Vertical Acquisition and Section 7 of the Clayton Act

Jason C. Blackford

Follow this and additional works at: http://scholarlycommons.law.case.edu/caselrev

Part of the Law Commons

Recommended Citation
Jason C. Blackford, Vertical Acquisition and Section 7 of the Clayton Act, 17 Cas. W. Res. L. Rev. 102 (1965)
Available at: http://scholarlycommons.law.case.edu/caselrev/vol17/iss1/6

This Article is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.
Utilizing the topic of vertical acquisition as the subject of his discussion, Mr. Blackford argues that the government and certain courts have erred in blindly applying strict legal criteria to test the validity of acquisitions without considering the economic ramifications of these combinations. After an historical analysis of the development of the current legal tests, the author demonstrates how these tests often yield a result inconsistent with that reached through an economic analysis. He concludes that these inconsistencies demand a re-evaluation of current methods of testing vertical acquisitions and makes concrete suggestions for reform.

Vertical Acquisition and Section 7 of the Clayton Act

Jason C. Blackford

VERTICAL ACQUISITION is a method of integrating a business enterprise through the purchase of assets or stock, or by the merger of various levels of operations in the extraction, production, distribution and consumption of goods. Horizontal acquisition is a combination of units on the same tier of any of these levels. Both of these methods of integration, as well as conglomerate acquisitions, are subject to the prohibitions of section 7 of the Clayton Act.

This article will analyze the legal and economic effects of an application of the guidelines of section 7 to vertical mergers. First, an examination will be made of the development of the legal tests under section 7. Second, the discussion will undertake an analysis of the economic and social consequences of vertical acquisitions. Finally, consideration will be directed to the development of possible guidelines and new concepts in evaluating the vertical acquisition of economic power.

The topic of vertical acquisitions has been selected for two reasons. First, vertical acquisitions illustrate the need to develop separate legal tests for different types of industrial combinations. Some authorities have applied the principles developed for horizontal integration to the significantly different problems presented by vertical acquisitions.

Secondly, vertical acquisitions demonstrate the failure of current

---


antitrust policy to consider economic results, such as price changes, output and technological progress. In order to achieve a rational antitrust policy towards vertical mergers, the legal tests under section 7 must not be at variance with economic thought. It is submitted that such a dichotomy of law and economics currently exists and must be eliminated.

A recent case, United States v. Aluminium, Ltd., is illustrative of the use of section 7 of the Clayton Act to prevent an industrial combination which presumably would have been economically beneficial. Aluminium, Ltd., the world's largest producer of primary aluminum, had arranged to acquire the assets of the Bridgeport Brass Company Metals Division of the National Distillers and Chemical Corporation and National Distiller's stock interest in two joint ventures in the aluminum fabricating field. Bridgeport Brass is a major fabricator of aluminum siding and awnings and is the nation's largest manufacturer of aluminum venetian blinds. The government sought an injunction to prevent the consummation of the acquisition. The attorneys for the Justice Department, proceeding under section 7 of the Clayton Act, alleged that the acquisitions would eliminate Bridgeport as a potential competitor of Aluminium, Ltd. in the primary aluminum market and would eliminate Aluminium, Ltd. as a potential competitor in the aluminum fabricating market. The government also claimed that the existence of a large integrated company in the traditionally fragmented aluminum fabricating field would have a detrimental effect on competition.

The attack on this transaction is not surprising in view of the constant assaults by the government on the aluminum industry in recent years but the wisdom of this particular attempt is questionable in light of the evidence introduced by Aluminium, Ltd. and Bridgeport. Affidavits were submitted by the defendants in opposition to the government's motion for a preliminary injunction. The affidavits stated that first, Bridgeport's market share of total aluminum shipments in 1963 was only 0.9 per cent — miniscule when compared with Alcoa's 32 per cent and Reynold's 20 per cent; secondly, it was noted that Bridgeport had been consistently operating at

---


a loss because it lacked its own reduction plant, and sufficient alumina capacity and bauxite reserves. Bridgeport did not have sufficient assets to acquire or to construct these facilities. Thus, to prohibit this sale might lock Bridgeport into a series of losses or force National Distillers to expend vast sums to integrate Bridgeport vertically by use of its capital. On the other hand, Aluminium, Ltd. has had difficulty in reaping the benefits of the world's largest market for fabricated aluminum because of the vertical integration of the existing domestic aluminum producers. The district court apparently found sufficient merit in these factors to dissolve the temporary restraining order and deny the preliminary injunction on the stipulation by Aluminium, Ltd. that it would operate Bridgeport separately until the legality of the acquisition was determined.6

The economic considerations surrounding the Aluminium, Ltd. purchase are certainly persuasive of the justification for the transaction. However, under the legal tests of the Clayton Act as developed by the courts, it is arguable that the acquisition was illegal. Certainly, in this area, law and economics ought to be akin. How the disparity between them developed is revealed by a study of the evolution of the criteria currently applied in determining the legality of a vertical acquisition.

I. PRE-1950 JUDICIAL REGULATION OF VERTICAL ACQUISITIONS

The concept that a vertical combination might in itself be subject to government regulation is a relatively recent development in antitrust law In fact, no case prior to 1947 could be said to have involved this issue. The first decision involving vertical integration, United States v Yellow Cab Co.,7 was presented to the Supreme Court after the trial court had dismissed the government's petition for failure to state a cause of action under sections 1 and 2 of the Sherman Act.8 In addition to manufacturing taxicabs, the Checker Cab Manufacturing Company controlled smaller companies which provided taxi service in several metropolitan areas. The Court agreed with the government's contention that an arrangement by which the operating companies agreed to purchase their requirements from Checker illegally foreclosed other taxicab suppliers from

7 322 U.S. 218 (1947). It is of interest to note that the Government eventually lost this case as it was found that sound business judgment had motivated the purchase of the affiliated corporation's cabs by the operating taxi companies.
a large part of the market. In addition, Justice Murphy stated that such an agreement might further restrain trade by preventing the affiliated operating companies from purchasing cabs in a competitive market. Consequently, if this integration were found to be a calculated plan to restrain trade or to create monopoly power, then it would constitute a violation of the Sherman Act. Thus, the Yellow Cab decision first introduced the element of market foreclosure as a prohibited practice.

The first application of the foreclosure concept to vertical acquisitions was in United States v. Columbia Steel Corp. The United States Steel Corporation had purchased the Consolidated Steel Corporation, the leading fabricator of steel products on the West Coast, in order that the latter might serve as an assured outlet for the steel shapes and plates produced by U.S. Steel's giant Geneva plant. The government's complaint alleged that:

Upon consummation of said purchase the business now owned by Consolidated and its subsidiaries will be permanently eliminated as a substantial market for the rolled steel products of producers other than Columbia and other wholly-owned subsidiaries of U.S. Steel. Said business now owned by Consolidated will also be permanently eliminated as a competitor with U.S. Steel and Columbia in the manufacture and sale of fabricated steel products in the Consolidated market.

The necessary effect of said agreement is to eliminate substantial competition in the sale of rolled steel products and the manufacture and sale of fabricated steel products and said agreement is therefore in itself an unreasonable restraint of trade and commerce in violation of Section 1 of the Sherman Act.

In its brief the government argued that the precedent established in United States v. Yellow Cab Co. rendered an acquisition per se illegal when a substantial portion of the market was foreclosed by any vertical integration scheme. The Supreme Court avoided this issue by stating that the Yellow Cab case had come before the Court on a motion to dismiss and therefore the only question before the Court in that case was the sufficiency of the allegations contained in the government's complaint. The Court concluded that the acquisition of Consolidated Steel did not unreasonably restrict the opportunities

---

11 334 U.S. 495 (1948)
12 Complaint, United States v. Columbia Steel Corp., supra note 11.
13 332 U.S. 218 (1947)
of competitive producers of rolled steel to market their products. The Court stated that the consumption of rolled steel by Consolidated Steel was less than 3 per cent of the rolled steel sold in the area where Consolidated marketed its products. However, the Court appears to have been in error in its definition of the relevant market in which to determine the competitive effect of the acquisition. The eleven-state area in which Consolidated sold its products was not relevant when it was the sales to Consolidated that were being foreclosed.

An important effect of the Columbia Steel case was to give a new impetus to Congressional efforts to amend the antitrust laws to prevent concentrations of economic power by corporate acquisitions.

II. THE CELLER-KEFAUVER AMENDMENT TO SECTION 7

The old section 7 of the Clayton Act was applicable only to acquisitions that lessened competition between the merging corporations. Prior to 1950, section 7 provided:

[T]hat no corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital of another corporation engaged also in commerce, where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition, or to restrain such commerce in any section or community, or tend to create a monopoly of any line of commerce.

This section was originally aimed at preventing holding companies from growing into "trusts" by acquiring stock in competitors and thus exercising industry-wide control. Administrative and judicial construction, of the original section 7 strictly limited the applicability of the statute to acquisitions which: (1) involved direct competitors in a horizontal line of commerce; (2) had a substantial effect

15 United States v. Columbia Steel Corp., 334 U.S. 495, 508-09 (1948). The element that was never mentioned in the opinion, yet implicit in every word is the feeling that the Government was estopped from attacking this acquisition because of the Government's post-war insistence that U.S. Steel should purchase the Geneva steel complex and because an assured market for the products of that plant was a necessity to insure the profitable operation of that plant.

16 Ibid.

17 38 Stat. 731 (1914).

18 Ibid. (Emphasis supplied.)

19 S. REP. No. 698, 63d Cong., 2d Sess. 1 (1914).

upon competition in the line of commerce;\textsuperscript{21} and (3) operated to overpower the attempts of other firms to compete on an equal basis.\textsuperscript{22}

In 1950, these restrictions were eliminated by the enactment of the Celler-Kefauver amendment to section 7.\textsuperscript{23} The amended statute provides:

[That] no corporation engaged in commerce shall acquire directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.\textsuperscript{24}

The amendment effected three major changes in section 7 (1) the extension of coverage to acquisitions of assets; (2) the elimination of the requirement that competition between the acquired and the acquiring corporations be substantially lessened; and (3) the substitution of the market concept of "any line of commerce" for the phrase "in any community."

The enactment of the Celler-Kefauver amendment was the result of intense Congressional and administrative efforts to overcome the deficiencies inherent in the original statute. The legislative history of the amendment\textsuperscript{25} reveals two main congressional motives: first, to "plug the asset loophole"\textsuperscript{26} of the original section, and second, to subject corporate mergers to advance approval by the Federal Trade Commission.\textsuperscript{27} In formulating the provisions of the amendment,

\textsuperscript{21} International Shoe Co. v. FTC, 280 U.S. 291 (1930).
\textsuperscript{22} Temple Anthracite Coal Co. v. FTC, 51 F.2d 656 (3d Cir. 1931)
\textsuperscript{24} Ibid.
\textsuperscript{25} An excellent summary of the legislative history of § 7 may be found in MARTIN, MERGERS AND THE CLAYTON ACT 221-53 (1959).
\textsuperscript{26} As originally enacted, § 7 did not apply to the acquisition of the assets of one corporation by another. Brown Shoe Co. v. United States, 370 U.S. 294, 316 (1961). The legislative history of the Celler-Kefauver Amendment clearly indicates that this loophole was a prime target of the Act's sponsors:

The purpose of the proposed legislation is to prevent corporations from acquiring another corporation by means of the acquisition of its assets, whereas under [sic] the present law it is prohibited from acquiring the stock of said corporation. Since the acquisition of stock is significant chiefly because it is likely to result in control of the underlying assets, failure to prohibit direct purchase of the same assets has been inconsistent and paradoxical as to the over-all effect of existing law. S. REP. NO. 1775, 81st Cong., 2d Sess. 2 (1950).

\textsuperscript{27} Handler & Robinson, supra note 20.
the legislators were not as concerned with the possibility of market foreclosure through vertical acquisition as they were with the increasing economic concentration resulting from horizontal mergers. As part of a study of economic concentration, the Federal Trade Commission stated in a 1947 report that although acquisitions and economic concentration were increasing, few of the acquisitions were in industries that were already concentrated. On the subject of vertical acquisitions, the report stated:

Vertical integrations have a particularly severe effect upon small business during periods such as the present which are plagued by shortages of raw materials, components, etc. During such periods, large firms frequently reach backward to acquire important suppliers, and in so doing, reduce the amount of supplies available for small independent business.

Viewed as a whole, however, the 1947 report considered the vice of vertical arrangements to lie in the attendant increase in economic concentration rather than in the foreclosure of sources of supply or the elimination of outlets for goods. A subsequent 1948 report of the Commission was even more vigorous in its attack on increased economic concentration; in fact, the report argued that any merger which would result in such an increase in concentration was against public policy. The 1948 minority report of the House Judiciary Committee criticized the FTC study for its emphasis upon the amount of concentration and its apparent disregard for the effects of mergers on prices, employment and production efficiency. However, the final report on H.R. 2734 which amended section 7 did not reiterate this criticism, although in the committee hearings on the bill neither the Federal Trade Commission nor any other witness introduced evidence as to the effect of mergers on prices, employment and efficiency.

---

29 Id. at 12.
30 Id., at 12.
31 H.R. REP. No. 596, 80th Cong., 2d Sess. (1949) (minority report) The criticism of the FTC study is supported by a study undertaken by the Tax Research Program of the Harvard Graduate School of Business Administration. A summary of this study may be found in Lintner & Butters, Effects of Mergers on Industrial Concentration, 1940-1947, 32 REV. OF ECONOMICS & STATISTICS 30 (1950). A series of replies and counter-replies to the Harvard Study may be found in 33 REV. OF ECONOMICS & STATISTICS 63 (1951).
The final house report specifically included vertical acquisitions within the ambit of the amendment:

Because section 7, passed in 1914, prohibited, among other things, acquisitions which substantially lessened competition between the acquiring and the acquired firm, it has been thought by some that this legislation applies only to the so-called horizontal mergers. If, for example, one or a number of raw material producers purchases firms in a fabricating field (i.e., a "forward vertical" acquisition), and if as a result thereof competition in that fabricating field is substantially lessened in any section of the country, the law would be violated, even though there did not exist any competition between the acquiring (raw material) and the acquired (fabricating) firms.\textsuperscript{34}

The Congressional debates do not, however, specifically refer to the concept of foreclosure in vertical situations, but emphasize instead the horizontal effects of integration.\textsuperscript{35} Professors Handler and Robinson summarized the legislative history of amended section 7 as follows:

Conclusions from the legislative history. These conclusions emerge from the legislative history of the amended section 7. (1) The defect that spawned the amendment was the 1914 statute's "asset loophole", it was Congress's undeviating concern to subject asset acquisition to Clayton Act regulation. (2) Efforts to engraft standards of per se illegality on this corrective legislation were abortive. (3) Instead, the original substantive criteria were revised to make clear (a) that all acquisitions between competing companies would not be banned; (b) that, \textit{per contra}, it was unnecessary to go to the opposite pole and prove an actual unreasonable restraint of trade or monopolization, as under the Sherman Act, and (c) that the congressional intent was to steer a middle course between these two extremes, whereby legality would turn on whether a substantial lessening of competition or a tendency to create a monopoly was reasonably probable. (4) The fate of an acquisition was to be determined, not by dollar amounts, percentages, or other shorthand formulae, but on a case-by-case examination of all matters evidencing the acquisition's likely impact on the vigor of competition.\textsuperscript{36}

It is imperative to recognize that the particular problems of vertical integration were not prominent in the studies and discussion preceding the enactment of amended section 7. The analyses of the amendment's congressional proponents and the Federal Trade Commission were directed instead at concentration on the horizontal level. This distinction will take on added importance in the sub-

\textsuperscript{34} H.R. Rep. No. 1191, 81st Cong., 1st Sess. 1 (1949)

\textsuperscript{35} Cf. Martin, \textit{op. cit. supra} note 25, at 252-54.

\textsuperscript{36} Handler & Robinson, \textit{supra} note 20, at 664.
sequent discussion of whether economic concentration is a proper test of the legality of a vertical acquisition.\(^{37}\)

III. JUDICIAL INTERPRETATIONS OF THE AMENDED SECTION 7

A. Pre-Brown Shoe Decisions

At the present time, the only authoritative interpretations of the merger provisions of section 7 are administrative and judicial decisions. While there was no definitive decision involving vertical acquisitions under the amended section 7 prior to 1957, several cases involving horizontal mergers indicated the possible direction of future decisions on the legality of vertical acquisitions.\(^{38}\)

The 1953 decision in *In the matter of Pillsbury Mills, Inc.*\(^{39}\) involved an acquisition with both vertical and horizontal elements. There, one of the largest suppliers of flour acquired the assets of two corporations thereby increasing its manufacturing capacity and its marketing position in the southeastern part of the country. In discussing section 7's prohibition against acquisitions which "substantially lessen competition," the court refused to equate the meaning of this term with that of the identical phrase in section 3 of the Clayton Act.\(^{40}\) The Commission stated that the standard to be applied under section 7 could not be specifically determined but rather could only be described as laying somewhere between the per se doctrine and the rule of reason.\(^{41}\) The standard of proof under the Clayton Act was ruled to be less strict than that required by the Sherman Act because the former statute was designated to prohibit Sherman Act violations in their incipiency. The Commission further stated: (1) that an economic analysis must be made of the industry and of the effect of the acquisition on *competition*, not competitors, within the industry; and (2) that no single characteristic of an acquisition of itself would be sufficient to determine the effect on competition.\(^{42}\) Thus, in order to prove a violation of section 7, the government was required to show more than that the resultant combination controlled a substantial amount of sales and affected a

\(^{37}\) See text accompanying notes 96-97 infra.


\(^{39}\) 50 F.T.C. 555 (1953)

\(^{40}\) Id. at 563.

\(^{41}\) Id. at 569.

\(^{42}\) Id. at 571.
substantial portion of commerce. The Commission indicated that an economic analysis of the effect of the acquisition on competition should be undertaken to determine the legality of the integration. Emphasis was directed toward the impact on competition rather than the effect on specific competitors.

In 1957, the *Columbia Steel* case\(^{43}\) still remained as the leading case on vertical integration. However, in that year the Supreme Court handed down its decision in *United States v. E. I. duPont de Nemours Co.*\(^{44}\) The government had instituted an action directed at forcing duPont to relinquish its 23 per cent stock interest in General Motors Corporation.\(^{45}\) The main contention was that duPont was using its stock ownership to increase its sales of automobile finishes and fabrics to General Motors. Both the government and the defendants argued the case in the Supreme Court as a Sherman Act question and made only passing reference to the original section 7 of the Clayton Act. However, the Court did not feel so restricted and proceeded to apply the original terms of section 7 to vertical acquisitions. By way of justification the majority opinion stated:

> The first paragraph of § 7 [old], written in the disjunctive, plainly is framed to reach not only the corporate acquisition of stock of a competing corporation, where the effect may be substantially to lessen competition between them, but also the corporate acquisition of the stock of any corporation, competitor or not, where the effect may be either to (1) to restrain commerce in any section or community, or (2) tend to create a monopoly of any line of commerce.\(^{46}\)

The opinion also cited statements by Senator Chilton on the floor of the Senate to substantiate this interpretation.\(^{47}\) Mr. Justice Burton in his dissent challenged the research of the majority with his analysis of the legislative history of the original Clayton Act:

> The remarks of Senator Chilton relied upon by the majority do not indicate that he thought that § 7 was applicable to vertical integrations. His statements indicate merely that he thought that the restraint and monopoly clauses of § 7 were not entirely synonymous with the substantially lessening competition clause.\(^{48}\)

In his review of the Congressional debates on the original Clayton

---

\(^{43}\) *United States v. Columbia Steel Corp.*, 334 U.S. 495 (1948).

\(^{44}\) 353 U.S. 586 (1957).

\(^{45}\) It should be noted that the action was instituted prior to the passage of the Celler-Kefauver amendment. Thus, the Court applied the provisions of the former § 7.


\(^{47}\) *Id.*

\(^{48}\) *Id.* at 614 n.5 (dissent).
Act, Justice Burton found only one reference to the problem of vertical integration. Senator Reed had proposed an amendment to stiffen the provisions of the act and Senator Chilton inquired whether the amendment would prevent a manufacturer of steel from acquiring a corporation that mined iron ore. Senator Reed answered negatively: "But I call the Senator's attention to the fact that if the illustration he uses would not be covered by the language of my amendment it certainly would not be covered by the language I seek to amend."  

After ruling that the original section 7 applied to the facts in the duPont case, the Court was then faced with interpreting the old provisions. Mr. Justice Brennan, in the majority opinion, stated that the government had established a violation of section 7 when the evidence demonstrated that (1) the market affected was substantial and that (2) there was a likelihood that competition may be foreclosed in a substantial part of that market. Since duPont did supply quantitatively and percentage-wise, a large share of General Motors' requirements, the Court concluded that there was sufficient market foreclosure to permit an inference of injury to competition. The application of this foreclosure test is quite similar to the foreclosure analysis arising under the proscriptions of section 3 of the Clayton Act against contractual vertical arrangements. Foreclosure in this decision was used in a vertical sense since concentration in the horizontal market structure was not involved. The volume of the purchases by General Motors was sufficiently great to support a finding of a substantial foreclosure of sales outlets of duPont's competitors. The stock acquisition was therefore ruled to be for the purpose of allowing duPont to entrench itself as the primary supplier of General Motors' requirements for automotive finishes and fabrics and was declared a violation of section 7.

The foreclosure criterion was used in a different context in a subsequent vertical acquisition decision, United States v Bethlehem Steel Corp. The case arose out of the government's claim that Bethlehem's purchase of the assets of Youngstown Sheet & Tube Company violated amended section 7. Since Bethlehem was integrated into several steel fabricating fields not occupied by Youngs-

---

49 51 Cong. Rec. 14455 (1914) (remarks of Senator Reed)
52 See Kessler & Stern, Competition, Contract and Vertical Integration, 69 Yale L.J. 1, 69-70 (1959)
town, Bethlehem's competitors in the fabricating field would be deprived of Youngstown as a source of supply and as a market for products which were also made by Bethlehem. In finding that this fact would yield certain competitive advantages to Bethlehem, the district court used the following example:

From a competitive standpoint the most desirable source of rope wire for a non-integrated wire rope company is a rope wire manufacturer, such as Youngstown, which produces its own wire rods and which does not compete in the manufacture and sale of wire rope. The competitive disadvantages to the independent wire rope fabricator of purchasing rope wire from a competitor are: (1) in a period of shortage of rope wire a competitor-supplier may supply his own needs first; (2) the competitor-supplier, as a sales argument against the independent, may point to the latter's dependency upon him, the supplier, for raw materials; (3) if the independent sells wire rope below his competitor-supplier's price for wire rope he may lose his source of supply, thus giving his supplier a form of price control over him; and (4) the opportunities for a price squeeze on the independent are enhanced, since the supplier may shift his profit between rope wire and wire rope in such a manner as to narrow or eliminate the independent's margin of profit on wire rope.

It should be noted that the court adopted the foreclosure argument in terms of protecting competitors of Bethlehem, rather than making a quantitative analysis of the foreclosure as was done in duPont. The court did not refer to possible increases in concentration in the lines of commerce where Bethlehem was a fabricator. The emphasis was clearly on the protection of competitors.

In his delineation of the relevant market the district court judge refused to allow any concepts of product flexibility to expand the scope of the relevant market; product flexibility was restricted to cases brought under the Sherman Act. Since foreclosure under the market concentration test (quantitative foreclosure) or under the competitor protection concept depends upon the existence of alternate sources of supply and outlets, the existence of interchangeable product substitutes is crucial. The exclusion of substitute products in determining the relevant market or line of commerce permits the application of section 7 to relatively small firms which are nevertheless dominant in a highly specialized field.

54 Id. at 611-12.
55 Id. at 592.
56 Id. at 612-13.
57 Id. at 594 n.34.
58 Id. at 593 n.36.
In two other cases prior to the Supreme Court's landmark decision in Brown Shoe Co. v. United States, lower courts were confronted with the question of whether foreclosure was to be measured by a quantitative analysis of the effect of the acquisition on a horizontal level or construed as an anticompetitive device which would injure competitors.

The effect upon competitors was the primary focal point of the court's opinion in United States v. Maryland & Va. Milk Producers Ass'n. An agricultural co-operative of over 2,000 dairy farmers in Maryland and Virginia, which produced and marketed milk on the wholesale level, purchased Embassy Dairy, their only significant competitor in the District of Columbia. Embassy marketed the milk from 120 independent dairymen who were horizontal competitors of the co-op and who had cut deeply into co-op sales in Washington. By the purchase of Embassy, the co-op effectively eliminated its competitors' means of distribution, thereby foreclosing them from the market. To protect the competitors of the co-op, the court held that the acquisition was illegal. It should be noted that this purchase by the co-op would have been ineffective as a foreclosure device if entry into the wholesale market could have been accomplished with relative ease, for in such a case a new competitor could then have replaced Embassy.

In United States v. Jerrold Electronics Corp., a manufacturer of community antennas sought to purchase a series of community television systems throughout the nation. In its defense, Jerrold asserted that these purchases were for investment purposes and vigorously resisted the government's examination. First, the district court inferred an evil motive on the part of the defendant because of its un-cooperative attitude when requested to provide certain information. The court concluded that the acquisitions must have been for the purpose of providing captive customers for the parent corporation. Second, with respect to the resulting foreclosure, the court made the following analysis:

---


60 370 U.S. 294 (1962)


Section 7 of the Clayton Act does not make every acquisition of a buyer by a seller unlawful, even though there is a reasonable probability that the acquired concern will purchase its requirements from its owner in the future. There must be a reasonable probability that the acquisition will have the condemned effects of substantially lessening competition or tendency to create a monopoly.

This determination is extremely difficult to make when each acquisition forecloses only a small segment of the market.

Yet at some point the cumulative effect of these acquisitions will reach the prohibited proportions.\(^\text{63}\)

Thus, foreclosure was not evaluated by any resultant competitive advantages; rather the amount of the foreclosure on a horizontal level was determinative. Since the acquisition was the start of a trend toward horizontal accumulation of power, the court found section 7 to be violated.

B. *Brown Shoe Co. v. United States — A Summary and Analysis*

The most authoritative decision on the subject of vertical integration is *Brown Shoe Co. v United States*.\(^\text{64}\) The Brown Shoe Company, a leading manufacturer of shoes and a large retailer of the same product, merged with G. R. Kinney Company, Inc., also a manufacturer and a large retailer of shoes.\(^\text{65}\) The government claimed that both the vertical and the horizontal aspects of the merger were in violation of section 7 of the Clayton Act. As to the malevolence of vertical arrangements, the Supreme Court stated:

The primary vice of a vertical merger or other arrangement tying a customer to a supplier is that, by foreclosing the competitors of either party from a segment of the market otherwise open to them, the arrangement may act as a 'clog on competition' which 'deprive(s) rivals of fair opportunity to compete.' Every extended vertical arrangement by its very nature, for at least a time, denies to competitors of the supplier the opportunity to compete for part or all of the trade of the customer-party to the vertical arrangement. However, the Clayton Act does not render unlawful all such vertical arrangements, but forbids only those whose effect 'may be to substantially lessen competition, or tend to create a monopoly' in any line of commerce in any section of the country.\(^\text{66}\)

\(^{63}\) *Id.* at 566.

\(^{64}\) 370 U.S. 294 (1961).

\(^{65}\) At the time of trial, Brown Shoe Co. operated thirty shoe factories and controlled 1230 retail outlets. It was the fourth largest shoe manufacturer in the United States, accounting for 5% of domestic shoe production. In the five year period prior to 1956, Brown Shoe had acquired seven companies engaged solely in the manufacture of shoes. The other partner in the acquisition, Kinney, was the twelfth largest shoe manufacturer, producing one-half of one cent of all shoes in the United States. Kinney's 360 retail stores accounted for 1.6% of shoe sales in the nation.

\(^{66}\) *Brown Shoe Co. v. United States*, 370 U.S. 294, 323 (1962) (Citations omitted.)
The Court then undertook an economic analysis of the merger with the emphasis on four major factors. First, the amount of the foreclosure was analyzed.\textsuperscript{67}

Since diminution of the vigor of competition which may stem from a vertical arrangement results primarily from a foreclosure of a share of the market otherwise open to competitors, an important consideration in determining whether the effect of a vertical arrangement "may be substantially to lessen competition, or tend to create a monopoly" is the size of the share of the market foreclosed. However this factor will seldom be determinative.

If the share of the market foreclosed is so large that it approaches monopoly proportions, the Clayton Act will, of course, have been violated; but the arrangement will have also have run afoul of the Sherman Act. And the legislative history of § 7 indicates clearly that the tests for measuring the legality of any particular economic arrangement under the Clayton Act are to be less stringent than those used in applying the Sherman Act. On the other hand, foreclosure of a \textit{de minimus} share of the market will not tend "substantially to lessen competition."\textsuperscript{68}

Thus, the Court held that foreclosure in a quantitative amount on a horizontal level was one of the tests of illegality under section 7. It assumed that sufficient foreclosure would substantially lessen competition. The amount of foreclosure sufficient to make an acquisition unlawful was found to depend in part upon the distribution of economic power throughout that level and the extent of prior integration. There should be no consideration of whether economic consequences of the foreclosure are detrimental or beneficial, but rather a strict quantitative analysis of the foreclosure.

Second, a brief examination of the business purposes motivating the merger was made by the court.\textsuperscript{69} The primary purpose of this psychoanalysis of the acquisition was to keep the "failing firm" test a viable escape route. Apparently, the onus of illegality is removed from an acquisition if the financial difficulty of one of the participants is of such magnitude as to cause the possible elimination of this firm from competition unless the acquisition is permitted. This requires an estimate of the seriousness of the firm's plight balanced against the potential harm resulting from the presence of an integrated competitor in the failing firm's line of commerce.

Next, the Court directed its attention to the degree of existing concentration and the trend toward centralization within the in-
"In an industry as fragmented as shoe retailing, the control of a substantial share of the trade in a city may have important effects on competition. If a merger achieving five percent control were now approved, we might be required to approve future merger efforts by Brown's competitors seeking similar market shares." The Court warned that once a trend toward concentration develops, any acquisition will be suspect. However, illegality will be found only when a substantial part of the line of commerce is foreclosed or affected adversely. Although this approach is similar to the quantitative foreclosure analysis, it is somewhat different in that a structural examination was made of the trend within the entire industry. Therefore, whether the units within the relevant line of commerce are small and non-integrated or are large and integrated becomes an important consideration.

The last factor examined by the court was the economic efficiency and potential price reduction which might result from a vertical acquisition. However, these economic consequences were held to be irrelevant to the question of the legality of a vertical acquisition.

The retail outlets of the integrated companies, by eliminating wholesalers and by increasing the volume of purchases from the manufacturing divisions of the enterprise can market their brands at prices below those of competing independent retailers. Of course some of the results of large integrated or chain operations are beneficial to consumers. Their expansion is not rendered unlawful by the mere fact that small independent stores may be adversely affected. It is competition, not competitors, which the Act protects. But we cannot fail to recognize Congress' desire to promote competition through the protection of viable, small, locally owned business. Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these considerations in favor of decentralization.

All economic consequences except for market structure were rejected. The Court refused to formulate a legal balancing process by which the benefits of the acquisition could be weighed against its detrimental effects. In support of this position, the Court relied upon the admonitions against concentration contained in the

70 Id. at 332.
71 Id. at 343-44.
72 Id. at 344.
73 Ibid.
The approach taken in Brown Shoe represents a modified "rule of reason" which is to be applied in determining the legality of an acquisition under section 7. The term "rule of reason" is appropriate since emphasis is placed upon the amount of the foreclosure and the degree of concentration. The rule of reason is "modified," however, since the emphasis of the Court's analysis is directed at the effect on market structure rather than toward an evaluation of the economic consequences of the acquisition. The specific legal guidelines relating to vertical acquisition which can be extracted from the Brown Shoe decision may be summarized as follows:

(1) The doctrine of Yellow Cab is reaffirmed in that vertical integration is not per se illegal. (2) The vice of a vertical acquisition lies in the foreclosure of markets and sources of supply. The extent of the foreclosure is determined by a study of the quantity of foreclosure on a horizontal tier and not by an evaluation of the effect upon competitors. (3) The "percentage" test of market foreclosure is not a controlling element in determining the legality of a proposed vertical acquisition. A vertical acquisition will not be saved by the fact that the resulting combination forecloses a small percentage of the relevant market. (4) Economic efficiency and reduced prices for consumers will not protect a vertical acquisition from the thrust of the new section 7 of the Clayton Act. (5) It is apparent that the Supreme Court, at least as presently constituted, will apply section 7 to stop in its incipiency any discernible trend toward oligopolistic competition.

C. Vertical Acquisitions After Brown Shoe — Confusion and Uncertainty

The post-Brown Shoe decisions have failed to adhere to the guidelines established in that decision and considerable confusion has resulted. Interpretations by the lower courts and the Justice Department together with the decision of the Court in United States v Aluminum Co. of America (Rome Cable) have con-

74 Id. at 315.
75 352 U.S. 218 (1947).
tributed to that confusion. In the latter case, the government instituted an action to void Alcoa's acquisition of the stock and assets of Rome Cable, a manufacturer of wire and cable products. The trial court, after a review of the industry, the structure of the market, the factor of foreclosure, the purpose of the acquisition, and the effect of the combination on competition found that section 7 was not violated. The trial judge followed the teachings of Brown Shoe with precision and correctly applied this lesson to the facts. The Supreme Court reversed and remanded for divestiture on two grounds: (1) the trial court's definition of line of commerce was ruled to be too narrow, and (2) the acquisition was found to have substantially lessened competition. With respect to the latter point, Justice Douglas, in writing for the majority, relied upon the test of concentration within an industry as developed in United States v. Philadelphia Nat'l Bank (a horizontal acquisition)

It would seem that the situation in the aluminum industry may be oligopolistic. As that condition develops, the greater is the likelihood that parallel policies of mutual advantage, not competition, will emerge. That tendency may well be thwarted by the presence of small but significant competitors. Though percentagewise Rome may have seemed small in the year prior to the merger, it ranked ninth among all companies and fourth among independents in the aluminum conductor market. Rome's competition was therefore substantial. Preservation of Rome, rather than its absorption by one of the giants, will keep it 'as an important competitive factor,' to use the words of S. Rep. No. 1775 [81st Cong., 2d Sess.] p. 3.

The Supreme Court did not consider the purpose of the acquisition or the absence of foreclosure, but rested its opinion solely on the necessity to keep small competitors in the market. The question then arises: does this opinion supersede the rule of reason as stated in Brown Shoe? It is submitted that this case is outside the judicial mainstream since it applies a horizontal market structure test as the sole criterion of legality for a vertical acquisition. This case might be used in the future as a precedent for a government position that
resultant size of the merger is sufficient for illegality under section 7.

A court of appeals decision in *United States v. Kennecott Copper Corp.* is more in line with the principles of *Brown Shoe*. There, Kennecott sought to acquire Okonite, the second largest independent producer of insulated wire and cable. Kennecott was an integrated miner, miller, smelter and refiner of copper, but engaged in little fabricating. Prior to the acquisition Kennecott was not a supplier of Okonite, but the court presumed that after the combination Okonite would be a "captive" fabricator for Kennecott. The elimination of this large independent fabricator was not only sufficient foreclosure to warrant sanction under section 7, but was part of a trend toward concentration in the wire and cable fabricating field. The court viewed market structure as an objective of antitrust policy, rather than as an analytical tool for determining the effect of the acquisition on competition. The result of this decision has been to insulate the integrated competitors of Okonite from the competitive pressure which would have resulted had the company been allowed to integrate.

Not all of the acquisitions challenged by the Justice Department have been invalidated by the courts. Although some of the judicially approved acquisitions were evaluated after *Brown Shoe*, there has been a tendency on the part of the finders of fact in these cases to consider the economic consequences of the acquisition rather than undertake an analysis of the market conditions and of the degree of foreclosure.

One recent vertical acquisition that has received judicial blessing was the purchase by Tidewater Oil and by Pan-American Petroleum, a wholly owned subsidiary of Standard Oil, of the gas and oil producing property of Honolulu Oil Company which was in the process of liquidation. This acquisition was unusual in two respects: (1) this was a "backward vertical" merger rather than the typical "forward vertical" integration that has characterized the development of most major oil companies; (2) this purchase was at a time when there was a glut on the oil market. The government challenged the purchase under section 1 of the Sherman Act and section 7 of the Clayton Act. The line of commerce which was held to be relevant was the crude oil and natural gas market for the

---

82 231 F. Supp. 965 (S.D.N.Y. 1964)
whole United States. The court held that the acquired gas and oil reserves constituted only a *de minimus* supply when considered in this line of commerce. The crude oil of Honolulu accounted for only .10 per cent of domestic refinery consumption and .51 per cent of all domestic crude oil production and .45 per cent of the total proven reserves in the United States. The trial court noted the oil glut and the decline of oil reserves of the twenty largest oil firms. The structure of the industry was found to be competitive on the basis of evidence of easy entry into the crude oil production market.

Of interest is the fact that the government introduced no witnesses from the oil industry who could testify to the anti-competitive effects of the acquisition, whereas the defendants' witnesses testified to the absence of an adverse effect and to consumer benefits. Considering the competitive atmosphere prevalent in the industry, the minimal amount involved in the acquisition and the lack of anti-competitive evidence, the court held that the acquisition was legal.

Another recent victory for firms desiring to integrate vertically was the approval by a Texas District Court of the acquisition by National Steel Corporation of one of the leading manufacturers of pre-fabricated metal buildings in the southwestern United States. The court after reviewing the voluminous exhibits submitted by the parties, concluded that the acquisition was legal. The decision did not refer specifically to precedent but instead succinctly applied a test similar to that enunciated in *Brown Shoe*. Thus, *Brown Shoe* generally is still the main definitive decision involving vertical acquisitions and the primary source of legal guidelines in this area.

In summary, the development of social control over vertical acquisitions reached its judicial maturity in *Brown Shoe* which recognized vertical acquisitions as requiring special legal principles. *Rome Cable* should be regarded as an erroneous application of horizontal principles to a vertical problem. On this threshold of legal maturity, it is advisable to re-examine the economic and social foundation of the criteria of legality for vertical combinations. In particular, the relationship between law and economics should be

---

85 From 1946 to 1960, the crude reserves of the 20 largest oil companies declined from 52.1% to 49.6% of total crude oil reserves. Some major oil companies have recently encountered extreme difficulty resulting from the lack of proven reserves.


87 Id. at 80609.
examined to see if the legal consensus represented by *Brown Shoe* is economically sensible.

IV THE ECONOMIC RAMIFICATIONS OF VERTICAL ACQUISITIONS

Often those working in a special area of social control, such as trade regulation, become so immersed in the existing institutions that they fail to periodically reconsider the concepts underlying these institutions in light of changing conditions. It is submitted that such reconsideration is necessary with regard to some of the economic effects of the legal prohibitions of the antitrust laws, specifically section 7 of the Clayton Act.

The legal standard of "substantially lessening competition" which is enunciated in section 7 and its application have evolved into a modified "rule of reason" as exemplified by *Brown Shoe*; but how much economic "reason" is involved in the application of this rule? Before such reasonableness may be ascertained, it is necessary to analyze the sacred cow "competition," which is fundamental to the so-called modified rule of reason under section 7.

The term "competition" has been bandied about with eloquent dexterity by the legal profession, jurists, economists, professors and businessmen.88 There are many technical definitions of competition — perfect and imperfect competition, "workable" competition, monopolistic competition, duopoly, monopsony, and oligopoly, to name but a few. Competition is but a generic concept which embraces all of these variants of market structure. Competition in its generic sense is the degree to which firms in the same market area vie for the favor of the purchaser of their product.89 To speak of economic competition in terms of ease of entry,90 absence of market power,91 or a lack of control over price92 is to improperly

88 ATT'Y. GEN. NAT'L COMM. ANTITRUST REP. 320-39 (1955); MASSEL, COMPETITION AND MONOPOLY 186-233 (1962); Adelman, Effective Competition and the Antitrust Laws, 61 HARV. L. REV. 1289 (1948); Clark, Toward a Concept of Workable Competition, 30 AM. ECON. REV. 241 (1940)

89 ATT'Y. GEN. NAT'L COMM. ANTITRUST REP. 320-39 (1955); BACH, ECONOMICS 444-76 (3d ed. 1957)

90 BAIN, BARRIERS TO NEW COMPETITION (1956). See also, Modigliani, New Developments on the Oligopoly Front, 66 J. POL. ECON. 215 (1958).

91 See generally MACHLUP, THE ECONOMICS OF SELLER'S COMPETITION (1952); Adelman, Concept and Statistical Measurement of Vertical Integration, in BUSINESS CONCENTRATION AND PRICE POLICY 281 (1955)

add a built-in measuring rod to the definition of economic competition. Ease of entry, market power and degree of control over price are only characteristics of the market area in which the firms operate.

In the drafting of the amended section 7, the legislators relied heavily on two FTC reports\(^3\) which indicated that the largest firms controlled a substantial portion of the manufacturing assets in the United States.\(^4\) The reports concluded that concentration tended to decrease the vigor of price competition and the aggressiveness of these larger corporations.\(^5\) The legislators in the enactment of the Clayton Act and its subsequent amendment sought to curb this economic concentration by preventing acquisitions that could create such power.

Concentration is defined as the distribution of economic control in a specific horizontal level of commerce.\(^6\) Control over concentrations of economic power differs fundamentally from the promotion of a competitive market unless a definite causal relation can be demonstrated between accumulated economic power and the vigor of the competitive atmosphere. Concentration in absence of such proof is but a description of the market structure whereas competition — in its generic sense — denotes the degree to which competitors seek the favor of the buyer.

Because of the basic distinction between competition and concentration, it is reasonable to ask: is concentration a proper test of the economic effect of vertical integration? If a producer and a fabricator merge, both initially maintain their relative standing in their respective markets. One of the primary ways to improve that standing is to cut prices, assuming the integration will permit such

---

\(^3\) FTC, The Present Trend of Corporate Mergers and Acquisitions, S. Doc. No. 17, 80th Cong., 1st Sess. 6-7 (1947).

\(^4\) This is quite evident by reference to S. REP. No. 1775, 81st Cong., 2d Sess. (1950). For a general reference, see Bodner, Vertical Mergers Under Section Seven, 22 A.B.A. ANTITRUST SECTION 106 (1964).

\(^5\) An appraisal of this report does not reveal the causal link between "bigness" and lack of price competition. The references to concentration breeding lethargy were to industries where there was only one substantial firm in the market. The statistics gathered seemed to be outdated.

\(^6\) Concentration, as used in this article, is the share of the market accounted for by the largest firms in that particular market. The dimension of the companies' activities may be measured by such criteria as output, sales, assets, or employment. Concentration does not mean the share of economic activity accounted for by the large companies in the economy as a whole. MASON, ECONOMIC CONCENTRATION AND THE MONOPOLY PROBLEM 16-18 (1957). The economic theory of market concentration has been ably demonstrated by CHAMBERLIN, THE THEORY OF MONOPOLISTIC COMPETITION (1933) and by ROBINSON, THE ECONOMICS OF IMPERFECT COMPETITION (1933).
reductions. Their competitors can respond either with a price reduction or by some other sales device such as advertising contests, or better service or can choose not to respond and suffer the resulting loss of sales. In all cases, the net return on assets for the combined firms would be reduced unless cost savings could be achieved by increased volume. Note that an integrated unit would probably also have a reduced return on its assets in spite of its size. On the other hand, if the price is determined by horizontal factors, the integrated fabricator could not charge a higher price than if it were an independent fabricator. Price is determined by factors on the horizontal level and will probably be at the point at which marginal cost equals marginal revenue. It can be concluded that vertical integration does not imply a power over price unless cost savings can be achieved.

The argument is often advanced against vertical acquisitions that such integration will enable the firm to reduce its price on one tier in order to expand its share of the market on that level. Assuming that the economic units desire to maximize their profit, this "deep pocket" argument is valid only if (1) the economies of scale are sufficient to permit greater total profit, or (2) other integrated firms are unable to achieve such economies. Furthermore, to reduce prices on one level without a corresponding cost decrease would tend to lower the return on assets and the total profit of the venture. The final phase of the "deep pockets" argument is that price reductions on one level subsidized by other tiers will eliminate competitors. But such reduction is possible only if entry into that level is relatively difficult because exploitation of a dominant market position in the form of raised prices and accompanying profits would attract new entrants. If entry is difficult, then the vertically integrated firm must have expended substantial resources to enter the new tier and a higher rate of return might be economically justifiable.

Assuming concentration is the applicable test for vertical integration, which this writer questions, the question then arises as to whether the absence of concentration actually encourages beneficial economic consequences? An economist, desiring to demonstrate the results obtainable in a situation where economic units are numerous and of approximately equal size, would cite the classical model of perfect competition.97 The existence of this model economic

97 An excellent interpretation of this model may be obtained from SAMUELSON, ECONOMICS 441-50 (3d ed. 1955).
structure would theoretically yield the following consequences:

1. **Price** — the consumer would be able to purchase the product at the lowest price;
2. **Output** — the desires of the consumer would be immediately satisfied;
3. **Technological advances** — the technological progress would proceed at the fastest pace;
4. **Profits** — would be sufficiently high to insure the investment of sufficient economic capital.

Unfortunately, such a model has never existed and probably will never become a reality. The importance of this classical model lies in its economic goals. Thus, to determine the degree of competition desired in a given line of commerce, the economic results obtainable at such a level of competition might be projected and evaluated. This approach contrasts sharply from that used to legally evaluate a particular market structure, *i.e.*, an examination of the resultant degree of foreclosure and concentration. This economic analysis of consequences is a pragmatic approach which is built on the premise that "that which works is good." 89

A determination of the economic effect of a vertical acquisition would normally include a study of the factors shown in the following table: 100

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Price</td>
</tr>
<tr>
<td></td>
<td>(a) The economies v. the diseconomies of scale</td>
</tr>
<tr>
<td></td>
<td>(b) The possibility of reducing market expense</td>
</tr>
<tr>
<td></td>
<td>(c) The possibility of eliminating transfer costs</td>
</tr>
<tr>
<td></td>
<td>(d) The potential reduction of inventory</td>
</tr>
<tr>
<td></td>
<td>(e) The possible lower initial costs of vertical entry into the market</td>
</tr>
<tr>
<td></td>
<td>(f) The ability to wage price competition</td>
</tr>
<tr>
<td>2</td>
<td>Output</td>
</tr>
<tr>
<td></td>
<td>(a) Assured sources of supply</td>
</tr>
<tr>
<td></td>
<td>(b) Captive outlets for lower tier</td>
</tr>
<tr>
<td></td>
<td>(c) Degree of utilization of capacity</td>
</tr>
</tbody>
</table>

---

88 BACH, op. cit. supra note 89, at 407.
89 This sounds quite similar to that paragon of virtues, "workable competition", however, it differs fundamentally as "workable" or "effective" competition attempts to identify the conditions which provide the substance of advantageous competition. The analysis suggested in this paper is first focused on the results of an acquisition, and the conditions that characterize the market at the stage of optimum economic result are the "workable" competition for that market. ATT'Y. GEN. NAT'L COMM. ANTITRUST REP. 320-39 (1955). Bain, *Workable Competition in Oligopoly: Theoretical Considerations and Some Empirical Evidence*, 40-2 AM. ECON. REV. 35 (1950); see generally, STOCKING, *WORKABLE COMPETITION AND ANTITRUST POLICY* (1961).

(d) Possibilities for quality control

(3) Technological Advances
(a) Degree to which resources are properly allocated
(b) Possible loss of flexibility on lower tier
(c) The combined resources for increased research and development

(4) Profit
(a) Spread of economic risk in several markets v. increasing the economic risk
(b) Access to new financing
(c) Increased ability to control price

These represent most of the factors that an economist would evaluate under an economic "rule of reason" to determine resulting economic benefits or detriments of a vertical acquisition. It is apparent that the economist's rule of reason differs fundamentally from the rule propounded by the Supreme Court in Brown Shoe.101

First, economies of scale and cost reductions have been specifically rejected as not pertinent to a determination of the legality of an acquisition under Brown Shoe. Considering solely economic consequences, such cost savings may be passed on to the consumer in the form of reduced prices or increased quality, or may be retained as profits or may be divided to yield both a price reduction and an increase in surplus. It should be noted that if the profits achieved by vertically integrated units are excessive,102 other firms will be tempted to integrate. Thus, to maintain their market position, the previously integrated firms would be forced to reduce their prices to meet competition from the new entrants or keep their profits at a level to discourage new entrants.

Second, foreclosure of competitors has been viewed as a major evil under many judicial interpretations.103 It is reasoned that the competitors on one tier are prevented from selling to or purchasing from the acquired firm on another tier with a resultant injury to competition. This might be a valid approach if there were not already existing integrated corporations which were able to achieve their present status through the expenditure of their own resources to expand their facilities. To prevent integration by acquisition

---

101 The difference between law and economics is nothing new and has been widely discussed. ATTY. GEN. NAT'L COMM. ANTITRUST REP. 339-41 (1955); DEWEY, MONOPOLY IN LAW AND ECONOMICS (1958); Bok, Section 7 of the Clayton Act and the Merging of Law and Economics, 74 HARV. L. REV. 226 (1960); Massel, Legal and Economic Aspects of Competition, 1960 DUKE L.J. 157 (1960)

102 Note also that accumulated earnings which are not distributed to shareholders of the corporation are subjected to a tax under INT. REV. CODE OF 1954, § 531.

VERTICAL ACQUISITIONS

would not only increase the cost of combining several stages, but would also serve to protect existing integrated units and concentrations of economic power. On the other hand, permitting vertical acquisition would enable smaller, aggressive units to challenge the existing or potential giants and to serve as a force to sustain a competitive atmosphere.

It must also be recognized that the foreclosure concept is dedicated to the protection of individual competitors. Protection of competitors should not be confused with the encouragement of competition. From an economic standpoint, valid requirement or output contracts can accomplish the same results as an acquisition, thus there is no reason to deny flexibility to all competitors. All are aware that some companies fail financially — this is an accepted fact in the business community. For a judicial body to extend its protective cloak over competitors is to stifle certain phases of competition. Competition by its nature implies that some competitor must eventually lose; however, the consumer is the ultimate winner.

Finally, the Supreme Court is clear in its condemnation of acquisitions which are part of an integration trend within a particular industry. From an economic standpoint, it is logical that the only firms which will normally be able to compete on the same basis with the previously integrated corporations will be those that can integrate vertically. To deny the benefits of integration to a smaller firm that is in the same relevant line of commerce with larger integrated companies, would be to encourage and protect existing concentration and promote the creation of monopolies. The presence of other comparable units will tend to strengthen the competitive atmosphere and, in the absence of horizontal conspiracies to regulate prices, the consumer would receive the benefits of integration.

An application of these two divergent lines of reasoning, legal and economic, to the acquisition of Bridgeport Brass by Aluminum Ltd., results in contrasting conclusions as to the merits of the acquisition. Under a solely economic test, the costs of the parties are significantly reduced — (1) marketing and transfer costs are eliminated; (2) Aluminum Ltd.'s cost of entry is lowered; (3) Aluminum Ltd.'s entry into the fabricating market presents an im-


105 See, e.g., Brown Shoe Co. v. United States, 370 U.S. 294 (1961)

106 See text accompanying notes 3-6 supra.
mediate economic force in lowering prices. Such an occurrence is a much more effective lever in the reduction of prices than is the mere threat that Aluminium Ltd. might integrate forward by building its own facilities. Aluminium Ltd. now also has an assured market for some of its production, and quality control becomes easier. There is, of course, some loss of flexibility by the parties, but there is an increase in funds available to Bridgeport Brass for technological innovation. The acquisition should turn an unprofitable fabricating operation into a potential money-maker. Admittedly, under a market structure approach, the combination would create an economic force in the aluminum fabricating industry; however, this would tend to counterbalance the existing integrated organizations. The government’s allegation that the competitors of Aluminium Ltd. might be foreclosed from an outlet for their product is of questionable merit since the six major integrated United States producers of aluminum control 80 per cent of the total aluminum market.

If this example in the aluminum industry is any indication of economic results that spring from the application of the so-called legal “rule of reason” enunciated in section 7, then from an economic viewpoint, a re-examination of the presently-applied antitrust concepts is necessary. This fresh look is imperative because the courts and the trust-busters have become so involved in the characteristics of the market, that the practical results of a proposed vertical acquisition have been overlooked. Originally, fragmentation was thought to produce the best economic results. It would be folly for society to accept this economic principle without empirically evaluating the model in the modern business climate. Since America is a nation of pragmatists, our economic policy makers should be pragmatic in their regulation of business.

V Social Aspects of Vertical Acquisition

The reason given by the Supreme Court in the Brown Shoe case for its apparent repudiation of economic results as guiding criteria in determining the legality of the acquisition was the social desirability of maintaining a fragmented market structure.107 The courts interpreted congressional intent as favoring an economic model in which the individual units are of relatively small size and are constantly competing for the consumer’s business on relatively equal terms. Undoubtedly, some of our legislators might have en-
visioned this type of economy at the turn of the century; however, two world wars and fantastic technological changes today make this theory as outdated as the horse and buggy. Business is today confronted by a formidable host of power groups, each seeking to gain concessions at the expense of the other. Organized labor is accelerating its consolidation of economic power through an increasing membership and by gains at the bargaining table and in the halls of Congress. Labor is not hesitant to use its new-found influences.

The twentieth century has witnessed not only the development of corporate giants whose activities span the globe, but also the formation of multi-nation economic blocs, all of which are engaged in a race for the favor of international consumers. From an international perspective, the United States must permit the organization of effective industrial competitors which have the economic strength and techniques to successfully engage in this crucial contest. From a domestic viewpoint, there are now in existence vertically integrated units in every sector of the economy. To prevent competitors of these units from enjoying the benefits of vertical integration would be to insulate the existing powers of economic concentration from competitive pressure.

The growth of the strength of federal and local governments has created a political force within which the business community must operate and exist. A symbiotic relationship must be present between business and government for a nation to prosper. Corporations are a major source of tax revenue and provide most of the weapons and equipment for the nation's defense. A strong economy is capable of furthering the government's policy of maintaining stable prices and relatively low unemployment. In return for its contributions to the nation's economy, business receives: (1) protection in the form of patents, trademarks, an orderly securities market, control of unfair competitive practices and other similar devices; and (2) special favors such as tariffs, financing through the Small Business Administration and other government agencies and technological assistance. This relationship cannot function effectively if business units are rendered inefficient because of government interference; in such cases business obviously cannot function as a source of tax revenues or as a producer of equipment for government use.

Society is composed of a multitude of large and small forces which constantly shift or coalesce while seeking to promote their
own purposes. Regardless of the relative merits of such a system, it remains the reality in which we live. If the government attempts to regulate the potency and size of the individual forces, then it must also seek to regulate the remaining forces in order to develop countervailing powers within the economy. Such a task is not only Herculean but would tend to run against the fiber of our traditional concepts of government.

The important lesson to be learned from a discussion of the above forces in our society is that bigness alone should not be held to be evil per se. In fact, the power accompanying such a condition might be necessary under modern conditions. The arguments pro and con for recognition of a type of monopolistic competition have been adequately detailed elsewhere.\(^8\) It is not the purpose of this article to assert that all vertical acquisitions are socially beneficial but rather to raise the hypothesis that not all such acquisitions can be condemned as socially harmful merely because economic power would result.

VI. CONCLUSION

From the preceding analysis, it is possible to recognize that under the modified legal rule of reason as enunciated in *Brown Shoe* and under the economists' guide to workable competition, economically beneficial combinations may be thwarted through the blind application of rigid rules. In an effort to safeguard those acquisitions which may yield price reduction to the consumer, advance technology and permit a more efficient allocation of resources, it would be prudent to re-examine several fundamental antitrust concepts:

A. *Competition.*—The type of competitive market structure consisting of numerous small units envisioned by the legislators drafting the Clayton Act and amended section 7 is not only out of contact with modern conditions but also impractical from an economic viewpoint. The advantages of monopolistic competition or competition between large industrial units must be reconsidered by the policy makers.

B. *Economic Effect.*—To evaluate the legality of a merger or sale of assets under the antitrust laws, the economic consequences such as price, output, technological advances and allocation of resources should be determined and considered. The economic

---

analysis should be shifted from a study of market conditions to a
determination of whether economic goals are satisfied.

C. Size.—The accumulation of economic power should not
be feared. There are existing countervailing forces to regulate
the activities of any economic giant. Business regulation should be
directed at practices rather than structure.

D. Guidelines.—The policy makers should devise administra-
tive guidelines by which the businessman and his attorneys can
determine whether a proposed combination will be subject to chal-
lenge under either the Sherman Act or the Clayton Act. Informal
conferences between the government and those seeking an acquisi-
tion should be held and should include a discussion of the economic
effects of proposed combination. The present system does not fully
inquire into all the ramifications of a merger or the sale of a busi-
ness.

It is only through self-analysis that the sacred cows and myths
that arise can be challenged and, if necessary, destroyed. It is pro-
posed here that a national committee be formed from all sectors
of the economy to re-examine the fundamental concepts underly-
ing the governmental regulation. This representative committee
should undertake an empirical appraisal of all facets of competition
and of competitive practices. This study should include all maj-

109 Perhaps, a new approach has already started. Donald F. Turner, in his first
public speech as chief of the Justice Department's antitrust division, said: "We should
not attack a merger simply because the companies are large in the absolute sense and
we should not attack aggressive but fair competitive conduct simply on the basis that
some competitors are hurt." On the other hand, he rejected the economic consequences
approach as he believes that a competitive market is the best way to help growth and

110 The new antitrust division chief, Donald F. Turner, has recently announced the
creation of a 12-man staff headed by Edwin M. Zimmerman to formulate a set of guide-
lines to identify transactions that are violations of the acquisition provisions of § 7
This committee is to seek advice from the business community and from educators,
but the establishment of a business advisory group was rejected.

The probable outline of these guidelines was revealed by Mr. Turner in a panel
discussion at the annual meeting of the Federal Bar Association on Sept. 17, 1965. Mr.
Turner took the position that the guidelines would probably be based on the degree of
concentration in the industry under investigation. All economic factors would be dis-
regarded. Accordingly, industry would be prevented from presenting the beneficial
results and the economic motivation of an acquisition. 219 ANTITRUST & TRADE REG.
REP. A-9 (Sept. 21, 1965). This view contrasts with the earlier view taken by Mr.
Turner in his initial statement upon assuming his present position. See note 109 supra.
However, it is very much in line with the opinions which Mr. Turner has expressed
on a previous occasion. See Turner, Conglomerate Mergers and Section 7 of the Clay-
ton Act, 78 HARV. L. REV. 1313, 1318-19 (1965). It is submitted that the formulat-
ion of general guidelines for acquisitions cannot be based on a single factor without
an expressed legislative directive or without a broad inquiry into the economic ram-
ifications of such guidelines. See generally, Bock, Reliability of Economic Evidence in
industries with specific attention directed to the means by which economic goals of low prices, technological progress and proper allocation of resources can be achieved in each. Such a study could serve as a factual background from which the courts and the government could evolve a coherent policy for developing competition in business. Law and economics must coalesce in this area; therefore, such a study should concentrate on combining both legal and economic analyses.

Only a socially mature society can indulge in introspective analysis and evaluation. It is imperative for America to develop and maintain a vigorous and strong privately-owned economy. To achieve this end, a logical and reasonable government policy for business must be developed.