Competition policy in the United States[1]

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1. Introduction

In the 1990's, we have witnessed a true explosion in the enactment of antimonopoly legislation around the world. Most of the countries of Central and Eastern Europe have enacted such laws, with Poland leading the way in 1990.[3] In Africa, laws are under development in Ghana and Zimbabwe, with laws already in existence in Morocco, South Africa, and Tunesia, and recently enacted in Zambia.[4] In the former Soviet Union, laws have been enacted in Russia, all three Baltic countries, Belarus, Kazakhstan, and Ukraine; in addition, a draft law is under development in Mongolia.[5] Indonesia and Malaysia both have draft laws under consideration. And in Latin America, new laws in Peru (1990), Venezuela (1992), Mexico (1992), Jamaica (1993), and Brazil (1991 and 1994) have joined existing laws in Argentina, Bolivia, and Chile.[6] In all, roughly sixty-five countries on six continents now have competition laws.

Drafters and enforcers of these laws have frequently looked to the experience of both the United States and the European Community for examples and guidance.[7] In this paper I will discuss some of the most important aspects of the U.S. law and enforcement experience and seek to draw certain lessons that may be useful for new antimonopoly authorities, especially those in economies making the transition from socialism to capitalism.

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3 See Fox and Ordover (1991), Pittman (1992a and 1992b), the collections of papers in Estrin and Cave (1993) and Saunders (1993), the review of these two collections by Pittman (1993), and Slay (1994).

4 Kovacic (1992); Gray and Davis (1993).

5 Pittman (1992a and 1992b); Joskow, Schmalensee, and Tsukanova (1994); Kovacic and Thorpe (1994).

6 Coate, Bustamante, and Rodriguez (1992); Dutz (1992); Gray and Davis (1993); Newberg (1994); Stevens (1995).

7 See Langenfeld and Blitzer (1991), McDermott (1991).This trend is lamented by Godek (1991) and Waller (1994); see the response to Godek by Ordover and Pittman (1991, 1992).

2. Cartel Enforcement

2.1 The Legal Standard

Section 1 of the Sherman Act, the law passed in 1890 that is the foundation of U.S. antitrust enforcement, states that "every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."[8] This language has been interpreted by the U.S. Supreme Court as forbidding those agreements which restrain trade "unreasonably" — that is, "which [are] unreasonably restrictive of competitive conditions."[9]

Such terminology might seem to suggest that the Supreme Court was calling for judges and juries to balance the competitive benefits and costs of a particular agreement, seeking to determine whether the agreement is "unreasonable", and therefore illegal. And indeed in a variety of cases such a balancing — called a "rule of reason" analysis — must take place.

However, the Court has given special treatment to a particular class of agreement: horizontal agreements (that is, agreements among competitors) whose principal focus is the price that will be charged, the bid that will be submitted, the quantities that will be sold, or the customers or territories that will be served. The Supreme Court has determined that these kinds of agreements are so universally and obviously destructive of competition that they are <u>always</u> unreasonable and that they are thus illegal "<u>per se</u>". That is, if it can be proven that one of these types of agreements actually occurred, the parties to the agreement are guilty of a Sherman Act violation, and no discussion of the alleged reasonableness or benefits of the agreement is necessary.[10]

2.2 Exceptions?

A <u>per se</u> illegality rule for the most clearly anticompetitive of collective behavior has important advantages. It allows businesses to know with certainty that particular well-defined forms of behavior are illegal and will not be tolerated. (In fact, in the U.S. the prohibition of this behavior is considered so clear and certain that the behavior is ordinarily punished as a criminal, not civil,

8 15 U.S.C. 1 (1988).

9 Standard Oil Co. v. United States, 221 U.S. 1, 58 (1911).

10 See Northern Pacific Railway v. United States, 356 U.S. 1,5 (1958):"There are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use."See also National Society of Professional Engineers v. United States, 435 U.S. 679, 692 (1978).

violation of the law.) It economizes on enforcement and judicial resources by not requiring an elaborate inquiry into the rationale or likely outcome of behavior that is almost always harmful to the public.

However, there have always been firms that have argued that their particular horizontal agreements had special public benefits and so deserved special treatment. It is worth addressing two of these defenses that have been decisively rejected by the Supreme Court and one that has been accepted.

In 1927 the Sanitary Potters' Association was found guilty of fixing the prices for sales by its members of vitreous pottery for bathrooms and lavatories. The Association's defense was that the prices fixed were "reasonable" and so did not harm the public. The Supreme Court found against the Association:

> The power to fix prices, whether reasonably exercised or not, involves power to control the market and to fix arbitrary and unreasonable prices. The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow. ...Agreements which create such potential power may well be held to be in themselves unreasonable or unlawful restraints, without the necessity of minute inquiry whether a particular price is reasonable or unreasonable as fixed and without placing on the government in enforcing the Sherman Law the burden of ascertaining from day to day whether it has become unreasonable through the mere variation or economic conditions.[11]

A few years later, during the Depression, the major oil companies sough to stop the practice of some small firms of selling large quantities of crude oil and refined oil products at "distress" prices by buying up the extra quantities themselves. When accused of violating the Sherman Act they argued that not only was the price level resulting from this collective arrangement "reasonable" but that in fact without this arrangement competition would be "cut-throat" and prices "ruinously" low. In other words, far from agreeing on monopoly prices, the parties to the agreement claimed that they were seeking to keep prices from falling so low that some of them would be forced out of business. The Supreme Court did not accept this argument, either:

> Ruinous competition, financial disaster, evils of price cutting and the likely appear throughout our history as ostensible justifications for price fixing. If the so-called competitive abuses were to be appraised here, the reasonableness of prices would necessarily become an issue in every price fixing case. in that event the Sherman Act would soon be emasculated. ...Congress has not left with us the determination of whether or not particular price-fixing schemes are wise or unwise, health or destructive.[12]

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11 United States v. Trenton Potteries Company, 273 U.S. 392, 397-98 (1927).

12 United States v. Socony-Vacuum Oil Company, 310 U.S. 150, 221 (1940).

The per se rule would preclude also any de minimus defense based upon the small size of the firms involved or their small share of the market in which they operate, and the Department of Justice has often prosecuted small firms operating in local markets.[13] One could argue that firms whose shares of a market are collectively small could not effectively collude to raise price, and some competition laws do include an exemption from cartel provisions for firms with small market shares.[14]Nevertheless the price of this provision is a heavy one; if a firm must know the metes and bounds of the relevant markets in which it operates and both its own market share and the shares of its competitors in those markets to know whether it may legally engage in collusive agreements, the clarity and force of the per se rule are weakened considerably.[15]

Still there are explicit agreements among competitors concerning price, output, and so on that do not ordinarily run afoul of the Sherman Act. These are agreements which are formed in the process of the creation of a joint venture or other legitimate joint activity and which are truly "ancillary" to that joint activity.

When two enterprises agree to engage in some joint, socially productive activity — for example, the construction of a factory to manufacture a product that neither is currently producing — it may be necessary for them to agree not to compete in certain ways if they are to establish the cooperative relationship necessary for the joint productive activity to be successful. The courts have recognized this. Nevertheless, the courts have also taken care to insure that the joint activity is not a mere subterfuge to justify anticompetitive agreements.

Specifically, U.S. courts have been careful to insist that for a horizontal restraint to be considered "ancillary" — and so "reasonable" under section 1 of the Sherman Act — it must meet two conditions: it must be 1) closely related to the purpose of the joint activity and 2) no broader than necessary to achieve its purpose.[16]

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13 For an interesting discussion, see Joyce (1989).Market share may of course be an important part of a rule-of-reason case, where a significant harm to competition must be demonstrated."If two shirt-makers form a joint sales agency, a court would not think that the venture constituted with a significant restraint without a showing that the collaborators occupy a notable share of some defined market."(Areeda [1986], at VII.377).

14 An example is the Hungarian competition law, which provides that an "agreement does not fall under a prohibition, if ... it is of negligible importance" (Section 15), and "an agreement is of negligible importance, if the parties concluding it have together a less than 10 percent share of the total respective market, regarding the commodity in question" (Section 160.A similar de minimus exemption is included in the stated enforcement practice -- though not the competition statute -- of the European Community.See Bael and Bellis (1990), at 224, or Raybould and Firth (1991), at 2.4.

15 Pittman (1992), at 493.

16 ABA Antitrust Section (1992), at 379, citing Rothery Storage & Van Company v. Atlas Van Lines, 792 F.2d 210, 224 (D.C. Circuit 1986), cert. denied, 479 U.S. 1033 (1987); Brunswick Corp., 94 F.T.C. 1174, 1275 (1979), cert. denied, 472 U.S. 1018 (1982).

2.3 Foreign Firms

Just as the acts of U.S. citizens in a foreign nation ordinarily are subject to the law of the country in which they occur, the acts of foreign citizens in the United States ordinarily are subject to U.S. law. Foreign firms that do business in the United States are fully subject to the antitrust laws, including the strictures in section 1 of the Sherman Act against "contract[s]...or conspirac[ies] in restraint of trade." A foreign firm may be found guilty of participating in a conspiracy to fix prices, and its executives or agents may be subject to criminal penalties.

Indeed, even a foreign firm that does little or no business in the United States may be subject to the Sherman Act if it is party to an anticompetitive agreement that has a "direct, substantial, and reasonably foreseeable" effect on United States commerce.[17] Of course, whether the Department of Justice would actually seek to prosecute such conduct may be affected by a variety of factors, including both international comity and the applicability of so-called "foreign sovereign immunity" and "foreign sovereign compulsion" defenses.[18]

2.4 Vertical Agreements

Although a large proportion of the enforcement activity under section 1 of the Sherman Act has been directed against horizontal agreements — that is, agreements among firms that compete with each other — the law applies also to vertical agreements — that is, agreements and restrictions involving a firm and its suppliers or a firm and its distributors or customers. Among the most important of vertical restrictions observed in market economies and covered by U.S. law are the following:

a. tying: selling a product only on the condition that the purchaser will purchase a second product simultaneously.

b. exclusive supply: purchasing a product only on the condition that the seller not supply one's competitors.

c. exclusive distribution: selling a product to a distributor only on the condition that the purchaser not also distribute the products of one's competitors.

d. territorial restrictions: selling a product to a distributor on the condition that the distributor sell only in a certain territory, often with the

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17 Foreign Trade Antitrust Improvements Act of 1982, Public Law No. 97-290, 96 Stat. 1246 (1982), codified at 15 U.S.C. 6a (1988).

18 U.S. Department of Justice (1988), at 78-79.

assurance that no other distributors of the product will be allowed to sell in that territory.

e. refusal to deal: selling a product to some willing distributors but not to others, or refusal to sell a product to anyone (as opposed to, for example, leasing it).

f. resale price maintenance: selling a product to a distributor on the condition that the distributor will sell the product to its customers at an agreed-upon price, or at a price no lower than a certain price (or, occasionally, at a price no greater than a certain price).

Historically, antitrust law had dealt somewhat harshly with vertical agreements and restraints — especially tying and resale price maintenance, which were treated as per se violations. However, over the past twenty to thirty years, a growing body of economic and legal analysis has suggested that these kinds of restraints may perform useful and procompetitive functions in the economy — for example, to assure the maintenance of the quality of the product, to protect trade secrets, and to facilitate entry into new markets.[19]

The law has thus come to treat most vertical agreements and restrictions, under the rule of reason, in a relatively lenient manner: firms are free to choose their customers, their suppliers, and the terms under which they will deal with both their customers and suppliers, without interference from the antitrust laws, *unless there is clear harm to competition.* In turn, the most important prerequisite for a judicial finding of clear harm to competition from a vertical agreement has been a finding of a significant degree of market power held by one of the parties to the agreement.[20]

In fact, in the presence of significant market power, vertical agreements and restrictions of the kind described above may be challenged as violations of section 2 of the Sherman Act rather than of section 1 — that is, as acts of "monopolization" or abuse of a dominant position.

The principal exception to this gradual easing of the legal strictures against vertical restraints and agreements has been in the case of direct agreement on resale prices. Resale price maintenance continues to be treated as a per se violation of section 1.[21]

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19 See, for example, Klein, Crawford, and Alchian (1978) and Schwartz and Eisenstadt (1982).

20 Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977); Monsanta Co. v. Spray-Rite Serv. Corp., 465 U.S. 752 (1984); ABA Antitrust Section (1992) at 116-193.

21 Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911); ABA Antitrust Section (1992) at 100-115.

3. Mergers

3.1. The Legal Standard and the Enforcement Guidelines

Section 7 of the Clayton Act — enacted in 1914 as the second major element of U.S. antitrust legislation — prohibits mergers and acquisitions "in any line of commerce or in any activity affecting commerce in any section of the country, [where] the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.[22]

The Department of Justice and the Federal Trade Commission, with joint responsibility for enforcing this statutory language, in 1992 jointly issued Horizontal Merger Guidelines (which replaced an earlier set of such Guidelines).[23] These Guidelines set forth what may be summarized as a five-step process for the analysis of proposed mergers and acquisitions by the two agencies. Although the Guidelines do not have the force of law, they do explain how the agencies analyze mergers, and a discussion of the five steps may illuminate the principal issues involved in merger enforcement. They are as follows:

a. market definition and description

b. identification of firms that participate in the relevant market and their market shares

c. identification of potential adverse competitive effects from the merger

d. market entry

e. efficiencies

Let us consider each of these five steps in turn.

3.1.a. Market Definition and Description[24]

The Guidelines note that a merger is unlikely to create or enhance market power or to facilitate its exercise unless it significantly increases concentration and results in a concentrated market, properly defined and measured.[25]

But what, exactly, is a market? We may define it loosely as consisting of all of those goods that are close substitutes for each other from the consumer's point of view. (Of course, "consumers" of many goods are firms, not individuals.) Or, to put it another way, if a single firm were the only producer

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22 22U.S.C. 18 (1988).

23 U.S. Department of Justice and Federal Trade Commission (1992).

24 For more extensive discussions, see Werden (1983, 1992, 1993) and Pittman (1994).

25 Guidelines at 1.0.

of a particular collection of goods, would that single firm possess monopoly power? Could it raise the price of those goods to their monopoly level? If the answer is yes, that collection of goods constitutes a market.

It frequently happens that how the market is defined determines whether a particular merger would be judged "substantially to lessen competition." Consider two examples:

In 1986 the Coca-Cola Company announced its intention to purchase the Dr. Pepper Company and merge the operations of the two companies.[26] The Federal Trade Commission investigated the proposal and concluded that the two firms competed in a market that it labelled "carbonated soft drinks". In that market Coca-Cola was the number one firm with over 37 percent of U.S. sales in 1985, while Dr. Pepper was the number four firm (after PepsiCo and Philip Morris, producer of Seven-Up) with almost 5 percent of U.S. sales. The Commission argued that the merger of two firms representing such a large share of the market would significantly reduce competition and asked a Federal District Court to prevent the merger.

Coca-Cola responded that its carbonated soft drinks competed not just with other carbonated soft drinks but with other beverages as well — coffee, tea, milk, fruit juices, and even water. The judge determined that while there might be some competition among all these beverages, in fact the principal competition to Coca-Cola was other carbonated soft drinks, and that such drinks constituted a market under the legal standard of the Clayton Act. He ordered that the acquisition and merger not take place.

Consider a second example. In 1983 the Santa Fe and Southern Pacific Railroads, two of the four principal railroads serving the Western United States, announced their intention to merge.[27] The Department of Justice investigated the merger and concluded that the parties competed in a number of local markets for "rail freight transportation". In many of those markets — for example, from Los Angeles to Houston or from San Francisco to Kansas City — the merger would reduce the number of firms participating in the "rail freight transportation" market from two to one or from three to two. The Department argued that such a reduction would significantly lessen competition and asked the Interstate Commerce Commission — the federal government agency that regulates railroads — to deny the merger.

The railroads responded that motor trucks could carry any commodity that railroads could carry and that therefore the proper market definition was "freight transportation", a market in which hundreds of firms competed, even at particular locations. (The long distance, truckload-cargo-carrying trucking

26 The case is described in greater detail in White (1989).

27 The case is described in greater detail in Pittman (1990).

business in the U.S. is structured in a reasonably competitive way.) The Commission accepted this argument for some commodities (many high-valued manufactured goods, for example) but not for others (many bulk commodities) and ruled that the merger would significantly reduce competition for shippers of the latter commodities at many locations. It thus rejected the merger proposal.

3.1.b. Identification of Firms that Participate in the Relevant Market and the Market Shares of those Firms

In identifying the market, the focus is on the demand side, on what products are close substitutes from the purchaser's point of view. The next step of the analysis is to move to the supply side, to determine what firms are in the market and what are their shares of the market.

Firms that currently supply the particular market that has been defined are of course included in the market, although if there is some reason to believe that their supply to the market is constrained to its currently level and would not expand in response to an increase in price, that must be taken into account. In addition, if a firm is not producing a product that is in the market just now but it seems clear that the firm could easily and quickly and without major expenses begin to produce such a product if given the right incentive, that firm is included in the market as well. The inclusion of such a firm in the market is intended to reflect its likely impact on decisions made by firms currently actually producing in the market.

Firms included in the market are then assigned market shares based on both their capacity or sales currently devoted to the market and on the capacity or sales that would likely be devoted to the market in response to a price increase. Shares may be measured in terms of either dollars or physical units and in terms of either sales or capacity as these are judged best to reflect the importance of the firm in the market in the future.

Two special cases may be of interest here.

i. First, if a foreign firm currently exports the product to the United States, it likely would be included in the list of market participants just like an American firm. However, if sales from that firm's country in the United States are subject to an import quota, the total sales of firms from that country included in the market will not exceed the amount of the quota.

ii. Second, if there is some reason to believe that the current sales or capacity of a firm do not accurately reflect its future role in the market, that fact will be taken into account in estimating market shares. For example, a firm currently selling a large quantity of coal in a market but with sharply declining coal reserves would be credited with a smaller market share than its current sales would warrant.[28] Similarly, a firm with a deteriorating or obsolete capital stock would be credited with a smaller market share than a firm currently making the same level of sales that had a technologically advanced capital stock.

3.1.c. Identification of Potential Adverse Competitive Effects from the Merger

When a particular market has been identified as one where a merger would increase concentration by a particular amount, the next question is, what would be the effect on competition of such an increase in concentration? The Guidelines focus on two possible harmful effects on competition from a merger: the increased likelihood of collusive behavior, and the increased likelihood of unilateral harmful behavior.

Economists have identified a list of characteristics of particular industries that many believe may make collusion in a industry more likely.[29]These characteristics include homogeneity of the product, secrecy of the terms of transactions, and sales that are frequent and relatively small. In such industries, the available evidence suggests strongly that a cartel with a small number of members would be easier to organize and operate than one with more members, and therefore that a merger between two industry members may enhance the likelihood of collusive behavior. Where an industry has these characteristics that are believed to make collusion more likely, a merger may be challenged for this reason.

However, an increased likelihood of collusion is not the only anticompetitive outcome to be feared from a merger. Even in industries that do not possess the characteristics feared to be associated with collusion, a merger may harm consumers by providing a particular firm with the incentive and wherewithal to take unilateral anticompetitive actions.

The clearest example is probably the case of a concentrated industry with differentiated products where two firms whose products are considered by purchasers to be close substitutes wish to merge.[30] Before the merger, the products that are close substitutes act as constraints on each other's prices: the seller of the first knows that if he raises its price he will lose sales to the second. After the merger, this constraint is eliminated, since sales of the second product

28 U.S. v. General Dynamics Corporation, 415 U.S. 486, 501 504 (1974).

29 See especially Stigler (1964).

30 More detailed discussions of this issue are available in Willig (1991), Ordover and Willig (1993), and Werden and Rozanski (1994).

are as good to the firm as sales of the first. The result is likely to be an increase in the prices of both products.

Consider the recent Department of Justice investigation of a proposed merger in the market for "stomach remedies". The makers of two products, Pepto-Bismol and Maalox, proposed a merger. Stomach remedies are differentiated products, heavily advertised, each with a slightly different "position" in the market, each focusing on a slightly different range of stomach symptoms. The Department's evidence — including the internal planning documents of the two firms — suggested that, for some consumers suffering some symptoms, Maalox was the product considered the closest substitute to Pepto-Bismol. Thus before the merger, one important constraint on the desire by Pepto-Bismol to raise its price was the fear that many of its customers would respond to buying the closest substitute, Maalox. After the merger, of course, the constraint would be removed, because this consumer response would not harm the merged firm. The likely result of the merger would then have been higher prices for both products, and it was on this basis that the merger was challenged by the Department.

3.1.d. Entry

As noted earlier, firms that could easily and quickly begin production in a market are included as market participants and are even assigned estimated market shares. However, even if there are no such firms that are "poised" to begin production and so may be assumed to have a clear influence on the current operation of the market, there may be firms that are interested in selling in this market and would enter if given the proper incentive — that is, if the market price rose sufficiently.

Such firms are called "potential entrants", and their presence in a market may affect the decision of the Agencies whether to challenge a merger. In fact, the Guidelines state that a merger that might be challenged according to the other criteria that we have discussed — namely, market definition, market concentration, and competitive effects — will not ordinarily be challenged if it is determined that in response to a price increase in the market, entry is likely to take place that is both timely and sufficient to counteract the price increase.

Consider the most important parts of this statement more closely.

i. "price increase". Not just any price increase is a matter of concern in merger analysis. The price increase of concern to the agencies is one that is "small but significant and nontransitory. The "bright line" that is often used is a price increase of five percent that will last "for the foreseeable future",[31] but this line may be changed in particular circumstances.

ii. "likelihood" of entry. Entry must be "likely" to take place following an increase in price, not simply a remote possibility. It is often possible to identify particular firms, domestic or foreign, that seem possible candidates for entry, and to interview their officials to learn more about the likelihood of entry. If the initial analysis has suggested that entry is likely, but no firm can be found that is interested in entering, it may be that some "barrier to entry" exists that has not been identified:

iii. "timeliness" of entry. In order to ease the concerns of the government concerning an otherwise anticompetitive merger, entry must be likely to take place within a short enough period of time that consumers would not be significantly harmed by a short-run loss of competition. The Guidelines suggest a period of two years as a criterion for timeliness, but in some cases — especially in durable goods markets — a longer period may be used.

iv. "sufficiency" of entry. As noted above, the entry that is "likely" and "timely" must also be of sufficient scale to counteract the loss of competition that would otherwise take place following the merger. One interesting example here occurs in the context of the "differentiated products" industry merger described above: if the merger would combine two firms whose products are the closest substitutes for each other in the market, then any entry that would alleviate the competitive concerns must provide a product that is not only in the market but that is in fact a close substitute to the products of the merging firms.[32]

Entry that is "timely, likely, and sufficient" may cause an otherwise anticompetitive merger not to be challenged either because it is believed that firms in the market following the merger will be able to raise prices for such a short time that consumers will not be significantly harmed or because it is assumed that firms in the market following the merger, seeing the likelihood of entry if they raise prices, will choose not to do so.

3.1.e. Efficiencies

Some would argue that even a merger that would cause a significant harm to competition should be allowed if it can be demonstrated convincingly that the merger would result in efficiencies of even greater magnitude than the welfare losses from the harm to competition. Others would argue that such a

31 Guidelines at 1.11.

32 Guidelines at 3.4.

merger should be allowed only if it can be demonstrated convincingly that these efficiencies would not only result from the merger but would also be passed along to consumers in the form of lower prices or better products (rather than simply enjoyed by producers in the form of higher profits).

> The Supreme Court has never taken either position. The Court stated in 1967 that possible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition.[33]

However, the Guidelines state that as a matter of prosecutorial discretion the agencies may decline to challenge an otherwise anticompetitive merger where it can be shown both that the merger would result in significant efficiencies and that the merger is the only way to achieve the efficiencies.[34]

A special form of efficiencies defense to a merger that would harm competition is the so-called "failing firm" defense. If a firm is losing money and about to go out of business, and if its productive capacity would leave the market as a result, it is difficult to see how consumers would be worse off if the assets were instead purchased by a competitor. On the other hand, just because a firm is losing money and about to go out of business, it does not follow that its productive capacity would leave the market. Thus the agencies (supported by court decisions) require that four conditions be met before declining to challenge an otherwise anticompetitive merger because one of the firms is "failing".[35]

i. The firm will find itself unable to meet its financial obligations in the near future.

ii. The firm would be unable to reorganize successfully under Chapter 11 of the Bankruptcy Act.[36]

iii. The firms have made good-faith but unsuccessful efforts to find alternative purchasers for the assets who would keep the assets in the relevant market and would not result in a reduction in competition to the same degree as the proposed merger partner.

iv. Without the merger, the assets of the failing firm would exit the relevant market.

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33 FTC v. Procter & Gamble Co., 386 U.S. 568, 580 (1967).See also United States v. Philadelphia National Bank, 374 U.S. 321, 370-71 (1963), ABA Antitrust Section (1992), at 319-322.

34 Guidelines at 4.

35 Guidelines at 5.1.36.

36 11 U.S.C. 1101-1174 (1988).

In practice, it is very difficult for merging parties to convince either the agencies or a court that the efficiencies claimed to flow from a merger are of sufficient size and can be measured with sufficient confidence that an otherwise anticompetitive merger should be allowed.[37] The issues involved in a "failing firm" discussion are somewhat more conducive to objective measurement, and this defense therefore has a higher success rate.

4. Monopolization

Section 2 of the Sherman Act states that:

> Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony.[38]

This provision has always provided serious problems of interpretation which are founded upon the conflicting desires of society for, on the one hand, firms to compete as strenuously as possible and, on the other hand, for both consumers and other firms to be protected from the possible abuses of a firm that has competed so strenuously that it has achieved a monopoly position.

Early judicial interpretation of this provision was strict. The leading example is the ALCOA case,[39] in which Judge Learned Hand, once he had established the possession of market power by ALCOA, condemned as monopolistic behavior (or "monopolization") actions that would ordinarily be considered merely aggressive competitive conduct:

> It was not inevitable that [ALCOA] should always anticipate increases in the demand for ingot and be prepared to supply them. Nothing compelled it to keep doubling and redoubling its capacity before others entered the field. It insists that it never excluded competitors; but we can think of no more effective exclusion than progressively to embrace each new opportunity as it opened, and to face every newcomer with new capacity already geared into a great organization, having the advantage of experience, trade connections and the elite of personnel.[40]

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37 For an example of the considerations involved, see Pittman (1990) and the more extensive discussion in Pittman (1988).See also the more general discussions by Fisher (1987, at 36, 38), Schmalensee (1987, at 44), and White (1987, at 18).

38 15 U.S.C. 2 (1988)

39 United States v. Aluminum Company of America 148 F.2d 416 (2d Cir. 1945)

40 .Ibid.

Later courts feared, with good reason, that this interpretation of the Sherman Act would discourage business behavior that society would be better off encouraging, such as cost-cutting innovations and the construction of new productive capacity. The current judicial interpretation of the statutory language is thus significantly narrowed from that of Judge Hand:

> The offense of monopoly under of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.[41]

The challenge remains, of course, to "distinguish" "growth or development as a consequence of a superior product" from "the willful acquisition or maintenance of [monopoly] power". We do not want public policy to discourage businesses from seeking to provide such a good product that they will gain a high market share; or, in Judge Hand's words, "the successful competitor, having been urged to compete, must not be turned upon when he wins."[42] At the same time, we do not want to permit conduct that is clearly exclusionary, that preserves and protects a monopolistic position on the market.

Consider two examples. In the early 1950s there was formed in the United States a joint venture of flower sellers called the Florists' Telegraph Delivery Association, or FTD. FTD was a nationwide network whereby

i. A customer in, say, Washington, who wanted to send flowers to his mother in Atlanta could order and pay for the flowers in a flower shop in Washington;

ii. the flower shop in Washington would send along the order to the national FTD network, keeping a portion of the payment as a service fee;

iii. the national FTD network would send along the order to a flower shop in Atlanta, keeping a portion of the payment as a service fee; and

iv. the flower shop in Atlanta would receive the remainder of the payment and deliver the flowers to the mother of the original customer.

This network provided a valuable service to consumers, clearly increasing consumer welfare as a result.

However, at some point the FTD organization began insisting that flower shops belonging to this network belong to no other such network of shops. This contract provision must have had a substantially harmful effect on competition

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41 United States v. Grinnell Corporation, 384 U.S. 563, 570-71 (1966), emphasis supplied.

42 ALCOA, 148 F.2d at 430.

in the business of providing this nationwide network of flower shop coverage. The provision would make it very difficult for a new network to become organized, because it would not be in the interest of individual shops to leave the first organization until the second was fully structured and operational — and if it was not in the interest of any individual shop to join, then the second network would never become fully structured and operational.

The Justice Department sued FTD, which signed a consent decree agreeing no longer to impose this "exclusivity" requirement upon its members.[43]

A second example involves the issue of "predatory pricing". Predatory pricing may be defined as the situation where a firm with market power lowers its price to a level below its costs in order to drive a rival from the market and then raise its price to the monopoly level. As in the prosecution of other kinds of monopolization cases, the government agency seeking to attack predatory pricing must act carefully lest it discourage innocent, procompetitive behavior as well; in general, after all, we <u>want</u> firms to compete with each other by lowering their prices and so benefiting consumers. The Supreme Court has summarized the dilemma well:

> Cutting prices in order to increase business often is the very essence of competition. Thus, mistaken inferences in cases [of predatory pricing]...are especially costly, because they chill the very conduct the antitrust laws are designed to protect. We must be concerned lest a rule or precedent that authorizes a search for a particular type of undesirable pricing behavior end up by discouraging legitimate price competition.[44]

One important issue in the prosecution and adjudication of predatory pricing cases has been the measurement of costs. Areeda and Turner (1975) suggest that as a theoretical matter, prices should be considered predatory if they are below marginal cost, and that as a practical matter, since marginal costs are difficult to determine with precision, prices could be considered predatory if they are below average variable cost. Some courts have used this test for predatory prices, but others have not, and a scholarly controversy over the appropriateness of the test has raged for many years.[45]

A second issue concerning predatory pricing has been the issue of "recoupment": since costs are difficult to measure, and since we want to

43 U.S. v. Florists' Telegraph Delivery Association, Civ. No. 15748 (E.D. Mich.), Complaint (June 1, 1956) and Final Judgement (June 1, 1956).The suit was brought under section 1 rather then section 2 of the Sherman Act.

44 Matsushita Electric Industrial Company v. Zenith Radio Corporation, 475 U.S. 574, 594 (1986).A good general discussion of the issues surrounding predatory pricing is Myer (19940.

45 For a summary and discussion, see Scherer and Ross (1990), at 468-79.

discourage ungrounded allegations of predatory pricing, courts have increasingly required a demonstration that the structure of the market in question makes it likely that, once the competitor has been driven from the market, the alleged predator could in fact expect to "recoup" its losses by charging monopoly prices. In fact, some courts have been influenced by a call by Joskow and Klevorick (1979) for a "two stage" test for predatory pricing, in which an analysis of the structure of the market, and a finding that the market was indeed one where predation might succeed, would be required <u>before</u> an analysis of prices and costs were in order.

Both issues were important in the monopolization cases brought by the Justice Department against the International Business Machines Corporation (IBM) in 1969.[46] The government charged (among many other charges) that IBM had introduced it 360/90 "super computer" series as a predatory weapon against the model 6600 super computer series of the Control Data Corporation, with the full knowledge that the 360/90 system would be introduced and sold in such a way that revenues would not cover costs. Although IBM vigorously denied this charge — though it did not deny that <u>in fact</u> lost over $100 million on the 360/90 series — I believe that an unbiased reading of the record demonstrates that the charge was correct. [47]

Nevertheless a new government withdrew from the IBM litigation in the middle of the trial, convinced that the case was mistaken. A good portion of the reason for the withdrawal was that the new head of the Antitrust Division, fearful of mistakenly prosecuting procompetitive price cutting as anticompetitive predatory pricing, insisted upon a solid demonstration that both elimination of Control Data as a competitor and later recoupment of its predatory losses was a rational expectation by IBM. When this could not be demonstrated, he chose to withdraw.

5. Discussion and Conclusions

Thus ends a quick tour of competition policy in the United States. What lessons might there be in this hundred years of experience for a country that is beginning its own enforcement experience? I would offer the following three points:

First, a good competition law and strong enforcement are important, even vital components of a policy of economic liberalization. Surely they are not all that is necessary — especially in a small economy the creation and maintenance of the liberalization of foreign trade must count as a vital component as well

46 The case is described in greater detail in Fisher, McGowan, and Greenwood (1983), Pittman and Snapp (1983), and Pittman (1984).

47 Pittman (1984) seeks to demonstrate this.

— but they are, in fact, necessary; without them, customers will not enjoy the full benefits of other liberalizing policies, as firms collude to raise prices, merge to remove competition, or take monopolistic actions to destroy competitors, all without government interference.

Second, as I have noted, competition law enforcement can be somewhat complex. It is important, especially early in a country's enforcement experience, that businesses, other government agencies, and the public understand just what a competition agency is trying to accomplish. In addition, businesses must understand the law if they are to comply with it. Thus a young competition agency, to maximize its effectiveness, should focus on attacking behavior that is most clearly harmful, and most clearly understood to be harmful, to the economy. I would suggest two kinds of cases for early enforcement attention:

a. Agreements among competitors to raise price. Everyone can understand that when the meat producers of Hungary or the cement producers of Slovakia (or the cement producers of Pennsylvania) sit around a smoke-filled room and agree that they will all raise their prices, the public is harmed.[48]

b. Arrangements by dominant firms to entrench their dominant positions by tying up supply or distribution networks, thus making entry into their markets by foreign firms or new domestic firms more difficult.If a firm that already controls the beer market in a country signs contracts with the trucking companies that distribute the beer around the country that these companies will carry no other firm's beer, it is easy to understand how this will help to keep customers from having a choice of other beers.[49]

Finally, if it is to be a successful law enforcement agency, a competition agency must have information to operate. It must be able to demand the information it needs from private firms, and, backed up by the judicial system, it must be able to punish those who refuse to cooperate. A law that does not give these powers to the competition agency will not be a strong law. (Of course, in return, the competition agency must vigorously safeguard the confidentiality of any sensitive business information that it receives.)

One good example of how this works is in the merger control provisions of the United States and European Community competition laws. In both cases, firms above a certain size of assets or annual sales must notify the competition agencies before they may merge with other firms. The laws set a limit on the

48 "Meat Price Cartel", Supreme Court of the Republic of Hungary Kf. I.25.259/1992/14, affirming Office of Economic Competition Vj. 49/1991/9's "Cement Producer Cartel", Slovak Antimonopoly Office, March 30, 1994.

49 "Borsod Brewery Plc.", Hungarian Office of Economic Competition, Vj-52/1992/13

time that these agencies may delay a proposed merger while they analyze its competitive effects. However, the laws provide that the "clock" on this time limit begins to run only when the firms have supplied all the information needed by the agency for its analysis. With this provision, the firms have every incentive to cooperative in providing the agencies with the information that they need. Without this provision — as has been sadly demonstrated in some Eastern European countries — they have every incentive to delay.[50]

A strong competition agency, empowered by a strong law to gather the information it needs and choosing its cases so as to demonstrate a clear and easy-to-understand enforcement policy, can make an important contribution to economic liberalization, and so to the welfare of every citizen.

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