Economics in Antitrust Policy:
Freedom to Compete vs. Freedom to Contract

by

Mark Steiner

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ISBN: 1-58112- 370-1
13-ISBN: 978-1-58112-370-8

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Economics in Antitrust Policy

Freedom to Contract v. Freedom to Compete

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Die Wirtschaftswissenschaftliche Fakultaet der Universitaet Zuerich gestattet hierdurch die Drucklegung der vorliegenden Dissertation, ohne damit zu den darin ausgesprochenen Anschauungen Stellung zu nehmen.

Zürich, den 31. Juli 2007

Der Dekan: Prof. Dr. H. P. Wehrli

Preface

Luxembourg, Summer 2002: I am surrounded by law students discussing the intensity of competition, market prices and what consequences anti-competitive agreements could have on them. But whenever I speak of competition – using economic ideas, numbers and terms – the law students and Professors have difficulties understanding me. Recognizing this lack of interdisciplinary knowledge important for competition policy (for both the economics and legal side), Professor Zaech – even though often critical towards 'too much' economic analysis – encouraged me to work as his Assistant and start my research at his chair for law. Being an economist at the Law Faculty for three years, I experienced the different approaches of law scholars and economics scholars towards antitrust policy first hand. I saw how both sides often wouldn't understand one another because they failed to learn more about the respective frameworks of thought and analysis. Intrigued by the challenge of shedding some new and critical light on the most controversial issues between legal and economic scholars, I started working on this interdisciplinary thesis on the role and the effects of economics in antitrust. Thanks to the support of Professor Frey, whom I owe much of my interest in the economic analysis of non-market activities, I received approval for my doctoral proposal in Law & Economics by the economics faculty.

I owe my gratitude to Professors Zaech and Frey for making this dissertation possible by inspiring and supporting me as faculty advisors. Among many other colleagues of the University of Zurich, I want to thank Laura Paez and Felix Schraner for their helpful and critical feedback during preparing and writing this thesis. Furthermore, special thanks go to Elaine Tan of the University of Royal Holloway in London, who contributed much by developing and discussing some major ideas for this work with me. My thanks also go to the other fellows and the members of the American Institute for Economic Research who gave me valuable inputs and critical feedback during countless discussions. Furthermore, I am grateful to AIER and the Progress Foundation in Switzerland for their financial support, which played a major part in making this dissertation possible. Last but not least, I give my special thanks to my mother and my family for their moral and financial support which enabled me to go through the PhD program successfully and write this dissertation.

Pfaeffikon, July 31st 2007

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"People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."

"The interest of dealers, however, in any particular branch of trade or manufacturers, is always in some respects different from, and even opposite to, that of the public. […] To widen the market may frequently be agreeable enough to the interest of the public; but to narrow the competition must always be against it, […]."

Adam Smith, the Wealth of Nations (1776)

"A limitation of competition, however partial, may have mischievous effects quite disproportioned to the apparent cause."

John Stuart Mill, Principles of Political Economy (1848)

"The case for a free system is not that any given system will work satisfactorily where coercion is confined by general rules, but that under it such rules can be given a form that will enable it to work. If there is to be an efficient adjustment of the different activities in the market, certain minimum requirements must be met; the more important of these are, […], the prevention of violence and fraud, the protection of property and the enforcement of contracts, and the recognition of equal rights of all individuals to produce in whatever quantities and sell at whatever prices they choose."

Friedrich Hayek, The Constitution of Liberty (1960)

1 Introduction

Economic freedom – an individual's ability to participate in the economy with minimal outside interference – is one fundamental aspect of liberty. It consists mainly of the freedoms to contract and compete. The freedom of contract, or individual autonomy to enter into agreements, has been a key to the foundation of economic development. It ensures, together with private property rights, that assets are transferred to the party which utilizes them best. Indeed, Nobel laureate Douglass North has highlighted the importance of the freedom to exchange property rights in explaining the rise of western economic power. The freedom to compete on the other side results from the absence of non-market obstacles which prevent firms and entrepreneurs from entering, staying, or participating in the markets they choose to buy or sell quantities at prices of their choice. This liberty is crucial in ensuring a free market where producers and consumers can enter and exit without hindrance or coercion exercised by other parties, and one in which competition and the profit motive can bring the greatest social good as envisioned by Adam Smith.

In the field of antitrust however, the freedoms to contract and compete can and do contradict. Profit-maximizing companies desire perfectly competitive input markets to minimize their costs, but want monopolistic markets for their outputs to maximize their profits. Consequently, they have strong incentives to undermine competition in their output markets. In a world without competition laws, many companies would thus eliminate competition by using their freedom to contract, either by entering into legally enforceable agreements which fix prices or divide up markets, or by merging and acquiring rivals to gain market control. Such agreements directly interfere with other firms' liberty to compete. In other words, guaranteeing and safeguarding the companies' abilities to compete comes at the cost of restricting their freedoms to contract. And even though these anti-competitive practices may sometimes fail, the ubiquity of cartels and other anti-competitive measures throughout history suggests that a limited form of government intervention is necessary; both to constrain this detrimental aspect of free contracting and protect the freedom to compete. The state is needed to define and enforce the rule of law and thus, set the rules necessary for markets governed by competition. Its role in antitrust is a delicate one though: Government intervention itself necessarily limits the economic freedom of individuals and firms, and limiting the freedom of contract has potentially detrimental effects on economic activity as well. Hence, antitrust policy must find the right balance between the two freedoms of competition and contract, allowing competition to flourish while upholding the contractual freedoms necessary for a functioning market. Antitrust policies used to define this balance by providing clear-cut rules of conduct for rival entrepreneurs and firms. Within those rules, rivals were free to compete with all actions they deemed necessary to succeed. In some instances though, these rules would forbid conduct that could have created beneficial effects for the public, and economics delivered the tools to analyze situations in which that was the case. This application of economics to antitrust rendered policy recommendations which helped improving antitrust policy. The capacity of economic analysis to balance the competitive effects caused by the conflicting freedoms to contract and compete in possibly every case further extended the influence of economics in antitrust. Normative economic analysis could provide measurable dimensions for 'competition' through measures like efficiency and welfare. With these economic tools, antitrust policy would not be constrained to an 'indirect' mechanism providing and enforcing a strict framework of negative rules within which the competitive process could take place and in turn lead to the maximization of welfare. Economics would allow for a policy directly aiming at promoting welfare by 'balancing' the welfare effects of individual business practices, permitting contracts with benign effects and prohibiting contracts with detrimental effects on welfare in potentially every case.

However desirable such a system directly aiming at the maximization of social welfare might seem, it suffers from inherent deficiencies. Indeed, putting a government agency in charge of evaluating past market outcomes or forecasting future market outcomes should raise concerns. Even the best economic tools are not capable of forecasting outcomes in competitive markets with certainty, and a system based on such tools can lead to considerable problems. A critical review of the current antitrust policies in the Unites States and the European Union, both relying on such a system, will expose the caused problems and their negative effects. Furthermore, identifying and analyzing the problems offers insights for solutions and recommendations for better policy alternatives.

I will begin by depicting the historical development of laws specifically aiming at balancing limitations between the freedoms to contract and compete. Section two starts by explaining the need for such legislation and the corresponding institutions protecting competition on theoretical and historical grounds. The second part of the Section then portrays the development of specific antitrust or competition laws in the common law countries and in continental Europe up to the point where economic analysis started playing a major role. Before turning to the growing influx of economics into antitrust during the last semi-century, Section three describes some basic economic theories influencing competition. The influence of different economic ideas has inspired various concepts of competition, each of them rendering different and often opposing policy recommendations. Section four is concerned with the past developments in antitrust, beginning with the first important incorporation of economic analysis into policy in the 1950's and 1960's. It displays the continuous adoption of new economic concepts and tools into competition policy, and the corresponding depreciation of strict per se rules. The problematic consequences of the leading role economic analysis has become to play in the current antitrust policies on both sides of the Atlantic will be put forth in the three parts of Section five. The first part deals with the growing legal uncertainty due to ambiguous conclusions drawn from different economic theories and models, which also led to an increasing scope for intervention by authorities. It will be illustrated that especially the ambiguous economics of merger review and vertical restraints have caused considerable legal uncertainty for businesses. The second part explains the rent seeking incentives created through the application of economic analysis and efficiency defenses in antitrust policy. The resulting dissipation of resources into rent seeking activities probably causes significant costs, and although they are hardly measurable, some rough estimates from litigation and practice are given. The third and final part of Section five depicts the increasing growth in the budgets of antitrust and competition authorities in the U.S. and the EU. The statistical data of both policy areas prove how the extensive focus on economic analysis and the described problems have led to a surge in per case administrative enforcement costs. The following Section six presents some possible policy alternatives to correct the problems caused by the current system. Drawing from institutional economics and the review of the empirical literature on legal uncertainty, economic freedom and economic growth, I make the case for protecting competition through clear per se prohibitions based on generalizable rules. Based on these grounds and further empirical evidence, I finalize with concrete policy recommendations for merger review and contracts in restraint of competition. At last, Section seven closes with some concluding thoughts.

2 The Historic Development of Antitrust

2.1 The Freedom of Economic Activity and the Market

When the great economic classics, in the midst of them Adam Smith, discovered the market process and scientifically described it, there existed no United States of America, and the French Revolution had not taken place yet. But the ideas of freedom that were to lead to the fight for independence in North America and the Revolution in France were in the heads of the scholars and inspired them to discover and develop new theories. During the following 18th century, the discovery of the market order, the idea that prices determined on a free market could coordinate a whole nation's economy, fell on fertile grounds among the many leaders of the idea of freedom. The newly discovered market order had a major connection with the idea of freedom: It could present solutions for taking away the responsibility of the government to control individual people's incentives and actions in order to make them do what's best for society. In a system guided through the market process, individuals would be self-regulated to coordinate their efforts automatically to the benefit of the society as a whole. The remaining task for the government would be to protect the conditions under which this market could work satisfactory.[1] Thus, government only needed to protect these conditions by providing the institutions which enacted and enforced the necessary laws. This allowed reducing previously god-given Kings and Reigns almighty functions of government – to the liking of many people in the times of the French Revolution – to a helping hand. Everything else, the control of the economy, the stimulation or motivation of individuals to be productive, or the control of individuals' actions would be guided by the market process. Hence, the government's circle of competencies was cut rigorously, the unity of government power was split into three separate powers constraining one another, and the political power was given to the individuals, making them the new 'sovereign' of a nation.

Such a functioning market economy is governed by market prices, signals which result from individuals' evaluations of values for goods and transactions. Every individual and every entrepreneur searches for his or her best price-cost-combination based on indi-

1 Eucken (1952), pp. 242 et seq.

vidual preferences. Private individuals as well as businesses will be able to understand those signals and act accordingly. Given the limitedness of resources, the price system replaces many of the necessary mechanisms for sanctions and rewards previously provided by absolute governments. The market will automatically direct individuals' actions in a way that allows private profits to be made from socially beneficial – or correct – actions, and private losses will be suffered by those who engage in socially wasteful transactions.[2]

When the classical economist described that market order they did not bother to specify the details of the institutional frameworks used in their writings, they simply took them for granted. Considering themselves in the service of their time and their countries, they reasoned in terms of the institutions they were surrounded by. What most of the famous English 'classics' had in mind stands out clearly: They envisaged the legal institutions of a private-property economy that left so much room for free contracting that they almost left limitations to that freedom outside of their economic analyses. Indeed, English economists always reasoned with reference to the actual extent and sphere the English law and administrative practice left for private decision makers; and to the fact that they were subject to prevailing moral habits.[3] This reflects that even these early economists were well aware of the need for institutions which provided and maintained the conditions enabling a functioning market for a whole economic system. The history of different institutional settings confirms that both legal institutions and these 'prevailing moral habits', reflected through other e.g. social, political or ethical institutional conditions have a decisive impact on the performance of an economy and the prosperity of a civilization.[4] The performance and the outcome of markets however, as much as they are influenced by these other intuitional conditions, are determined to an important part by the framework of laws protecting market exchanges and the corresponding enforcement regime.[5] And even though this part of the whole institutional framework might not be a sufficient condition for a successfully functioning market, it clearly is a necessary condition. Hence providing the appropriate laws and enforcement mechanisms creating the institutions which allow and facilitate market exchanges is a central task for a government if it wants the market process to function, thrive and provide its participants with prosperity and wealth.

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2 Boehm (1980), p. 199.

3 Schumpeter (1954), p. 545.

4 See e.g. Rosenberg, Birdzell (1986); North (1990), pp. 107 et seqq.

5 See Rubin (2005).

2.2 Competition and its Restriction

Maybe the most important result of establishing a functioning market is that it can allow competition to guide the market process. The virtues of competition on a market are endless: It allows customers to select between alternatives; forces businesses to regard and serve their customers' wishes in the best possible way, while at the same time keeping the prices as low as possible; it leads firms and entrepreneurs to innovate, research new ways to produce or provide services, develop new technologies and better products; and many other merits could be added. The competitive process of continuously searching for new innovations, more efficient ways to produce or distribute, or improve product quality to deliver more value to customers is exhausting for firms and entrepreneurs. This gives them incentives to circumvent this straining process by asking for government protection or, if that is not available, restrain the competitive process by colluding or merging with competitors. An even more important incentive to restrict competition stems from a market force itself: Every successful entrepreneur's goal must be to his maximize profits. As a result, he would prefer perfectly competitive input markets while enjoying a monopoly for his outputs. Adam Smith already recognized theses incentives and their detrimental consequences for the welfare of a society:

> "The interest of dealers, however, in any particular branch of trade or manufacturers, is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition is always the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public; but to narrow the competition must always be against it, […]."[6]

Driven by these incentives, competition will not just 'happen', but firms must be 'forced' to compete through institutional settings which counteract their incentives to restrict competition.

The resulting problem was addressed by the classical economists only in very limited ways, for they took competition as and institutional assumption rather than the result of certain given conditions. Most of them neither defined what competition constituted in

[6] Smith (1776, 2003), p. 339.

their writings nor analyzed the logical content of competition.[7] In the minds of most of these classical economists, competition merely meant the absence of monopoly and of public price fixing, which both were rigorously condemned.[8] However, not just Smith, but also Mill was aware of the problematic incentives that could lead to restrictions of competition, when he emphasized that competition often fell short of the maximum. In this case, he went further than Smith and advocated for a general correction to be applied to cooperative price setting and other practices which could only, like monopoly, be deviations from normal practice because they were conspiracies against public welfare.[9] Combining this postulate for preventing monopoly and price fixing with the assumptions that nearly all contracts should enjoy legal protection stresses the conflict of weighting the benefits of the unlimited freedom of contract against its possible detrimental effects when it was used to eliminate competition.

The essential conflict for this work thus exists among providing and enforcing the legal framework that secures two of the necessary conditions for a functioning and competitive market. Those are 'the enforcement of contracts, and the protection of individual rights to produce whatever quantities and sell at whatever prices actors choose.'[10] The caveat is that the freedom of contract can be used to limit or violate the rights of freely choosing prices and locations for selling or buying products and services. Certain contractual obligations, if upheld by Courts, impede the freedom to compete, hence harming or restricting competition and derogating or even eliminating the benefits of the competitive process. Obvious and well-known examples are contracts fixing prices and quantities between rival firms which take away the individual firms' or entrepreneurs' freedoms to produce quantities of their choice and set prices accordingly. In much the same way, a paramount freedom of contract allows a firm to acquire its rival's shares from stockholders, in the extreme case even creating a monopoly. Given such contracts are upheld by Courts, they both deprive involved and other firms of their freedoms to compete. Hence, this conflict between the freedom of contract and the freedom to compete must be solved

7 The exception was Antoine-Augustine Cournot, he was the first one to thoroughly define a concept of competition and introduce it into a mathematical framework; see Cournot (1838, 1929).

8 Schumpeter (1954), pp. 547 et seq.

9 See Mill (1848, 2004), pp. 247 et seqq.

10 Hayek (1960), p. 229.

in a matter that allows competition to flourish, while at the same time upholding contractual rights necessary for a functioning market.

The importance for research providing solutions for this conflict was addressed by Hayek in his article 'The Meaning of Competition'. On the development of contractual freedoms and the corresponding legislation and jurisdiction on cartels, monopoly, and the restraint of trade in general, he noted:

> "[…] the precise content of the permanent legal framework, the rules of civil law, are of greatest importance for the way in which a competitive market will operate. […] It seems to me that no doubt is possible that this development [in law], even where it fully maintained the principle of "freedom of contract", and partly because it did so, has greatly contributed to the decline of competition. But little intellectual effort has been directed to the question in what way this legal framework should be modified to make competition more effective."[11]

Following Hayek's statement in 1948, there has been an enormous development on the subjects of what legal framework, which antitrust law and which interpretations of these laws will improve or distort competition. Massive research by scholars of law as well as economics into antitrust and competition policy was conducted to provide answers for the problems resulting form the conflicts between the two freedoms. Before turning to these recent developments in which economics began to play a major role, a brief history of how the relevant antitrust laws in different countries were conjured and introduced will be given in the subsequent parts.

2.3 A Brief History of Antitrust

Specific antitrust or competition laws did not exist for long, only few countries created laws explicitly dealing with business practices eliminating or restricting competition before the 20th century. However, the depicted conflict between the enforcement of the freedom of contract against protecting the individuals' or firms' freedom to compete existed much longer. The balance between the two has historically been in favor of the former. In English case law, protection of agreements to fix prices or divide up markets

[11] Hayek (1948), pp. 115 et seq.

was maintained in most cases until it was recognized that most of them are against the public interest in 1894. In the United States, the Sherman Act passed in 1890 overturned the common law tradition of protecting restrictive agreements by outlawing contracts that hindered the freedom of exchange. In continental Europe, many states enforced cartel agreements in Courts and, in some instances, cartel membership was made compulsory. Powerful monopolies were not just tolerated but often facilitated by governments to create 'national champions' in key sectors. Fueled by the fear of powerful cartels and monopolies that existed before and during World War II, the establishment of the European Communities has lead most European countries to create specific laws giving the freedom to compete more weight against the previously dominant freedom to contract.

What follows is a brief historical overview of the developments in law and in Courts concerning the conflicting freedoms to contract and compete in England, the U.S., Germany and the European Communities. It will illustrate how legislators recognized the importance of competition and developed legal frameworks to protect it from restrictions.

2.3.1 English Common Law

It is a common misconception that English law has always protected free competition.[12] Prior to the late eighteenth and nineteenth centuries, when parliament passed laws to liberalize market activities, common law and royal statutes were harmful to free trade, often protecting or even creating restrictive practices and monopolies by Regulation. Four lines of earlier law have played some part in shaping what would be called antitrust policy today: Case law on the enforcement of contracts in restraint of trade, prohibitions against 'interference with markets', the application of the law of criminal conspiracy to combinations in restraint of trade, and the common law of monopoly.[13] Although the latter three had a limited influence for what is called antitrust policy today, the case law on the enforcement of contracts in restraint of trade was by far the most important. According to *Mitchel* v. *Reynolds* (1711), the doctrine for treating restraints of trade was defined as follows: covenants not to compete may be justified if reasonable and ancillary to some prin-

12 Letwin (1965), pp. 18 et seq.

13 For a more extensive overview of the common law evolution in these four areas see Letwin (1965), pp. 18 et seqq.

cipal legitimate transaction and if limited in time and space.[14] Because it required an assessment of the 'reasonableness' of certain contractual clauses, it is sometimes referred to as the first rule of reason.[15] The Courts' application of that restraint of trade doctrine was influenced by two ideologies: On one hand, liberal contract law meant that the Courts upheld all contracts freely entered into, even the ones restraining trade. On the other hand, when trade restraints hindered the right of an individual to work, or imposed costs on the public, Courts refused to compel parties to honor their collusive agreements. The conflicting results are best illustrated by looking at developments in Britain during the 19th century. For most of that century, Britain came close to many textbook conditions for free competition. The market-places were jostling with suppliers competing with importers on one side and competing for exports throughout the world allowed by a reign of free trade on the other side. In that environment, the *Mitchel* v. *Reynolds* doctrine was mostly used in cases involving professionals and their associations. Examples include masters or journeymen who sought to exclude unapprenticed workmen from their trade, or anti-competitive clauses in contracts of service or the sale of business.[16] While the Courts protected the rights of the individuals to compete in some of these cases, they showed little willingness to treat market-sharing arrangements between traders or manufacturing businesses as anything other than enforceable contracts. There might be a restraint of trade, but, as stated in an 1875 case:

> "[…] you are not to extend arbitrarily those rules which say that a given contract is void as being against public policy, because if there is one thing more that another against public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice."[17]

The judges viewed the freedom of contract as the paramount principle in serving the public even when it might create some negative effects. Courts thus upheld agreements to fix prices and divide up the markets in coach-making, box manufacturing, docking and build-

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14 See *Mitchel v. Reynolds* (1711), 1 Peere Williams' Reports 181; 24 English Reports 347.

15 Hylton (2003), p. 33.

16 Cornish, Clark (1989), p. 268.

17 *Printing and Numerical Registering v. Sampson* (1875); 19 Law Reports Equity 462, at 455.

ing industries, because the judges took the opinion that the law was not a means to promote competition.[18] The state also repealed restrictions on cartels, such as those prohibiting collusion among coal producers in 1836, because it permitted labor unions to organize workers and could not deny employers and firms the same right.

The notion that trade restraints might have severely harmful effects for the public slowly gathered more importance towards the end of the century and became decisive in the groundbreaking *Nordenfelt* case in 1894. The judgment established a precedent that would clearly outlaw all anti-competitive practices. In it, Lord McNaghten argued that

> "The public have an interest in every person's carrying on his trade freely: so has the individual. All interference with individual liberty of action in trading, and all restraints of trade of themselves, if there is nothing more, are contrary to public policy, and therefore void. That is the general rule. But there are exceptions: restraints of trade and interference with individual liberty of action may be justified by the special circumstances of a particular case. It is a sufficient justification, and indeed it is the only justification, if the restriction is reasonable, reasonable, that is, in reference to the interests of the parties concerned, and reasonable in reference to the interests of the public, so framed and so guarded as to afford adequate protection to the party in whose favor it is imposed, while at the same time *it is in no way injurious to the public*."[19]

In other words, individuals' freedom to trade in free markets necessarily comes before their freedom to contract, if the latter interferes with the former, and if the public suffers as a consequence. The *Nordenfelt* rule would be applied severely in order to guarantee an individual's right to take his labor where he chose. However, when it came to mutual restraints on business competition, horizontally between manufacturers or vertically down the distribution chain that were burgeoning at the time, the rule was applied with much less rigor. Since nothing had deprived the involved businesses of their freedom to enter the restrictive contract in the first place, there was a heavy burden in showing that nevertheless it was against public interest. War conditions, however, produced sudden demands

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18 Cornish, Clark (1989), p. 270.

19 *Nordenfelt v. Maxim Nordenfelt Guns & Ammunition Co.*, 6 English Ruling Cases 413, at 565 (italics added).

and unexpected scarcities which created immense opportunities for profiteering. That changed the perceptions of the public, politicians and even Courts considerably. During the war and the short post-war boom, Courts considered the freedom to compete paramount and would not uphold contracts for pooling associations fixing prices and quantities or even exclusive dealing clauses. With the collapse of the boom and the long slump during the 1920's, the Courts reverted to their old line, in many instances not even considering public interest.[20] It was only after World War II, when the Monopolies and Restrictive Practices Act of 1948 established the Competition Commission, when the first step for a law that actively promoted competition was made. The Commission, still referring to the common law doctrine, had the power to block mergers which were against 'the public interest'. The next milestone was the Restrictive Trade Practices Act of 1956, which was the first effective statute in English law that outlawed cartels directly, dismantled the wartime cartel system and strengthened what has been common law tradition at least since *Nordenfelt* in 1894.

2.3.2 U.S. Antitrust Law

The common law in the United States was somewhat less receptive to trade restraints than the English tradition. Many Courts banned price-fixing agreements and other anticompetitive agreements when they affected any of the necessaries of life.[21] Other rulings made no distinction between essential and non-essential items and declared so called 'naked' trade restraints illegal for all commodities and services.[22] Contrary to those rulings, other Courts followed the permissive approach that English jurists used for evaluating restraints for their legality under the doctrine of reasonableness laid down in *Mitchel* v. *Reynolds*.[23] The enactment of the Sherman Act in 1890, establishing a broad prohibition of restraints of trade, tried to overcome the ambivalence in the common law rulings and was a commitment to protecting competition.

20 See Cornish, Clark (1989), pp. 272 et seqq.

21 See *Richardson v. Buhl*, 77 Michigan Supreme Court 632 (1889).

22 See *Hoffman v. Brooks*, 23 American Law Register 157 (1884).

23 For the doctrine see Section 2.3.1. For cases upholding contracts in restraint of trade see *Skrainka v. Scharringhausen*, 8 Missouri Court of Appeals 522 (1880); *Leslie v. Lorillard*, 110 New York Court of Appeals 519 (1888).

Many restrictive agreements among potential competitors where used in establishing so called 'Trusts'. These Trusts were the outcome of allowing contracting which permitted agreements among individuals and firms under very few restrictions. Public opinion opposed abuses perpetuated by these gigantic enterprises, and advocated in favor of passing the Sherman Act. The first trust company was organized in 1882 by S.C.T. Dodd, the lawyer representing Standard Oil Alliance, a cartel of oil refiners. It enabled cartel members to coordinate production activities and close less efficient refineries. Trusts were later formed in sugar, whiskey, cottonseed oil and other industries within a short time. This trend sparked popular opposition and fear that the economy would soon be inundated by trusts. Trusts were seen as destroying the economic freedom of American entrepreneurs and consumers. Senator John Sherman opened the debate on his bill by drawing an analogy between trusts and tyrants. Economic freedom within the marketplace was parallel to political freedom. Just as the nation 'would not submit to an emperor', consumers and firms 'should not submit to an autocrat of trade', he argued. The Act was specifically addressing trusts, but included all other forms of contracts and conspiracies in restraint of trade (Sherman Act, Section 1):

> "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."

The importance of the bill at the time and the strong public opinion against the trusts was expressed by the fact that even attempts or conspiracies to establish a combination were deemed felonious (Sherman Act, Section 2):

> "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."

The first Section 1 case reached the Supreme Court in *Trans-Missouri* in 1897.[24] The Supreme Court ruled that the Sherman Act was applicable to Railroads, even though they were regulated by Federal Law, and held that the agreement in question was indeed in violation of the Sherman Act. Most importantly, it held that Courts should not continually monitor the reasonabless of agreements and review business records to issue decisions in

24 *Trans-Missouri Fright Association v. United States*, 166 United States 290 (1897).

every case. The necessary level of supervision and intervention by Courts would require too much information, tax the capacity of judges and was not envisioned by the framers of the Act.[25] However, the Court did not deliver a general rule on how to solve the dilemma of classifying agreements in restraint of trade on their reasonability, which led to an extensive dissent by Justice White.[26] That missing delineation in *Trans-Missouri* was to be addressed by Circuit Judge William Howard Taft only one year later in the Sixth circuit's opinion in *Addyston* (1898).[27] In one of the most important precedents for U.S. antitrust law, Taft clarified what the then new Sherman Act would do with the common law practices of distinguishing between ancillary and nonancillary restraints; and the possibility of allowing reasonable ancillary restraints:

> "But where the sole object of both parties in making the contract […] is merely to restrain competition, and enhance or maintain process, it would seem that there was nothing to justify or excuse the restraints, that it would be necessarily have a tendency to monopoly, and therefore would be void."[28]

Contrary to the English and partly the American common law, Taft left no doubts that there is no reasonableness test for today's 'hard-core' restraints such as price-fixing, concerted refusals to deal, territorial divisions, or similarly restrictive restraints, no matter if they were labeled ancillary. Taft further rejected the notion that the Court had the responsibility to determine economic reasonableness, because this would lead to a vague and ambiguous standard.[29]

The case also displayed the economic importance such restraints could have on trade within the U.S. as a whole. When Taft's opinion was affirmed by the Supreme Court, it declared that restraints of trade through private contracts should not be able to re-

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25 Hylton (2003), p. 93.

26 See *Trans-Missouri Fright Association v. United States*, 166 United States 290 (1897), at 343 et seqq.

27 See *Addyston Pipe & Steele Co. v. United States*, 85 Federal Circuit Court 271, 6th Circuit (1898), affirmed 175 United States 211 (1899).

28 *Addyston Pipe & Steele Co. v. United States*, 85 Federal Circuit Court 271, 6th Circuit (1898), at 278.

29 Recognizing the importance of this judgment for U.S. antitrust law, Robert Bork later notes that "Given at the time it was written, it must rank as one of the greatest, if not the greatest antitrust opinions in the history of the law.", Bork (1978), p. 26.

place Regulations prohibiting or obstructing interstate trade and thus limit free competition in the whole U.S. market:

> "If certain kinds of private contracts do directly […] limit or restrain, and hence regulate, interstate commerce, why should not the power of Congress reach those contracts just the same as if the legislation of some state had enacted the provisions contained in them? The private contracts may in truth be as far reaching in their effect upon interstate commerce as would the legislation of a single state of the same character."[30]

Hence, the Sherman Act was also a means of counteracting the negative effects of the freedom of contracting such as the desire of firms to restrict interstate commerce and thus competition among the different States. Similar to the European Communities more than 50 years later, the protection of the freedom to compete through antitrust law was a means to establish and protect a common domestic market within the borders of the United States for the benefit of all. No private agreements should be allowed to replace former restrictions by States which were illegal under the Commerce Clause of the Constitution.

In response to the prohibition of collusion and conspiracy to collude in the Sherman Act, industries began to consolidate. Aided by general incorporation laws first introduced in the states of New Jersey and Delaware, these rules enabled former trusts to merge and list on stock exchanges. The resulting large wave of mergers after 1890, following into the depression of the mid-1890s between 1895 and 1904, created a legal dilemma for Courts ruling on antitrust. They began questioning whether the automatic illegality of cartels and collusive practices in the Regulation could be extended to merged corporations. In the first case addressing the question, *Northern Securities v. United States* (1904), the Supreme Court held that all mergers between directly competing firms constitute a combination in restraint of trade and therefore violate Section 1 of the Sherman Act.[31] However, that per se illegality did not hold for long, and the decisive answer to the question was provided by Chief Justice Edward White in the two Supreme Court decisions

30 *Addyston Pipe & Steel Co. v. United States*; 175 United States 211 (1899), at 229.

31 See *Northern Securities Company v. United States*, 193 United States 197 (1904).