



## Antitrust and Competitive Strategy in the 1990s (Condensed)

As part of his campaign to eliminate intrusive and inefficient government regulations and to promote competition and the “magic of the market,” Ronald Reagan appointed William Baxter, an economist and Stanford University law professor, as his antitrust chief. Within a year of his appointment Baxter had settled two giant cases involving IBM and AT&T, and was being compared in his impact on antitrust precedent to Franklin Roosevelt’s legendary trustbuster, Thurman Arnold. Unlike Arnold, however, Baxter believed that economic efficiency, rather than social and political goals, should be antitrust’s ultimate objective. In expounding this view, Baxter represented a group of legal and economic scholars known as the “Chicago school,” who believed in antitrust enforcement to increase efficiency but not to neutralize the power of companies that held large shares of their markets. Antitrust policy under Baxter reflected the Chicago-school influence, and consequently many situations that had previously attracted antitrust scrutiny were no longer subject to prosecution in the Reagan years.

With the election of George Bush to the presidency in 1988, the Department of Justice’s approach to antitrust changed in subtle ways. During the Bush administration, the DoJ expanded its agenda to challenge the market power of large companies in industries over which Congressional leaders expressed concern, including the airline, health care, and oil industries. The administration also supported a broad interpretation of the antitrust laws with respect to joint manufacturing and research ventures between U.S. firms.

Under Bill Clinton the DoJ’s agenda for antitrust enforcement continued to expand. As the Chicago school lost influence, observers forecasted that challenges to proposed mergers would become more frequent. In an attempt to foster local competition, the DoJ began to scrutinize communications-industry mergers, the exemption of some health insurance companies, and the practices of high-tech firms. However, the Clinton administration also expressed an interest in building an “information superhighway,” signalling some flexibility about acts and practices that would enhance the competitiveness and overall financial health of high-technology industries.

As the antitrust agenda of the DoJ again shifted, managers, analysts, and legal scholars sought to understand the implications for firms’ competitive strategies.

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## Foundations of American Antitrust

Antitrust has its American foundation in the Sherman Act, the Clayton Act, and the Federal Trade Commission Act.

### The Sherman Act of 1890

Called "the Magna Carta of free enterprise" by the Supreme Court, the Sherman Act passed the Senate in 1890 by a 52-1 vote.<sup>1</sup> Section One prohibited contracts, combinations and conspiracies "in restraint of trade," while Section Two outlawed monopolies and attempts to monopolize. The act gave the DoJ enforcement authority and made offenses subject to the criminal penalties of fines and imprisonment.

Early effectiveness of the Sherman Act was limited by timid enforcement and narrow judicial interpretation. The DoJ brought only nine cases during the first five years of the Sherman Act, only 16 in the first 12 years, and only 22 in the first 15 years.<sup>2</sup> This meager record of prosecution, coupled with ambiguity in the scope of antitrust policy and the continued consolidation of firms in many sectors of the American economy, led to pressure for additional antitrust statutes.

### The Clayton Act of 1914

The Clayton Act was designed to prevent monopoly in its incipiency rather than to remedy its effects. To accomplish this goal, Congress authorized antitrust prosecutions whenever business practices "may...substantially lessen competition or tend to create a monopoly in any line of commerce, in any section of the country."

Section Two of the act forbade sellers from discriminating in price – selling goods of like grade and quality to different buyers at different prices – when such differences were neither cost justified nor necessary to "meet competition." This restriction on price discrimination was significantly strengthened in 1936 with the passage of the Robinson-Patman Act. Section Three limited the use of tying and "exclusive dealing" contracts. Tying contracts required purchasers or lessees to acquire a second, separate product in order to obtain the desired product. Exclusive dealing contracts obliged a purchaser or lessee *not* to deal in products of competitors. The prohibition on exclusive dealing prevented manufacturers from requiring exclusive commitments from distributors.

Section Four established the right of private parties injured by violations of the Sherman and Clayton Acts to sue the violators for treble damages (see **Exhibit 3**). Section Five enabled private plaintiffs to use an adverse judgment in a case brought by the Department of Justice as *prima facie* evidence against the defendant; cases settled by consent decree, in contrast, provided no such benefit. The latter provision created an incentive for firms to settle a government suit rather than face the possibility of losing, and then being sued for treble damages by competitors. Section Seven of the act prohibited anti-competitive mergers among competitors.<sup>3</sup>

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<sup>1</sup> *United States v. Topco Associates, Inc.*, 405 U.S. 596, 610 (1972).

<sup>2</sup> Richard Posner, "A Statistical Study of Antitrust Enforcement," *Journal of Law and Economics*, v. 13 (October 1970), p. 366.

<sup>3</sup> Section Seven was revised to apply to acquisition of assets and the use of stock in addition to the previously covered acquisition of stock. These amendments, known as the Celler-Kefauver Act, were enacted in 1950.

## The Federal Trade Commission Act of 1914

Passed at the same time as the Clayton Act, the Federal Trade Commission Act contained only one substantive antitrust section. As later amended, Section Five outlawed "unfair methods of competition" and "unfair and deceptive acts or practices." By process of judicial interpretation, Section Five came to include virtually all offenses outlawed by the other antitrust statutes. The real purpose of the act was to establish an expert administrative body, the Federal Trade Commission (FTC), to determine which methods of competition were unfair and to enforce the law.

Together, the three antitrust acts provided legal tools to fight what influential Supreme Court Justice Louis D. Brandeis called "the curse of bigness." Brandeis and others believed that antitrust policy should be used to moderate the power of large firms and to maximize the number of individual companies competing in the marketplace. In the landmark *Alcoa* case (1945), the Court ruled that because Alcoa had obtained a 90 percent share of the relevant aluminum ingot market, its efforts to secure ore reserves, electric power sources, and production capacity in advance of demand could be considered an unlawful attempt to maintain a monopoly:

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. [Alcoa] 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.<sup>4</sup>

## Enforcement

Despite the hopes of its sponsors, the Federal Trade Commission never achieved the status of an unchallenged arbiter of the nation's antitrust laws. Instead, responsibility for developing and enforcing antitrust policy was shared by the FTC, the Antitrust Division of the DoJ, and the courts.<sup>5</sup>

### The Federal Trade Commission

The FTC was an independent regulatory agency empowered with virtually the same civil jurisdiction as the DoJ. It had no authority to bring criminal charges. Cases heard and decided by the FTC could be appealed to the courts, and Congress could use a "legislative veto" to overturn FTC rulings.<sup>6</sup>

The FTC used two approaches to select cases: a "reactive" and an "investigative" approach. Under the former, the FTC relied on the "mailbag" – corporate and individual complaints received by the Commission's Bureau of Competition. Under the latter, the Bureau of Competition assumed

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<sup>4</sup> *United States v. Aluminum Company of America*, 148 F. 2d 416, 431 (2d Cir. 1945).

<sup>5</sup> In addition to the federal statutes and enforcement agencies, most states had some form of antitrust laws. Because most of the state laws were similar to the federal statutes, conduct that violated federal laws would most likely violate state laws and result in supplemental fines and jail sentences. Many state attorneys general actively enforced their laws and entered suits under federal statutes for treble damages on behalf of state agencies and individuals.

<sup>6</sup> The source of much of the data in this section is Robert A. Katzman, "Federal Trade Commission," James Q. Wilson ed., *The Politics of Regulation* (New York: Basic Books, 1980) and Katzman, *Regulatory Bureaucracy: The Federal Trade Commission and Antitrust Policy* (Cambridge: MIT Press, 1980).

the initiative to attack abuses in those sectors of the economy it believed were most negatively impacted by market power.

As a result of a trend toward the investigative approach, the Commission's resources were devoted increasingly to the pursuit of *structural* cases aimed at correcting market imperfections. This was in contrast to an approach that sought to punish companies for specific actions held to be in violation of the law (so-called *conduct* cases). Structural cases typically involved steps to alter the broad economic forces that encouraged consolidation within an industry. As the emphasis turned to structural cases, economists and not lawyers became the most influential FTC policy-makers. The shift also brought a decline in price discrimination suits, cases which usually had the effect of maintaining small, inefficient businesses.

In contrast to the economists, the roughly 200 attorneys in the FTC's Bureau of Competition tended to prefer to bring conduct cases, including those involving price discrimination issues, because these cases provided trial experience to attorneys who often stayed with the FTC for only a few years. Conduct cases also tended to be resolved more quickly than did structural ones. On one major structural case directed against the major oil companies, some forty attorneys were assigned during the first three years of investigation. Of the original staff, only one remained on the case at the end of the three years — with the resolution of the case nowhere in sight.<sup>7</sup>

### Department of Justice, Antitrust Division

The Assistant Attorney General for Antitrust, a presidential appointee, ran the Antitrust Division of the DoJ. "Prosecution-mindedness" had characterized the Division since at least the time of Thurman Arnold, and "winning cases" was important to Division attorneys. Since World War II, the Division's won/loss record exceeded 80%. When the Division thought the evidence was sufficiently persuasive, it brought criminal charges.<sup>8</sup> The Division also entered into negotiations with businesses to end litigation in exchange for consent decrees in civil cases, or *nolo contendere* (no-contest) pleas in criminal cases. Because the Division only brought charges when it had put together a very strong case, a high percentage of civil suits ended in consent judgments.

### Private Antitrust Suits

Another pattern in antitrust litigation was the growth in private antitrust actions. Both in terms of absolute number of cases filed and rate of growth, private antitrust litigation far outdistanced government-initiated suits from the end of World War II to 1980. Of 1,486 civil cases filed in federal courts in 1980, fewer than 3% were brought by the government.

## Applying Antitrust Law

Since virtually all contracts restricted competition to some extent, drawing the line between legal and illegal business arrangements was difficult, particularly given the breadth and ambiguity of the antitrust statutes. To simplify matters, judicial precedent had established a distinction between *per se* violation cases — cases involving infractions of the law for which there was no excuse — and *rule-of-reason* cases, where surrounding circumstances could excuse anti-competitive behavior.

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<sup>7</sup> Katzman, "Federal Trade Commission," p. 154.

<sup>8</sup> For a criminal violation under the Sherman Act, a company could be fined up to \$1 million, and an executive could be fined up to \$100,000 and sentenced to prison for up to three years.

Practices that were considered illegal *per se* typically involved direct anti-competitive conduct by firms in the same industry. For example, horizontal agreements to fix prices were considered a clear *per se* violation of the law.<sup>9</sup> Other practices subjected to a *per se* standard included horizontal allocations of production, territories, and customers; horizontal group boycotts or refusals to deal; some tying arrangements; and resale price maintenance. Resale price maintenance, also known as vertical price fixing, occurred when manufacturers dictated the prices retailers charged for their manufactures.

In contrast to the *per se* standard, the *rule-of-reason* approach required the courts to consider the factors that surrounded the competitive practice in question. If pro-competitive aspects outweighed the anti-competitive results, the behavior was judged to be legal. The Supreme Court defined the *rule-of-reason* test as follows:

The legality of an agreement or regulation cannot be determined by so simple a test as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint, and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse, but because knowledge of intent may help the court to interpret facts and to predict consequences.<sup>10</sup>

The ambiguity inherent in the *rule-of-reason* test had resulted in considerable uncertainty through the years over which competitive strategies were legal and which illegal. It had also preserved for defendants an opportunity to argue that their behavior did not constitute an unreasonable restraint of trade. No such argument was possible for conduct challenged under the *per se* test.

Interpretation of antitrust law and the intensity with which administrations pursued enforcement varied over the years. Under Reagan, major pending cases were dismissed and few new cases were filed. In contrast, President Clinton's new Assistant Attorney General, Anne Bingaman, took a much stronger stance on antitrust enforcement. Bingaman eliminated Reagan-era guidelines that had made it easier for manufacturers to fix prices with distributors. In April 1992, the DoJ and the Federal Trade Commission jointly issued new Merger Enforcement Guidelines that were widely considered to be more stringent. The guidelines indicated that the DoJ would closely examine proposed mergers that would strengthen the market shares of leading firms.

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<sup>9</sup> In the case of horizontal price setting, the courts did not trouble themselves to establish whether such strategies unreasonably restrained trade, but only whether the agreement in fact existed. When the evidence established the presence of such agreements, defendants were convicted of antitrust violations and subjected to the penalties contained in the law.

<sup>10</sup> *Northern Pacific Railway v. United States*, 356 U.S. 1, 5 (1958).

## Antitrust and Competitive Strategy

Managers sought to understand the impact of these changing policies on their competitive strategies.

**Pricing** Two major areas of pricing strategy had been carefully scrutinized under the antitrust laws: price fixing and predatory pricing. Price fixing occurred when a firm or group of firms adhered to an agreement on price levels. Such an agreement was *per se* illegal under Section 1 of the Sherman Act. Predatory pricing had been defined by some courts as pricing below marginal cost, and by others as pricing below average variable cost. Most cases focused on average variable cost because the more conservative measure was considered unlikely to penalize a more efficient company.

**Signalling** Under the doctrine of "conscious parallelism" the courts had held that some behavior, such as follow-the-leader price announcements or identical shifts in contract or credit terms, could constitute circumstantial evidence of a tacit agreement. The doctrine had been used to show that an implied agreement could be reached solely through signals given by competitors. However, something more than consciously parallel conduct was generally necessary to prove a violation of the law ("conscious parallelism plus").

**Capacity expansion and entry** Section Two of the Sherman Act, which prohibited the "attempt to monopolize," was the basis of prohibitions on capacity expansion and entry for firms with very large market shares. Two critical questions were asked in every Section Two action. First, does a firm actually possess monopoly power? This question required the court to define the *relevant* market. Second, if a defendant did possess monopoly power, was such power unfairly acquired, or did it result from superior performance, foresight, or skills?

Major Section Two monopoly cases occurred infrequently in large part because of the difficulty of proving the existence of a monopoly under the relevant case law. In the *Alcoa* case, for example, the court concluded that the defendant's 90% share of the relevant market did constitute a monopoly, but it also suggested that market shares ranging from 33% to 64% under alternative definitions of the relevant market would have been insufficient to establish a monopoly. During the 1970s the FTC charged that the four major manufacturers of ready-to-eat breakfast foods had maintained a "shared monopoly" through restrictive retail shelf-space tactics, the proliferation of brands and trademark promotion, the artificial differentiation of products, unfair methods in product promotions and advertising, and the acquisition of companies. The Commission pursued the case unsuccessfully for nearly a decade.

**Mergers with "failing firms"** In certain limited circumstances, horizontal mergers that would otherwise be considered unlawful were allowed under the "failing firm" defense. The doctrine required that the acquired company be failing, with its resources so depleted that there was no prospect of rehabilitation and hence no threat to competition.

**Coalitions** The courts had allowed joint ventures when firms could establish that it was necessary to combine financial or technical resources to meet competition and that the coalition would not eliminate any significant competition among the participants. The Reagan Administration's approval of a 12-year agreement between General Motors and Toyota – the first and third largest automobile producers in North America – to share manufacturing and marketing tasks in the production of compact cars at GM's Fremont, California plant had cleared the way for an expansion of joint ventures.

**Licensing** The DoJ and FTC's "Antitrust Guidelines for the Licensing of Intellectual Property" (1995) addressed three types of licensing: patent, copyright, and trade secret law. Patents protected an invention from both imitation and independent creation. A copyright protected only

the expression, not the underlying ideas, so it did not preclude others from independently creating similar expression. Trade secret protection applied to information whose economic value depended on secrecy.

Licensing agreements came in many different varieties, and the law was complex, but the following guidelines generally applied:

- The DoJ and the FTC approached the issues of relevant market and market share in the intellectual property area in the same way that it treated such questions under Section 1 of the 1992 Horizontal Merger Guidelines: they identified firms in the relevant market and analyzed market concentration.
- In the “vast majority” of cases, restraints in intellectual property licensing arrangements were evaluated under the *rule-of-reason* approach.<sup>11</sup>
- In some cases, however, the courts concluded that a restraint's “nature and necessary effect [were] so plainly anticompetitive” that it should be treated as unlawful *per se*, without an elaborate inquiry into the restraint's purpose and effect.<sup>12</sup> *Per se* violations included price-fixing, output restraints, market division among horizontal competitors, some group boycotts, and resale price maintenance.<sup>13</sup>
- Licensing provisions that prohibited licensees from dealing with suppliers of substitute technologies were examined under the *rule-of-reason* approach.<sup>14</sup>
- Any requirement that certain products be purchased in order to obtain a license—a tying arrangement—was examined under the *rule-of-reason* approach. The Agencies were most likely to challenge a tying arrangement if: “(1) the seller has market power in the tying product, (2) the arrangement has an adverse effect on competition in the relevant market for the tied product, and (3) [the anticompetitive effects for the arrangements outweighed the efficiency justifications].”<sup>15</sup>
- The DoJ would not challenge a restraint in a licensing agreement if (1) the restraint was not a *per se* violation (“facially anticompetitive”), and (2) the licensor and its licensees collectively accounted for no more than 20% of each relevant market affected by the restraint. This “safety zone” was designed to provide owners of intellectual property a degree of certainty to engage in pro-competitive licensing agreements.<sup>16</sup>

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<sup>11</sup> U.S. Department of Justice and Federal Trade Commission, “Antitrust Guidelines for the Licensing of Intellectual Property” (“Antitrust Guidelines”), April 6, 1995, Section 3.4.

<sup>12</sup> *National Society of Professional Engineers v. United States*, 435 U.S. 679, 692 (1978).

<sup>13</sup> “Antitrust Guidelines,” Section 3.4.

<sup>14</sup> *Ibid.*, Section 4.1.2.

<sup>15</sup> *Ibid.*, Section 5.3.

<sup>16</sup> *Ibid.*, Section 4.3.