113. Each actor would have an interest in the other remaining solvent and able to perform.

114. The statement in the text assumes that the financial terms of the lease would not reflect the cost reductions.

115. For example, each will try to negotiate a larger share of the net profits.

was *per se* illegal or subject to the rule of reason, their facts demonstrate the importance of revenue/profit sharing on the assessment of competitive effects. In *Arizona v. Maricopa County Medical Society*,[116] doctors acting through their local medical associations agreed to accept a set of maximum payments for designated services provided to patients insured by certain insurance plans.[117] Arizona sued, alleging that the agreement was *per se* illegal price fixing. The plaintiff moved for partial summary judgment on liability and the district court denied the plaintiff's motion.[118] The Court of Appeals affirmed the district court order concluding that the alleged agreement was not *per se* illegal and its competitive effects would need to be determined.[119] The Supreme Court held that the agreement was *per se* illegal and that the district court should have granted summary judgment to the plaintiff.[120] The Court focused on the lack of risk sharing by the doctors:

> The foundations are not analogous to partnerships or other joint arrangements in which persons who would otherwise be competitors pool their capital and share the risks of loss as well as the opportunities for profit. In such joint ventures, the partnership is regarded as a single firm competing with other sellers in the market. The agreement under attack is an agreement among hundreds of competing doctors concerning the price at which each will offer his own services to a substantial number of consumers. It is true that some are surgeons, some anesthesiologists, and some psychiatrists, but the doctors do not sell a package of three kinds of services. If a clinic offered complete medical coverage for a flat fee, the cooperating doctors would have the type of partnership arrangement in which a price-fixing agreement among the doctors would be perfectly proper. But the fee agreements disclosed by the record in this case are among independent competing entrepreneurs. They fit squarely into the horizontal price-fixing mold.[121]

Thus, the Court imposed the *per se* rule because the doctors were not sharing the risks that revenues would be low or expenses high. The Court indicated that if the doctors had shared these risks, single entity treatment would have been appropriate. In *Maricopa*, the parties to the agreement shared neither revenues nor costs. In an earlier case, the Court held that an arrangement in which competitors shared revenues but not costs should be assessed under the rule of reason.

116. 457 U.S. 332 (1982).
117. *Id.* at 339-341.
118. *Id.* at 336.
119. *Id.* at 337-338.
120. *Id.* at 348-349.
121. *Id.* at 356-57.

In *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.* ("*BMI*"), copyright holders combined to offer a blanket license to copyrighted music.[122] Under the terms of the blanket license, a licensee could perform all of the copyrighted music of the copyright holders. Individual licenses to particular works were available from individual copyright holders at prices determined unilaterally by each copyright holder. The plaintiff claimed that the creation and pricing of the blanket license constituted *per se* illegal price fixing, and the court of appeals agreed.[123] The Supreme Court reversed and held that the creation and pricing of the blanket license was subject to the rule of reason rather than the *per se* rule.[124] Unlike the doctors in *Maricopa*, the copyright holders were not merely pricing a product that they individually produced. Rather, the copyright holders created a different product, the blanket license. No individual copyright holder could offer a license to millions of copyrights. This difference justified applying the rule of reason rather than the *per se* rule against price fixing. However, the copyright holders were not sharing the risk that costs would exceed revenues. The copyright holders were sharing the revenues from the blanket license, and ASCAP incurred some costs in administering the blanket license and enforcing the rights of the copyright holders. But copyright holders did not share the costs incurred in creating the copyrighted works. This meant that some copyright holders could make money while others lost money. No copyright holder had an interest in lowering costs incurred by other copyright holders. They were not residual claimants who shared the risk that profits would be low or losses high. This meant that they were not deemed to be a single entity whose actions were *per se* lawful under Section One. Of course, many of the actions of the copyright holders acting through ASCAP or BMI could be lawful under the rule of reason; however, they were not shielded from assessment by the single entity rule.

In *Texaco, Inc. v. Dahger*[125] the Court faced a situation where the sharing of net profits would justify single entity treatment. As in *Maricopa* and *BMI,* the issue before the Court was whether the defendants' conduct was subject to the *per se* rule against price fixing.[126] In *Maricopa*, the defendant doctors shared neither revenues nor costs and the Court applied the *per se* rule. In *BMI*, the copyright holders shared revenues but not costs, and the Court rejected the application of the *per se* rule in favor of the rule of reason. In *Dahger*, the parties to the agreement shared both revenues and costs of their joint activities. While the Court was only called

122. 441 U.S. 1, 5 (1979).
123. *Id.* at 6.
124. *Id.* at 24-25.
125. 547 U.S. 1 (2006).
126. *Id.* at 5.

upon to decide whether the *per se* rule applied, it implied that single entity treatment would be appropriate.

Dahger involved a joint venture between Texaco and Shell. Texaco and Shell had historically competed in the refining and sale of gasoline.[127] In 1998, Texaco and Shell formed a joint venture to pool their resources for refining and selling gasoline. Under the terms of the joint venture, Texaco and Shell shared the risk and profits from the venture.[128] The joint venture sold its gasoline under the original Texaco and Shell trademarks. The plaintiffs "alleg[ed] that, by unifying gasoline prices under the two brands, petitioners had violated the *per se* rule against price fixing . . . ."[129] The district court granted summary judgment for the defendants. It concluded that the rule of reason applied to the defendants' conduct and the plaintiffs asserted only a *per se* claim.[130] In holding that the *per se* rule against price fixing did not apply to the defendants' conduct, the Supreme Court focused on the sharing of risk of losses and opportunities for profits by the defendants, and invoked the single entity concept:

> These cases do not present [a *per se* illegal] agreement, however, because Texaco and Shell Oil did not compete with one another in the relevant market —namely, the sale of gasoline to service stations in the western United States — but instead participated in that market jointly through their investments in Equilon. In other words, the pricing policy challenged here amounts to little more than price setting by a single entity — albeit within the context of a joint venture — and not a pricing agreement between competing entities with respect to their competing products. Throughout Equilon's existence, Texaco and Shell Oil shared in the profits of Equilon's activities in their role as investors, not competitors. When "persons who would otherwise be competitors pool their capital and share the risks of loss as well as the opportunities for profit . . . such joint ventures [are] regarded as a single firm competing with other sellers in the market." As such, though Equilon's pricing policy may be price fixing in a literal sense, it is not price fixing in the antitrust sense. ("When two partners set the price of their goods or services they are literally 'price fixing,' but they are not *per se* in violation of the Sherman Act").[131]

The Court's invocation of the single entity concept was dicta because

127. *Id.* at 3-4.
128. *Id.* at 4.
129. *Id.*
130. *Id.*
131. *Id.* at 5-6 (quoting Arizona v. Maricopa Cnty. Med. Soc'y, 457 U.S. 332, 356 (1982); Broad. Music, Inc. v. Columbia Broad. Sys., Inc., 441 U.S. 1, 9 (1979)) (internal footnote omitted).

the only issue before the Court was whether the *per se* rule against price fixing applied to the defendants' conduct. In one passage, the Court mentioned both the single entity concept and stated that the plaintiffs could have challenged the defendants' behavior under the rule of reason:

> As a single entity, a joint venture, like any other firm, must have the discretion to determine the prices of the products that it sells, including the discretion to sell a product under two different brands at a single, unified price. If Equilon's price unification policy is anticompetitive, then respondents should have challenged it pursuant to the rule of reason.[132]

In a footnote to that passage, the Court noted that since the plaintiffs had not asserted a rule of reason argument, it need not address the possibility that Section One did not apply to the joint venture because of the single entity concept.[133] Therefore, while the Court in *Dahger* noted the possibility of single entity treatment for the joint venture and focused on the sharing of profits and losses, its holding is limited to the determination that the *per se* rule was not applicable to the defendants' conduct.[134]

The single entity theory treats concerted behavior among co-owners of a business organization as unilateral only when it is directed toward the generation of net profits to be shared by the co-owners. Concerted behavior that is unconnected with the firm, or that affects profits not shared with the other co-owners, is not protected by the single entity theory.[135] For example, in *Dagher*, Texaco and Shell combined their gasoline refining

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132. *Id.* at 7.

133. *See id.* at n.2 ("Respondents have not put forth a rule of reason claim. Accordingly, we need not address petitioners' alternative argument that § 1 of the Sherman Act is inapplicable to joint ventures.") (internal citation omitted).

134. Commentators have struggled with what *Dagher* means for the single entity concept, particularly post *American Needle*. *See, e.g.*, Herbert Hovenkamp & Christopher R. Leslie, *The Firm as Cartel Manager*, 64 VAND. L. REV. 813, 865-67 (2011) (arguing that the Supreme Court was careless to reference the single entity question in *Dagher*); Daniel R. Shulman, *Another View of* American Needle, 12 SEDONA CONF. J. 261, 265-69 (2011) (arguing that *Dagher* does not provide guidance on when joint ventures should receive single entity treatment); Gregory J. Werden, *The Application of the Sherman Act to Joint Ventures: The Law After* American Needle, 12 SEDONA CONF. J. 251, 256-58 (2011) (arguing that the Supreme Court's holding in *Dagher* only makes sense if it is viewed as a variation on the single entity idea).

135. *See generally*, Hovenkamp & Leslie, *supra* note 134 at 855 ("When a single entity is set up by the participants in order to control their actual or potentially separate business interests, as in *American Needle*, then there are multiple entities capable of conspiring for antitrust purposes . . . . Suppose two separate firms create a joint venture and each owns half. Depending on how it is structured and presented, a joint venture may appear to be single entity with its own name, logo, product, etc. However, for antitrust purposes, the joint venture is a product of concerted action, and actions by the venture management that limit the separate business of each firm are conspiratorial to the extent they limit competition that could otherwise have occurred.").

and marketing, and shared profits and losses. Pricing the resulting gasoline was part of the activity that gave rise to the shared profits or losses. Single entity treatment for this activity is justified. However, if Texaco and Shell also agreed about the price they would charge for home heating oil, this agreement would not be subject to single entity treatment.[136] This is so because Texaco and Shell would not be sharing profits and losses on home heating oil and thus would have no incentive to reduce each other's costs. Similarly, the joint venture agreement contemplated that both Texaco and Shell would cease refining and selling gasoline individually. Ceasing individual production and sale of gasoline does not itself generate any shared profits or losses. Therefore, the agreement to cease individual production and sale of gasoline is not protected by the single entity concept. Its competitive effects will be assessed under Section One.

This analysis is different from the familiar conclusion that the formation of a joint venture is subject to Section One scrutiny even if its operations are governed by the single entity concept. The formation of a joint venture is subject to Section One because at the moment of the agreement, the agreeing parties have not begun sharing net profits and are pursuing their own separate interests.[137] The analysis in the preceding paragraph does not depend on the timing of the agreement. Rather, it depends on whether the challenged activity generates shared net profits or losses. An agreement to fix the price of home heating oil would not generate such profits and losses, nor would an agreement to refrain from individually producing and selling gasoline. However, just because both such agreements are subject to assessment under Section One does not mean that the assessment would reach the same conclusion. The price fixing agreement would be *per se* illegal. Courts would assess the agreement to cease individual production and sale of gasoline under the rule of reason and it would presumably be lawful.[138]

In summary, the sharing of net profits or losses justifies single entity treatment for all activities generating those profits or losses. This is because sharing profits or losses incentivizes cost savings. However, single entity treatment extends only to activities generating the shared profits or losses and not to other activities of the parties. The competitive effects of those other agreements will be assessed under a *per se* rule or the rule of reason as appropriate. Sharing profits or losses is not the only basis for single entity treatment.

136. Indeed, such an agreement would be *per se* illegal price fixing.

137. The same can be said of a merger.

138. The joint venture in *Dagher* had been approved in a consent decree with the Federal Trade Commission and the attorneys general of several states. *Dagher*, 547 U.S. at 4.

B. *When One Person Substantially Controls the Activities of Another They Will Be Considered a Single Entity*

Single entity treatment is not only for those who share net profits. Employees of a firm who are acting to further their employer's interests are considered part of the firm. Analyzing why this is so will help determine the scope of single entity treatment for other actors cooperating with a firm. It is first important to note why employees are not covered by the rule analyzed in the prior section about actors sharing net profits. Employees are paid by their employers. However, employers pay their employees regardless of whether the employer is making or losing money.[139] Therefore, employees do not share in the risk of losses. Employees, like most other suppliers of inputs to the firm, receive payments that are expenses to the firm rather than a distribution of profits.

If employees are input suppliers who do not share in the risk of profits or losses, why are they considered part of the single entity along with those who share net profits? Other input suppliers are not considered part of the entity. Landlords, lenders, licensors of intellectual property, and sellers of all sorts of property and services are all separate entities capable of agreement with their tenants, borrowers, licensees, and buyers under Section One. Why are employees different? One possible answer is that the interests of the employee and employer are somewhat aligned, even if they are not sharing net profits. However, other input suppliers also have interests somewhat aligned with the firm. Landlords often receive rent affected by the gross revenue of the tenant. Similarly, licensors of intellectual property often receive license payments affected by the gross revenue of the licensee. Of course, for a firm engaged in the resale of products, its suppliers benefit when the firm sells more. Indeed, if a partial alignment of interests sufficed to make multiple persons a single entity, an overt cartel could be a single entity. Cartelists do not share net profits, but they all have an interest in maintaining a high price through concerted action. Therefore, a partial alignment of interests short of sharing net profits does not justify single entity treatment and does not explain why employees are treated as part of their employer's firm.

Another possible explanation for the inclusion of employees in the employer's firm is that the employees owe a fiduciary duty to pursue the interest of the employer. Further, unlike other agents, employees have a legal duty to obey orders from the employer about how they perform services for the employer. These are the reasons that Coase believed that employees are categorically different from other suppliers. This difference convinced Coase that employees were "inside" the firm and other suppliers

139. The statement in the text assumes that the employer remains solvent.

(and customers) were "outside" the firm.

The nexus of contracts perspective rejects this conclusion. Meckling and Jensen concluded that principals faced agency costs because agents would be tempted to ignore their legal duties and fail to pursue the principals' interests by shirking and otherwise pursing the agents' individual interests. Agency costs include the cost of monitoring the agents' performance, the cost of the agents "bonding" their performance, and an irreducible cost of the agents deviating from the principals' interests. Alchian and Demsetz believed that the control an employer had over an employee was not different from the control any buyer had over any seller. If an employee does not act as the employer wants, the employer's recourse is to fire the employee. Alchian and Demsetz point out that any buyer can take similar recourse against any seller, i.e., refuse to buy any more from that seller.

The employment relationship may be sufficiently different from other supplier relationships to justify single entity treatment under Section One. One difference between the employment relationship and relationships with other suppliers is in the nature of the contract. Other suppliers typically agree to supply some result. A supplier of a product agrees to supply the product described in the contract. A nonemployee supplier of a service agrees to supply the service described in the contract. Unless addressed in the contract, the buyer does not have the right to tell the seller how to build the product or supply the service. If Toyota agrees to buy tires from Goodyear, it gets the tires and does not have the right to tell Goodyear whether to run a night shift in the tire factory. If Toyota agrees to have an electrical company rewire a factory, Toyota does not have the right to specify which workers do which part of the rewiring. However, if Toyota used its own employees to make the tires or rewire the factory, it would be able to direct the employees with respect to the details of performing their jobs.

The agency cost concept correctly asserts that Toyota would face monitoring and other costs in making its employees do as directed and not shirk. However, in dealing with third party suppliers, Toyota would face a bigger problem. If Toyota tells the third party supplier to do something, the supplier has the legal right to refuse. The tire supplier and the electrical company can refuse to do what Toyota wants and still get paid.[140] In dealing with its employees, Toyota does have monitoring and other costs in detecting shirking and other failures of performance. However, if Toyota overcomes these costs and detects the employee's deviation, it can fire the employee. The employee cannot shirk or defy Toyota's orders and still be

140. The statement in the text assumes that the contract does not give Toyota the right to give the order.

paid. Employees might sometimes get away with shirking, but they do not have the right to shirk.

In one sense, this is just to say that Coase was right. The employment relationship might be categorically different from relationships with other suppliers. The legal right of the employer to tell the employee what to do allows the employer to make adaptations *ex post* rather than being stuck with an *ex ante* bargain. With other suppliers of goods and services, the firm bargains *ex ante* for various contractual rights. If circumstances change, the firm cannot adjust the bargain without the consent of the supplier. With employees, *ex post* adjustments are possible. It is, of course, true that the employee can quit if he or she does not consent to the employer's directives. However, the employee cannot refuse the directives and keep his or her job. If nonemployee suppliers are on very short term contracts, this distinction might not make much of a difference. The nonemployee supplier with a short-term contract does have the benefit of its bargain and can assert its contractual rights. However, in a very short-term contract the benefit of the bargain does not last very long. Like an employee, the nonemployee supplier who refuses to accept the directive of the buyer does so at the risk of losing its continuing relationship with the firm, i.e. being "fired."

It is possible that employees will be more willing to accept adaptation by employers than nonemployee suppliers with short-term contracts. Employees typically make the bulk of their income from their employment. Nonemployee suppliers typically do not make the bulk of their income from one customer. In situations where a seller makes the bulk of his or her income from one source, adjusting to the termination of the relationship is more costly than adjusting to the loss of one of many customers. In a sense, the seller has invested in an undiversified portfolio. In such a situation, the employee/seller is more dependent on the single source of income and may be more willing to follow the demands of the employer for midterm adaptation.

It is also possible that agency costs will be lower in an employment relationship than in a nonemployee setting. Agency costs include the cost to the principal of monitoring the agent's conduct to determine if the agent is shirking or otherwise not pursuing the interests of the principal. It is possible that these monitoring costs are lower in the employment setting than with nonemployee suppliers. Employees often are performing tasks that the employer is familiar with. These tasks are often performed on the employer's premises. They are often performed in the presence of supervisors. They are often directed at goals that are very specific and short-term. If the goal is not accomplished, the employer can easily and quickly detect it. If an employee is directed to wash a window, the employer will easily and quickly detect if the employee has complied with the order. All of these characteristics of employment make it easier to monitor employees than nonemployee suppliers and thus make it more likely that employees will do as the employers direct.

The contractual right of an employer to direct an employee, the greater willingness of employees to accept midterm adaptations by the employer, and the increased effectiveness of monitoring by employers justify the rule of *per se* legality that is the foundation of the single entity concept.

C. The Relationship of the Sharing of Profits Test and the Control Test

The sharing of net profits test analyzed in Part A above concludes that parties who share net profits should be treated as a single entity for all agreements related to the production of those net profits. The control test analyzed in Part B above concludes that employers and their employees should be treated as a single entity for all agreements in which the employees are following the directions of the employers to advance the employers' interests. In an important respect, the control test is dependent on the sharing of net profits test.

The control test does not exist as a separate justification for single entity treatment. Control alone is not sufficient to justify single entity treatment.[141] Control by a party with the incentive to reduce costs and maximize net profits is required. If the controlling party does not have the incentive to reduce costs and increase revenues, thereby maximizing net profits, the control does not justify single entity treatment. For example, in an overt cartel, the cartel members might agree to obey the directions of one person with respect to what quantity to produce and what price to charge. The cartel members might even agree that the controlling person could tell them how to produce the cartelized product. Although control would be present, the single entity conclusion would not be appropriate. This is because cartel members do not share net profits and therefore do not have an incentive to reduce each other's costs. Similarly, the person given control by the cartel members does not share the costs of all of the cartel members and therefore does not have the incentive an owner does to reduce costs and maximize net profits.

The control test concludes that employees are part of the employer's firm because the employer is seeking to maximize net profits. In the simplest situation, the employer is a sole proprietor, i.e., a single living individual. If the sole proprietor has no employees and conducts all of his

141. For an argument that control through ownership should be the determining criterion of single entity analysis, see Benjamin Klein, *Single Entity Analysis of Joint Ventures After American Needle*, 78 ANTITRUST L.J. 669 (2013).

or her business alone, the single entity fiction does not come into play. When the sole proprietor hires an employee, the single entity question arises. Although the employer and the employee are two people agreeing as to various aspects of the business, should courts treat them as a single person? The sharing of net profits test does not come into play, because the sole proprietor retains all net profits after paying expenses, including the wages of the employees. The control test comes into play because the employer controls the conduct of the employee. The single entity conclusion is appropriate because the employer has the incentive to reduce costs and increase revenue and is controlling the conduct of the employee to accomplish that end.

When an employer has more than one owner sharing net profits, single entity treatment remains appropriate. The inclusion of more than one person sharing net profit does not alter the conclusion. Treating all persons sharing net profits as falling within the fictional single entity is justified by the shared incentive to reduce costs and maximize net profits. This is true even though the various owners do not control each other. The control of the owners over the employees justifies inclusion of all of the owners and all of the employees in the single entity because the people with the correct incentives control the people who do not share these incentives. In short, the single entity should include all of the people with the incentive to reduce costs and maximize net profits and all of the people they control.

D. Partially Owned Subsidiaries: Testing the Tests

A difficult and unresolved problem for the single entity theory is the treatment of an agreement between a parent corporation and a partially owned subsidiary. This issue was explicitly left unresolved by the Court in *Copperweld*.[142] In approaching this problem, it is useful to recall the issues that are resolved. If two corporations, A and B, each make five percent of the sales in an otherwise highly fractionalized market, an agreement between A and B will be assessed under Section One of the Sherman Act. The agreement would be *per se* illegal if it fixed prices or allocated customers.[143] If the agreement is not subject to a *per se* rule, it will be

142. *See* Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 767 (1984) ("We limit our inquiry to the narrow issue squarely presented: whether a parent and its wholly owned subsidiary are capable of conspiring in violation of § 1 of the Sherman Act. We do not consider under what circumstances, if any, a parent may be liable for conspiring with an affiliated corporation it does not completely own.").

143. The *per se* rule would apply even though the parties had a relatively small combined market share. *See, e.g.*, United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 224 n.59 (1940) ("[A] conspiracy to fix prices violates § 1 of the Act . . . though it is not established that the conspirators had the means available for accomplishment of their objective . . . .").

assessed under the rule of reason and could be legal if it enhanced competition. An acquisition of one firm by the other would, of course, be an agreement subject to Section One (and Section Seven of the Clayton Act).[144] However, given the highly fractionalized market and the relatively small market shares of the parties, the acquisition will likely be lawful.[145] Subsequent to the acquisition, the single entity concept will preclude further assessment of the behavior of the combined firm. If the acquisition takes the form of a merger, one of the corporations will cease to exist, and after the acquisition, the single entity concept will prevent further assessment of the activities of the combined firm under Section One.[146] If the acquisition takes the form of a stock acquisition by A of all of the shares of B, B will become a wholly owned subsidiary of A. *Copperweld* will treat A and B as a single entity precluding further assessment of the actions of A and B under Section One. However, what if the acquisition is a partial stock acquisition? What if A acquires only 60% of the shares of B? Should A and B be viewed as a single entity in this situation?

How would the sharing of net profits test treat an agreement between a parent corporation and its partially owned subsidiary? A and all of the other shareholders of B would share in the net profits generated by B. Therefore, the single entity concept would protect agreements related to the operation of B. These agreements would include decisions about what products B will produce, what B will charge for those products, and where they will be sold. This conclusion flows from the assumption that all of the shareholders of B have an interest in maximizing the profits of B, in which they all share. The single entity concept would not protect agreements restricting the activities of A or any of the other shareholders of B, because those agreements do not relate solely to the activities giving rise to the net profits shared.[147] Agreements between A and B that restrict what A could produce, how much it could charge, or where it could sell, would be assessed under Section One. Therefore, the question under the sharing of net profits test is not simply whether a parent and a partially owned subsidiary are capable of conspiring. The sharing of net profits test should also be applied in order to distinguish between agreements about the activities generating the net profits and agreements restricting other activities.

Should A's control of B by means of its majority ownership alter the

144. 15 U.S.C. 18 (2006).

145. *See* U.S. DEP'T OF JUSTICE AND THE FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES §5.3 (2010) ("Mergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and ordinarily require no further analysis.").

146. Courts could assess exclusionary actions of the surviving firm under Section Two if the firm acquired or became dangerously close to acquiring monopoly power.

147. *See supra* text accompanying note 136.

conclusion that agreements about the activities of B are protected by the single entity concept? Alternatively, should A's control of B alter the conclusion that agreements about the operation of A should not be protected by the single entity concept? As a threshold matter, it is important to recognize that applying the control test does not determine these questions. As discussed in the preceding part C, the control test applies to actors controlled by those who are sharing in the net profits of the entity. It concludes that employees of a firm are part of the firm for purposes of Section One because they are controlled by the actor or actors who have the incentive to reduce costs and maximize profits within the firm. In the case of a partially owned subsidiary, the controlling parent corporation is not the entire group of actors who share in the net profits. Therefore, the control test does not apply because the controlling party does not have identical interests to the group of the actors who are sharing net profits.[148] Since the control test does not apply, the issue depends on the application of the sharing of net profits test. As noted above, the application of the sharing of net profits test would ordinarily lead to two conclusions: first, that all agreements about the activities related to the generation of the net profits are protected by the single entity concept; and second, that agreements restricting the activities of the controlling parties are not protected by the single entity concept. The question is whether the control by the majority shareholding parent should alter these conclusions.

The conclusion that the single entity concept protects agreements related to the generation of shared net profits is called into question by agency cost analysis when one member of the controlling group exercises control. It has been argued that the control exercised by a majority parent should lead to the conclusion that the controlling parent and the partially owned subsidiary should be treated as a single entity for purposes of Section One.[149] However, agency cost analysis suggests the opposite conclusion: the majority shareholding parent could have the incentive to cause the subsidiary to operate at a sub-optimal level to protect the interests of the parent corporation. The controlling parent could cause the partially owned subsidiary to forego profitable transactions that would benefit the shareholders of the subsidiary because it would cost the parent. For example, imagine that the subsidiary has the opportunity to expand geographically into a territory traditionally served by the parent corporation. The incremental sales in the new territory would earn the subsidiary $100 in net profits but cost the parent corporation the same

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148. Further, the control test does not apply because, unlike employees, the management of the subsidiary does not owe a legal obligation to maximize the interests of the parent corporation rather than the entire group of shareholders of the subsidiary.

149. PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW 245-248 (3rd ed. 2010).

amount in lost profits. The parent corporation has an incentive to prevent the territorial expansion by the subsidiary because it will lose $100 but gain only $60. It has a 100% interest in its own profits but only a 60% interest in the profits of the subsidiary. Similarly, it may sell to the subsidiary an input for $100 that the subsidiary could have produced itself for $90. The subsidiary shares the $10 loss with its other shareholders, so the parent corporation bears only $6 of it. However, the parent shares the $10 gain with no one. The management of the subsidiary could well violate its fiduciary duty of loyalty in making these decisions benefitting the parent at the expense of the subsidiary.[150] But agency cost analysis is based on the assumption that the agent will sometimes yield to the temptation to seek its own self-interest at the expense of the principal. In this situation, the controlling parent is the agent for the group of shareholders of the subsidiary. As an agent, it is supposed to seek the interest of the group of which it is a member; however, it has an incentive to breach this duty. The minority shareholders have substantial monitoring costs in detecting and preventing this breach. These minority shareholders face a significant information hurdle in detecting the breach. Further, seeking redress for any breach they do detect would require a procedurally difficult derivative suit.[151]

The Sherman Act is not a tool for enforcing corporate law fiduciary duties. However, that is not the issue. The question is whether a rule of *per se* legality should shield any inquiry into the competitive effects of agreements between the parent corporation and the partially owned subsidiary. *Per se* legality is justified when the group who shares the net profits also controls the activities generating those profits. Is it justified when only one member of the group controls those activities, or does the potential for increased agency costs mean that a rule of *per se* legality should not be applied? In the preceding example involving potential territorial expansion by the subsidiary, in a world with no agency costs, the subsidiary would expand into the parent corporation's territory. The consumers would benefit from the competition between the two corporations. However, if agency costs prevent this competition from occurring, should the single entity concept deem this outcome *per se* lawful? The sharing of net profits test would conclude that the single entity concept should apply. A potential deficiency in the test is that it relies on the assumption that agency problems arising among the group sharing in the net profits will be overcome by effective business associations law. It

150. *Id.* at 233.

151. For discussions of shareholder demand requirements and the potential motion to dismiss by a special litigation committee, see Brehm v. Eisner, 746 A.2d 244, 254-55 (Del. 2000), Rales v. Blasband, 634 A.2d 927, 932-35 (Del. 1993), and Zapata Corp. v. Maldonado, 430 A.2d 779, 788-89 (Del. 1981).

is not obvious that this assumption is warranted.

The analysis in the preceding paragraph questions whether the normal outcome of the sharing of net profits test, protecting governance decisions directed at the activities giving rise to the shared net profits, should apply in the context of a partially owned subsidiary. The second question is whether the conclusion that agreements restricting the outside activities of the parties sharing in the net profits are subject to assessment under Section One should be altered when one of those parties controls the activities giving rise to the net profits. Imagine two easy cases. First, if two corporations, A and B, are unaffiliated competitors each making five percent of the sales in a highly fractionalized market, an agreement between A and B about what prices they will charge is illegal. Second, if A buys one percent of the stock of B, an agreement between A and B about what prices they will charge remains illegal. In this case, the sharing of net profits test would allow A to participate in the governance of B by voting for its directors. If a representative of A is elected to the board of directors of B, that representative could lawfully participate in deliberations of the board regarding how much B should charge for its products. However, the mere fact that A holds one percent of the shares of B would not mean that an agreement between A and B about how much *both* A and B would charge for their products would be automatically lawful. The shareholders of A and the shareholders of B are two different groups sharing two different pools of net profits. They are not a single group sharing an incentive to minimize a single set of costs yielding a single set of net profits. This conclusion does not change as the percentage of stock in B held by A increases, until it reaches 100%. At that point, there is only one group of claimants sharing one set of net profits, and they would be treated as a single entity under *Copperweld*.

Does it make a difference if the percent of stock held by A gives it control of B? It does not.[152] A's controlling B does not mean that an agreement restricting the activities of A should be protected by the single entity concept. As discussed in part C above, control is not a separate and sufficient test for single entity status. Control of employees by an employer justifies including employees in the same entity with the employer. However, this conclusion does not flow merely from control. The employer is a group of actors who share in net profits and therefore have the incentive to minimize costs and maximize net profits. This incentive coupled with the employer's control over the employees justifies single entity treatment. However, control by itself does not justify single

152. Others have argued that it does. *See* AREEDA & HOVENKAMP, *supra* note 149, at 246 ("The possible dividing lines are substantial ownership, majority ownership, or de facto control.").

entity treatment. Here, the control of the partially owned subsidiary by the parent does not meet the requirement that the controlling party shares the net profits. The controlling parent is only one of multiple parties sharing in the net profits generated by the subsidiary. Its interests diverge from the group sharing in the net profits generated by the subsidiary.[153] This divergence means that the controlling party is not the group sharing in the net profits, and, therefore, it does not meet the relevant requirement. Without the controlling group sharing in net profits, garden-variety control is irrelevant.

V. COPPERWELD AND AMERICAN NEEDLE UNDER THE SHARING OF PROFITS AND CONTROL TESTS

In both *Copperweld* and *American Needle*, the Supreme Court faced the question of whether groups should be treated as single entities for purposes of Section One of the Sherman Act. In *Copperweld*, the Court concluded that application of the single entity fiction was proper.[154] In *American Needle*, the Court reached the opposite conclusion.[155] Both of these conclusions are consistent with the layered application of the sharing of profits test and the control test.

In *Copperweld*, the Court faced the question of whether a wholly owned subsidiary should be included in the same entity as the parent corporation for purposes of Section One. This question is addressed to three different types of agreements. First, the agreement might only affect the activities of the subsidiary. For example, the agreement might limit where the subsidiary could operate, what it could sell and/or how much it could charge. Second, the agreement might only affect the activities of the parent corporation for such matters. Finally, the agreement could affect the activities of both corporations.

In addressing the question of the single entity status of a parent corporation and its wholly owned subsidiary, it is useful to remember how the sharing of profits test and the control test assess agreements involving only one corporation. The sharing of profits test would include all holders of equity securities as part of the fictional single entity. This is so because all of these parties share net profits and therefore have a shared incentive to reduce costs and maximize the shared net profits. Of course, the single entity fiction applies only to agreements respecting the activities that give rise to the shared net profits. The control test leads to the conclusion that all employees of the corporation should be included in the fictional single

153. *See supra* text accompanying notes 149-151.
154. Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 752 (1984).
155. Am. Needle II, 130 S. Ct. 2201, 2207 (2010).

entity for all agreements where the employees are furthering the interests of the employing corporation. This is so for two reasons. First, the employer has an incentive to reduce costs and maximize net profits, and second, the employer controls the activities of the employees.

In the *Copperweld* scenario, the alleged agreement includes both the parent corporation and its wholly owned subsidiary. The addition of a wholly owned subsidiary does not change the outcome under the sharing of net profits test and the control test. Under the sharing of net profits test, the creation of a wholly owned subsidiary does not alter the parties who are sharing net profits. If the subsidiary is wholly owned, the parent corporation owns all of its equity securities. Therefore, no one other than the parent shares in the net profits generated by the subsidiary. The parent corporation is of course a legal fiction. Only holders of its equity securities share its net profits. There is only one pool of net profits from which to share. The holders of equity securities issued by the parent corporation have the incentive to reduce the cost of all of the activities of the parent corporation and its wholly owned subsidiary, thereby maximizing the pool of net profits to share.

The control test also leads to the conclusion that courts should treat the parent corporation and its wholly owned subsidiary as a single entity. Because the holders of the equity securities of the parent corporation are the only parties sharing the net profits generated by the parent corporation and the subsidiary corporation, the control test asks whether those shareholders control the employees of both the parent corporation and the subsidiary corporation. The shareholders of the parent corporation elect the directors of that corporation. The directors of the parent corporation appoint the officers of the parent corporation, who in turn select and supervise its employees. One of the assets of the parent corporation is the stock of the subsidiary corporation. As the sole shareholder of the subsidiary, the parent corporation elects its directors. This decision is either made by the board of directors of the parent corporation or the officers of the parent corporation under the supervision of its board. The board of directors of the subsidiary appoints the officers of the subsidiary, who in turn select and supervise its employees. Because the officers or board members of the parent corporation select the board members of the subsidiary, they can control the management of the subsidiary. If members of the board of directors of the subsidiary attempted to defy the directives of the management of the parent corporation, the parent corporation could simply remove the members of the board of the subsidiary and replace them with new board members who will do as told. To simplify this process, the parent can simply elect its own employees as members of the board of directors of the subsidiary. Therefore, the holders of the equity securities of the parent corporation can control the behavior of the employees of the parent corporation and the employees of the subsidiary corporation. The control test concludes that the parent corporation, the subsidiary corporation, and the employees of both corporations should be included in the same single entity so long as the employees are advancing the interests of the corporations and, thus, the holders of the equity securities of the parent corporation.

In *American Needle*, the Court faced the question of whether it should consider the members of the National Football League as a single entity. The Court unanimously held that the answer to this question was no. This conclusion is consistent with the application of the sharing of net profits test and the control test. One potentially confusing aspect of the application of the sharing of net profits test and the control test to the joint activity in *American Needle* is that the members of the NFL controlled the licensing activities involved in the controversy. However, it is important to remember that the control test applies only after the application of the sharing of net profits test. If the controlling parties do not share net profits, the control test is not applicable. Therefore, the analysis must start with the application of the sharing of net profits test.

Members of the NFL did not share net profits, and therefore should not have been deemed a single entity. The joint licensing activity of the NFL members pooled only part of the economic activity of the members. League members hired players and team staff, entered into stadium agreements, sold tickets, and entered into broadcast agreements, all separate from the joint licensing arrangement that gave rise to the controversy in *American Needle*. Of course, actors do not need to pool all of their economic activity to qualify for single entity treatment. Shareholders of publicly held corporations typically invest only a small part of their wealth in the corporation. If a shareholder of General Motors also owns stock in Ford, two things are clear. First, the shareholder qualifies for single entity treatment with all of the other shareholders of General Motors. Second, General Motors and Ford do not qualify for single entity treatment together, despite the existence of the common shareholder. All of the shareholders of General Motors are sharing net profits and all agreements related to the production of that pool of net profits qualify for single entity treatment. This is true even though each of the shareholders has other investments and economic activities. Single entity treatment applies to agreements giving rise to the pool of net profits generated by General Motors, but not to other agreements.

Single entity treatment should not be denied to the joint licensing activity involved in *American Needle* merely because the league members have other economic activity that is not involved in the agreement to engage in joint licensing. Similarly, single entity treatment should not be denied to the joint licensing activity under the rule that single entity treatment extends only to agreements related to the joint production of net profits. The agreement at issue in *American Needle* was the joint decision to give an exclusive license to Reebok. This decision related directly to the joint licensing activity. But single entity treatment should be denied to the joint licensing activity involved in *American Needle* for two reasons. First, the agreement giving rise to the joint licensing activity restricted the activity of the league members outside the joint venture. Second, the league members were not sharing net profits because they were not sharing costs related to the production of the intellectual property subject to the joint license. The facts of *Dagher* illustrate both of these conclusions.[156]

Single entity treatment in the context of joint activity applies only to the agreements giving rise to shared profits. Single entity treatment does not extend to agreements that limit the activity of parties outside the joint activity.[157] In *Dagher*, the parties to the joint venture pooled all of their gasoline refining and distribution. They did not refine and distribute gasoline outside the joint venture. The agreement to cease refining and distributing gasoline outside the context of the joint venture did not qualify for single entity treatment (although it was likely legal under the rule of reason as reasonably related to the joint venture). Agreements about how to refine and market the gasoline produced by the joint venture qualify for single entity treatment because those agreements give rise to the shared net profits.[158] Similarly, if shareholders of General Motors agreed not to also purchase stock in Ford, single entity treatment would not be appropriate for this agreement. The agreement to refrain from buying Ford shares is not part of the production of the shared net profits. In *American Needle*, the league members agreed to license the intellectual property only jointly. They did not retain the right to license the intellectual property individually as well. This restriction on the separate activity of the teams is not subject to single entity treatment because it restricts the activities of the teams outside the context of the joint licensing activity. However, even if the league members had not agreed to restrict their license activity outside the joint licensing, the joint licensing would still not qualify for single entity treatment.

The sharing of net profits justifies single entity treatment because the parties have the incentive to reduce costs and thereby maximize net profits. The incentive to reduce costs creates efficiencies sufficient to justify a rule of *per se* legality. However, this rationale extends only to situations where parties share all of the costs of the joint activity. In *Dagher*, the parties

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156. *See supra* text accompanying notes 136 -137.

157. *See supra* text accompanying note 136.

158. The Court did not face this question because the only question presented to the Court was whether the agreement was *per se* illegal. *See supra* text accompanying notes 129-132.

shared all of the costs of the refining and distribution of gasoline. This sharing creates an incentive to reduce costs and therefore justifies single entity treatment. However, in *American Needle* the parties did not share all of the costs of creating and licensing the intellectual property subject to the license. The intellectual property in *American Needle* consisted of the trademarks of the teams. These trademarks had value because of the activities of the teams in playing football, and marketing live attendance and broadcast rights. The potential purchasers of hats and tee shirts wanted to buy the trademarked products because they liked the football teams. They liked the football teams because of how they performed in games. The teams did not share the costs of creating the teams and playing and broadcasting the games. Therefore, even if the teams were sharing the revenue from the joint licensing activities, they were not sharing net profits. Net profits are what are left after all of the costs of production are subtracted from revenue.[159] Because the league members were not sharing net profits and therefore did not have an incentive to reduce each other's costs, the rule of *per se* legality embodied in the single entity fiction is not justified. Further, since the sharing of net profits test is not satisfied, application of the control test is not required.

In summary, the layered application of the sharing of net profits test and the control test explains the outcome in both *Copperweld* and *American Needle*.

CONCLUSION

Although the single entity fiction fits comfortably with the Coasean

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159. A cartel can be run by sharing revenue, but not costs. Cartelists can use a jointly owned entity to make sales and share the revenue from those sales. The analysis in the text explains the importance of sharing costs as well as revenues in single entity analysis. Without sharing costs, single entity status is not justified. As the Court in *American Needle* noted, it would be paradoxical to use the single entity concept to grant *per se* legality to a cartel:

> If the fact that potential competitors shared in profits or losses from a venture meant that the venture was immune from § 1, then any cartel "could evade the antitrust law simply by creating a 'joint venture' to serve as the exclusive seller of their competing products." "So long as no agreement," other than one made by the cartelists sitting on the board of the joint venture, "explicitly listed the prices to be charged, the companies could act as monopolies through the 'joint venture.'" (Indeed, a joint venture with a single management structure is generally a better way to operate a cartel because it decreases the risks of a party to an illegal agreement defecting from that agreement). However, competitors "cannot simply get around" antitrust liability by acting "through a third-party intermediary or 'joint venture'."

Am. Needle II, 130 S. Ct. at 2215-16 (quoting Major League Baseball Props., Inc. v. Salvino, Inc., 542 F.3d 290, 335-36 (2d Cir. 2008) (Sotomayor, J., concurring in judgment)).

view of the firm, that view has been called into question by the nexus of contracts perspective. Even on its own terms, the Coasean view of the firm does not address the firm's boundary when the entrepreneurial functions of supplying capital, risk bearing, and management are divided among multiple actors. These are the scenarios that raise some of the most difficult single entity questions under Section One.

A layered test focused on sharing net profits and exerting significant control provides a principled basis for explaining the existence of the single entity fiction and for analyzing its contours.