DEPARTMENT OF JUSTICE

COMPETITION POLICY IN DISTRESSED INDUSTRIES

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1. **Introduction**

I am delighted to have the opportunity to speak at the American Bar Association’s Antitrust Symposium on Competition as Public Policy. In sponsoring this symposium, the ABA Antitrust Section indicates that “capitalism as we know it is under attack” and worries that “heavier government regulation is being touted as the solution.” Tomorrow we will continue our discussion of the central question posed in this symposium: “whether competition will continue to serve as the foundation for economic policy and legislation.”

This is no small question in these difficult economic times. But it is one I am eager to address here, in my first speech since rejoining the Antitrust Division as Deputy Assistant Attorney General for Economics. The Antitrust Division’s short answer is this: keeping markets competitive is no less important during times of economic hardship than during normal times.

As we map the course ahead for regulatory reform and competition policy, the first step is to diagnose the public policy failures that caused the current crisis so we can correct past errors and avoid repeating them. In this regard, it seems clear to me that the crisis in the financial sector primarily reflects a failure of government regulation, not any underlying failure in the ability of well-regulated competitive markets to serve consumers and promote economic growth.

Many vigorous supporters of free market capitalism have had their faith shaken in the past year. In testimony before Congress last Fall, Alan Greenspan, former Chairman of the Federal Reserve, confessed that he was “shocked” to have “found a flaw” in the model underlying his free market ideology.¹ Even more recently,

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¹ Testimony of Alan Greenspan before the House Committee on Oversight and Government Reform, October 23, 2008. Greenspan testified that “yes, I found a flaw, I don’t know how significant or
Richard Posner has published a book entitled “A Failure of Capitalism: The Crisis of ’08 and the Descent into Depression.” Need I say more?

While the current crisis has caused many to lose faith in the market, that is not at all my reaction. As an industrial organization economist who has devoted much of his research career to studying the interaction between government and business, I regret to say that the recent problems in the financial sector do not fundamentally surprise me. One hundred years ago, food safety regulation was put into place in response to problems with the food supply that the unfettered market was not able to solve. Forty years ago, environmental regulations were put in place in response to problems with air and water pollution that the unfettered market was not able to solve. And, of course, we have had a heavy overlay of financial regulations going back at least to the Great Depression, again in response to a crisis that the unfettered market was not able to solve, and arguably exacerbated.

Nor does the current crisis call into question the basic utility of neoclassical microeconomics for understanding how firms behave and how markets perform. In particular, notwithstanding great advances in the field of behavioral economics, I have seen nothing in the past year that would cause me to depart from the tried and true working assumption in antitrust economics that for-profit firms generally seek to maximize profits and that this quest usually benefits the public in a myriad of ways. Adam Smith’s teaching in this respect remains as valid as ever. But I hasten to add that this does not by any means imply profit-maximizing firms are always acting in the public interest, Adam Smith’s famous invisible hand notwithstanding. Indeed, much of industrial organization economics involves the study of markets in which firms have market power, where Adam Smith understood full well that business interests often depart from those of the public.

permanent it is, but I have been very distressed by that fact.” See Edmund Andrews, “Greenspan Concedes Error on Regulation,” New York Times, October 23, 2008.
Recall his famous statement: “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.”

As my mentor, Nobel laureate Joseph Stiglitz, is fond of saying, the Fundamental Theorem of Welfare Economics, which establishes conditions under which free markets lead to efficient outcomes, only applies under extremely restrictive conditions that are never even approximated in the real world. As we teach every first-year Ph.D. student in economics, there are three main reasons why markets fail to achieve efficiency (much less equity): externalities and public goods (such as pollution and climate change), imperfect information (which underlies the need for health and safety and financial regulations), and market power.

Which brings us to antitrust. Antitrust policy and enforcement is sometimes described as a form of “government regulation.” But it is a fundamentally different exercise. Unlike health and safety, environmental, and financial regulation, antitrust enforcement is not about steering the market in any particular direction other than the direction indicated by consumer preferences. The goal of antitrust is to ensure that firms compete to serve the needs of consumers, as reflected by their market demand for goods and services, even when vigorous competition is contrary to the interests of powerful and entrenched suppliers. In terms of the classic categories of market failure from the Fundamental Theorem of Welfare Economics, most regulations – including environmental regulations, health and safety regulations, and consumer protection regulations – primarily address

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2 The Antitrust Division is dedicated to disproving the sentence immediately following this famous one by Adam Smith: “It is impossible indeed to prevent such meetings by any law which either could be executed, or would be consistent with liberty and justice.”

3 Mark Whitener puts this nicely in his introduction, “A Crisis of Confidence,” to the cover stories on “Antitrust and the Economic Crisis” in the Spring 2009 issue of Antitrust: “If antitrust is viewed as just another form of regulation, we risk replacing antitrust’s analytical moorings with a series of ad hoc judgments by regulators.”
problems of externalities, public goods, and imperfect information. Competition policy primarily addresses the problem of market power.  

While antitrust analysis needs to take account of all applicable regulations, it unabashedly embraces the virtues of competition as a method of allocating resources, given those regulations. The current crisis provides no basis for wavering from this core principle, which has enjoyed bipartisan support since the Sherman Act was passed in 1890. Happily, unlike during the Great Depression (see below), there have been no calls of late for the wholesale abandonment of antitrust principles.

But the current crisis does force us to reconsider how competition policy should be fashioned during a time of economic distress. I use the term “competition policy” broadly, encompassing competition advocacy as well as enforcement of the antitrust laws. As Assistant Attorney General Varney stated in her speech earlier this week:

> The Obama Administration has pledged broad reforms across numerous industries, including banking, healthcare, energy, telecommunications, and transportation. The Antitrust Division will need to contribute our experience and expertise to these reform efforts. Indeed, part of our efforts will be to foster inter-agency discussions regarding the competition-related issues posed by existing and proposed regulations and policies, and to play an active role in competition advocacy.

The Antitrust Division will be playing an active role to ensure that government policies do not unnecessarily create or enhance market power and that they harness the beneficial power of competition wherever possible.

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4 In some situations, market power can itself result from imperfect information.

The remainder of my remarks are devoted to the narrower but very important question of how best to enforce the antitrust laws in distressed industries and as they impact financially weak companies in any industry. Antitrust analysis must always reflect market realities, including financial distress at the industry and/or firm level. Macroeconomic conditions are also relevant, but only inasmuch as they affect the specific industries or firms being studied in predictable ways.

2. Lessons from the Great Depression

History teaches us that suppliers, hurting during a sharp economic downturn, will look for ways to avoid competing and thereby trim their losses or boost their profits. In this quest, they are likely to find some sympathetic ears in high places. Teddy Roosevelt was a vigorous trustbuster until the Panic of 1907, when he pressured his Attorney General not to challenge U.S. Steel’s acquisition of a rival but potentially failing steel firm. This acquisition might have passed muster under something like the modern standard for the failing firm defense, but broader economic and political concerns were evidently at work.

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7 Dan Crane takes a rather gloomy view of competition policy during times of crisis: “In the almost 120-year history of the Sherman Act, no political administration has reacted to a crisis by calling for more vigorous enforcement of the antitrust laws. To the contrary, administrations of both parties have responded to crises—both martial and economic—by explicitly or implicitly pulling back on antitrust enforcement. Industrialists have used crises as opportunities to deepen their grip on markets.” See Dan Crane, “Antitrust Enforcement During Times of National Crisis,” *Global Competition Policy*, December 2008, p.4. Perhaps some comfort can be taken by noting that much of Crane’s discussion relates to reduced antitrust enforcement during times of war rather than economic distress.

We can learn a great deal about competition policy during tough times by studying competition and industrial policy during the Great Depression. While the federal government was not an enthusiastic trustbuster during the 1920s, the advent of the Great Depression made the Hoover administration even less interested in enforcing the antitrust laws, although to Hoover’s credit he did at least resist the calls for a wholesale repeal of the antitrust laws. As Secretary of Commerce, and later as President during the worsening depression, Herbert Hoover “urged businesses to cooperate through trade associations to exchange information and curb the wasteful features of competition.”

When Franklin Roosevelt took office in 1933, he put into place officials who were openly hostile to industrial competition. On June 16, 1933, Roosevelt signed into law the National Industrial Recovery Act (NIRA), which Ellis Hawley (1966) describes in his Chapter 3 as “The Triumph of Industrial Self-Government.” This act created the National Recovery Administration (NRA), which helped industries create and enforce so-called industry codes. These were effectively industry

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9 I focus here on the U.S. experience during the Great Depression. Similar lessons can be learned from the much more recent experience of Japan during its “lost decade.” Porter and Sakikibara conclude that weak competition policy in Japan contributed to Japan’s sluggish economic growth in recent years, stating: “While competition has long been vigorous in many Japanese industries and has been noticeably opened in the last decade, serious distortions and impediments to competition remain. Until Japan addresses these issues more frontally, the period of Japanese economic stagnation will be unnecessarily protracted.” Michael Porter and Mariko Sakikibara, “Competition in Japan,” Journal of Economic Perspectives, 18(1), 27-50 (2004), p. 47.


13 As Hawley explains, many of the ideas underlying the NRA came from “industrialists and pro-business planners, men who drew their ideas from the war experience or the Associational Activities of the nineteen twenties, and who felt that an enlightened business leadership, operating through self-governing trade associations, should make most of the decisions. The depression, so some of these business planners
agreements to limit price competition and restrict production, investment in plant and equipment, and the workweek. The *quid pro quo* was that part of the resulting higher profits would be shared with labor through higher wages: the NIRA provided antitrust exemptions to industries that accepted collective bargaining with labor unions. Indeed, shocking though it may seem today, the newly created Antitrust Division at the Department of Justice was involved in enforcing these collusive agreements.\(^\text{14}\) During the same time period, the Supreme Court, greatly influenced by the grim economic times, significantly weakened the Sherman Act’s prohibition on agreements in restraint of trade.\(^\text{15}\)

The danger of having the government organize the economy into cartels did not go unnoticed. Chapter 4, “The Association Idea in Retreat,” in Hawley (1966) describes how consumer groups and “antitrusters” fought many of the provisions of the NIRA, initially in vain. In 1936, the highly distinguished economist Harold Hotelling, whose work is fundamental to the theory of unilateral effects now commonly used in merger analysis, outlined the pernicious effects of cartelization throughout the broader economy. Hotelling’s perspective is nicely reflected in the title of his article: “Curtailing Production is Anti-Social.” Responding to a government decision to allow a domestic oil cartel to form, Hotelling wrote:

> [T]he government assisted the oil companies in their successful attempt to curtail the flow of oil and the output of refined products, with the consequence that motorists must drive fewer miles and pay more for their gasoline. Not only has the reduction in output resulted in much loss of employment for labor in the oil fields and refineries, and the

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\(^{14}\) Waller, op. cit., pp. 572–73.

closing of many services stations which formerly prospered along the highways … but
since less gasoline means less driving, production control measures cannot but diminish
the use [of] motor vehicles.\textsuperscript{16}

Hotelling’s unheeded warning proved prescient. Some of the most influential
work on the Great Depression has been done by my Berkeley colleague Christina
Romer, who is now serving as Chair of the President’s Council of Economic
Advisors. As part of her overall study of the Great Depression, Romer has
examined the impact of the NIRA, concluding:

The more important effect of the NIRA was to diminish the responsiveness of price
changes to the deviation of output from trend. By preventing the large negative deviations
of output from trend in the mid-1930s from exerting deflationary pressure, it prevented
the economy’s self-correction mechanism from working. Thus, the NIRA can be best
thought of as a force holding back recovery, rather than as one actively depressing
output.\textsuperscript{17}

Romer’s conclusions are supported by more recent work by Harold Cole and Lee
Ohanian, who compare prices, wages and employment in industries covered by
NRA codes with industries not covered.\textsuperscript{18} They find that the NRA was an
important factor in slowing the recovery, explaining why GNP, consumption,
investment and hours worked remained significantly \textit{below} trend during the Great
Depression even though productivity quickly returned to trend and the real wage
was significant \textit{above} trend.\textsuperscript{19}

\textsuperscript{16} Harold Hotelling, “Curtailing Production is Anti-Social,” in \textit{The Collected Economic Articles of Harold
Hotelling}, Adrian C. Darnell Editor, p. 138.

\textsuperscript{17} Christina Romer, “Why Did Prices Rise During the 1930s?” \textit{Journal of Economic History}, 59(1), 167-199, p. 197.

\textsuperscript{18} Harold Cole and Lee Ohanian, “New Deal Policies and the Persistence of the Great Depression: A

\textsuperscript{19} Jason Taylor finds that output growth from March 1933 to June 1934 was significantly lower in
industries in which the NIRA created effective cartels than in other industries, but that many of these
cartels broke down in the Spring of 1934. Jason Taylor, “Cartel Code Attributes and Cartel Performance:
At the industry level, the conclusions of the National Recovery Review Board, created in response to widespread complaints about price fixing and collusion under the NRA, could not be clearer:

Our investigations have shown that in the instances mentioned the codes do not only permit but foster monopolistic practices and nothing has been done to remove or even to restrain them. If monopolistic business combinations in this country could have anything ordered to their wish, they could not order any thing better than to have the antitrust laws suspended.\(^{20}\)

The NIRA was challenged on several grounds and found to be an unconstitutional delegation of legislative power.\(^{21}\) Between the Supreme Court’s ruling that the NIRA unconstitutional, the passage of the National Labor Relations act, and a growing realization that the cartels sponsored by the NRA were causing significant harm and extending the economic downturn, Roosevelt, by the beginning of his second term, reconsidered his opposition to a strong competition policy.\(^{22}\) The clearest indication of this change was his appointment in 1938 of Thurman Arnold to lead the Antitrust Division.

Thurman Arnold quickly made his views known, stating: “If, through the application of the Antitrust Laws …, we can restore price competition, we will have gone a long way toward solving one of the major problems of the recession.”\(^{23}\) Under Arnold, the Antitrust Division opened a large number of

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\(^{20}\) National Recovery Review Board 1935, 3d report, pp. 34–37, as cited by Cole and Ohanian, p. 792-93, who also note studies done by the FTC finding limited competition in a number of manufacturing industries, including automobiles, chemicals, aluminum, and glass, and report that the NRRB also found evidence of monopoly in wholesale and retail trade.


\(^{22}\) Ellis Hawley, (1966), op. cit. at pp. 72–90.

\(^{23}\) As quoted in Halley, op. cit., p. 411.
investigations and brought a large number of cases. The number of antitrust cases
initiated by the Antitrust Division jumped to 48 during the 1937 to 1939 time
period; only 15 cases were filed in the previous three-year time period. The
Division filed 182 cases during the 1940 to 1942 time period, approximately 70%
of which were criminal cases.24

The primary lesson to be drawn from this experience is that keeping markets
competitive is no less important during times of economic hardship than during
normal economic times.25 Fortunately, this is a lesson that President Franklin
Roosevelt also appears to have drawn, albeit belatedly. The actions of the
Roosevelt administration, and subsequent research by historians and economists,
support the conclusion that the expansion in output resulting from competition is
part of the solution to tough economic times, not one of the causes of economic
downturns. Put differently, restriction of output at the industry level, which is the
hallmark of a cartel as well as the consequence of the artificial shortage associated
with monopoly prices, exacerbates the fundamental economic problem in a
recession, namely that production in the overall economy is well below capacity.

These lessons regarding microeconomic policies operating at the industry level
should not be confused with lessons regarding macroeconomic policies, namely
fiscal and monetary policy. The microeconomic lesson from the NRA experience
is that competitive markets are superior to monopolized or cartelized markets for
economic growth and recovery. The high-level macroeconomic lesson from the
Great Depression was that of Keynes: facing a sharp economic downturn, the


25 Reduced competition not only leads to higher prices and lower output in the short run, which inhibits
economic recovery. It also dampens the incentive to innovate, thus harming longer-term economic growth
as well.
government needs to increase spending, i.e., engage in expansionary fiscal policy, to increase aggregate demand.\textsuperscript{26}

3. Economic Analysis of Distressed Industries and Companies

\textit{A. General Principles}

While there is no theoretical or empirical basis for departing from the basic principles of competition policy during general economic downturns, financial distress at the industry or company level is certainly \textit{relevant} to antitrust analysis. This point should not be controversial; it is merely an application of the general principle that antitrust enforcement should take account of real-world economic conditions. I now explain, in broad terms, how we at the Antitrust Division will account for economic weakness at the industry and company level as we enforce the antitrust laws. Overall macroeconomic conditions are relevant only inasmuch as they affect current and expected future conditions at the industry or company levels.

First and foremost, I must stress that the same basic principles of antitrust economics apply during a recession as apply during an economic expansion. Stating this proposition reminds me of delivering a similar message before, during, and after the dot-com boom and crash: the same basic principles of economics apply to high-tech industries, and to the information economy, as to all other industries.\textsuperscript{27} It also reminds me of a central principle articulated in §2.1 of the

\textsuperscript{26} For a short, accessible discussion that can serve as an entrée to the huge literature on the causes of the Great Depression, see Christina Romer, “The Nation in Depression,” \textit{Journal of Economic Perspectives}, 7(2), 19-39 (1993).

Antitrust Guidelines for the Licensing of Intellectual Property published by the DOJ and FTC in 1995: “The Agencies apply the same general antitrust principles to conduct involving intellectual property that they apply to conduct involving any other form of tangible or intangible property.” Are these principles boring to those looking for the latest fad? Perhaps. But nevertheless correct. Basic economics does not change during a recession, any more than it changes with the advent of new technologies. Nor do the ultimate goals of the antitrust laws – protecting competition and consumers – change during an economic downturn.

Next, it is worth bearing in mind that antitrust cases involving distressed industries and companies arise during economic expansions as well as during economic downturns. Even in good times, some firms make financial mistakes, operate in shrinking markets (due to technological advances or changing tastes), suffer losses, and file for bankruptcy. During the 2000-2008 time period, about 35,000 firms filed for bankruptcy each year.\footnote{\textsuperscript{28}See \url{http://www.uscourts.gov/Press_Releases/2008/bankrupt_f2table_sep2008.xls} and \url{http://www.uscourts.gov/bnkrpctystats/sept2007/F2table.xls}. These data include bankruptcies leading to liquidations and well as reorganizations. During the 2000-2008 time period, about 62\% of all bankruptcies were liquidations under Chapter 7.}

Naturally, more industries and firms are distressed during a recession than during boom times. The number of bankruptcies rose from about 26,000 in 2007 to about 39,000 in 2008, a 50\% increase.\footnote{\textsuperscript{29}Even so, it is worth noting that the 2008 figure of 38,000 is equal to the average during 1999-2004, and far lower than any annual figure during the 1988-1998 time period. This reflects a secular decline in the number of bankruptcies. The average number of bankruptcies during the 1990s was about 57,000 per year.} Inevitably, there are more antitrust cases involving firms in financial distress during hard times than during good times. Plus, to the extent the current downturn is expected to persist, unfavorable projections for future industry conditions are relevant to the forward-looking analysis needed in antitrust cases. The bottom line: since antitrust analysis takes place at the industry and company level, while antitrust authorities are likely to see
more cases involving financially troubled firms during a recession than in better
times, the issues raised are not unique to a recession and do not require special
rules for financial distress arising during a recession.

B. Transitory Distress vs. Longer-Term Decline

When performing antitrust analysis in a distressed industry, it is important to
distinguish between a declining industry and one “merely” facing a cyclical
downturn. To illustrate, revenues in the newspaper industry have been declining
for some time, in large part due to changes in technology. The current recession
no doubt has accelerated this decline. However even before the recession began,
the newspaper industry was in the process of making some painful adjustments,
with newspapers looking at creative ways to grow their revenues and cut their
costs through collaboration and the use of creative business models.

Another major industry that has been in trouble of late is the U.S. automobile
industry. In this case, while there has been no long-term decline in the demand for
cars, U.S. manufacturers have increasingly faced pressure from foreign rivals.
And the recent sharp downturn in demand for automobiles has vividly exposed
pre-existing weaknesses, especially at Chrysler and General Motors. Traditional
antitrust principles are fully capable of accounting for foreign competition. And
the recent cyclical decline in the demand for automobiles provides no reason to
depart from those principles.

The U.S. airline industry presents yet another variation: while the airline industry
is hurting from the current recession, as it did after the attacks of September 11,
2001, it is not facing a long-term decline in demand. The overall trend in
passenger-miles is upward. The distinction between secular decline and cyclical
decline is important in antitrust because so much antitrust analysis, especially
merger analysis, is forward looking.
C. Financial Distress vs. Underlying Lack of Competitiveness

Turning to the individual firm level, one must distinguish between a firm “merely” facing financial distress and a firm whose fundamental ability to compete effectively in the future is in doubt. The classic case of the former is a firm that has important, valuable assets that should allow it to be an efficient competitor, yet is having difficulty meeting its financial obligations. Perhaps this firm took on too much debt when times were better, either related to an acquisition or to fund an overly aggressive growth strategy. Such a firm may well need to engage in a financial restructuring, and perhaps even file for bankruptcy under Chapter 11. Such a firm may need to enlist new management to set and execute a new strategy. But there are, as a general matter, good economic reasons to expect firms with valuable, industry-specific assets to emerge from their current financial difficulties as effective competitors. Reorganization through bankruptcy does not mean the removal of a competitor from the market. Hopefully, these propositions are not controversial. From my perspective, they reflect and dovetail nicely with the asset-based view of the firm from the field of business strategy.

D. Immediate Impact vs. Long-Term Industry Structure

We also should bear in mind that financial crises and recessions do end. Wise public policy involves looking ahead to the conditions likely to be present in any industry in the medium- and long-term, and not focus exclusively on short-term conditions or effects. This is especially true regarding mergers, which can permanently eliminate competitors in concentrated markets. Recessions are temporary, but mergers are forever.

E. The Financial Sector

The financial industry has experienced a massive failure of regulation that only recently became apparent. As noted above, the problems arising in the financial
sector, which have spread to the rest of the economy, provide no basis for departing from long-standing principles of competition policy. Properly regulated, competitive markets are still the best way to organize most economic activity and achieve economic growth. Including in the financial sector itself. If anything, the recent dramatic problems in the financial sector, and especially the dreaded concept that a financial institution is “too big to fail” and thus will qualify for government support, counsel for tougher antitrust enforcement, especially merger control, in that sector.³⁰ They also convince me of the value and importance of insuring that competition policy principles are fully respected and included as the government restructures the financial sector and establishes a new set of financial regulations that reflect what we have learned from the recent debacle and are suitable for the global financial markets of the 21st century.

4. Implications for Antitrust Enforcement

Fortunately, antitrust principles are very well established in the U.S., with broad, bipartisan support. Unlike during the Great Depression, we are not hearing calls for widespread abandonment of antitrust, even though the U.S. is experiencing the sharpest downturn in its economy since the 1930s. However, we do see some nibbling around the edges of antitrust.

Some of this nibbling comes in the form of calls for antitrust exemptions. I recently testified on antitrust enforcement in the newspaper industry.³¹ Some industry witnesses, noting the very tough economic conditions currently facing

³⁰ Government subsidies or bailouts for firms that are “too big to fail” might even be seen as an “efficiency” associated with a merger that creates a firm that is then “too big to fail.” Clearly, structuring a business so it might later qualify for an emergency government bailout does not constitute a true economic efficiency; if anything, the opposite is true.
many newspapers, were calling for antitrust immunity with regard to mergers and joint ventures. I explained why the Antitrust Division does not support further antitrust immunities for the newspaper industry.\textsuperscript{32} I stressed that antitrust law is sufficiently flexible to permit a wide range of business practices and creative business models that newspapers might employ as they seek to develop new sources of revenues and to cut costs to survive. I also noted that the failing firm defense may be applicable in some cases where two competing newspapers seek to merge and have assets that would otherwise exit the industry.

\textit{A. Alleviating Financial Stress by Reducing Competition}

More of the nibbling is likely to come as companies assert that their conduct is necessary for their financial stability or ability to survive, even if it might otherwise be seen as anti-competitive. Put bluntly, some companies are sure to ask antitrust enforcers, and the courts, to cut them some slack during tough times. What will be the response to such pleas?

In broad terms, our answer at the Antitrust Division is that we will continue to apply the tried and true methods of antitrust analysis that have served Americans well for over a century. The Antitrust Division cannot and should not look the other way when faced with practices or proposed combinations that will harm competition and consumers in the long run. Antitrust law, and enforcement of that law by the Antitrust Division, is sufficiently flexible to handle a wide range of industries and economic circumstances, including the present state of the economy. That said, we can give some more specific guidance regarding issues that are likely to come up with increased frequency during a recession.

The ultimate goal of antitrust law is to protect the competitive process so consumers are well served. The competitive process frequently leads to discounting, a common source of some annoyance to suppliers, especially during tough times. But consumers clearly benefit from vigorous price competition, including the enhanced discounting that tends to arise in industries with excess capacity. This principle remains generally valid even if that price competition puts some suppliers under increased financial stress. Indeed, the norm in a well-functioning market economy is for competition to put some suppliers under financial stress. “Antitrust law also does not protect the survival of firms for their own sake; as often stated, it seeks to protect competition, not competitors.”

One of the virtues of the competitive process is that it weeds out inefficient firms, or firms that fail to adjust to changing tastes or technology, and rewards firms that are most effective at serving consumers. As pointed out by John Fingleton, the CEO of the U.K. Office of Fair Trading, the evolutionary process, whereby some firms survive and others fail, can be especially intense, and especially valuable, during tough economic times. But these are exactly the times when suppliers may be most likely to seek some relaxation of the antitrust laws and most tempted to collude.

32 The newspaper industry has limited antitrust immunity under the Newspaper Preservation Act of 1970.
34 “A recession can facilitate strong growth in long term productivity. Unlike a boom, when inefficient players may survive and even grow, an economic downturn will tend to drive out the less efficient market players. This process of creative destruction leaves a stronger and more efficient supply base, thus driving innovation and productivity growth in the next period of expansion. This is a reason why competition agencies should apply a rigorous failing-firm ‘defence,’ especially in a downturn.” John Fingleton, CEO, Office of Fair Trading, “Competition Policy in Troubled Times,” January 20, 2009, available at http://www.of.t.gov.uk/shared_ofi/speeches/2009/spe0109.pdf.
35 Economic theory does not give a clear prediction regarding how incentives to collude vary with the business cycle. See, for example, Kyle Bagwell and Robert Staiger, “Collusion over the Business Cycle,” Rand Journal of Economics, 28(1), 82-106 (1997) and the references cited therein. The empirical literature is likewise ambiguous on how cartel activity varies over the business cycle, in part because not all cartel
Financial distress, in and of itself, is not an antitrust defense. As we enforce the antitrust laws, we will consistently protect the interests of consumers. Anyone who seeks to limit competition and pleads financial distress as a justification must make a convincing case that consumers will not be harmed by the proposed limitation on competition. The mere assertion that continued competition will leave the suppliers weakened and thus less effective competitors in the future is unlikely to meet this burden. For example, a showing that ongoing competition will reduce profits and thereby lead to a higher cost of capital for the merged entity will not be sufficient to show that competition harms consumers.  

B. “Ruinous Competition”

During an economic downturn, some industries will inevitably have substantial excess capacity. Under these circumstances, the prices resulting from competition may fail to provide many of the suppliers in the industry with a normal, risk-adjusted rate of return on capital. This may be true even for firms that are relatively efficient and have done a good job anticipating the needs of customers. The risk that a general economic downturn will reduce the rate of return on invested capital is, of course, but one of the many risks associated with business investments. Indeed, in many industries it is normal and expected that firms will experience some periods during which the risk-adjusted rate of return on capital is above normal, and other periods when it is below normal. Sound competition policy should not allow firms to restrict competition to avoid downside risks in

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activity is detected, so measuring cartel enforcement activities is not the same as measuring cartel activity. Nonetheless, a good argument can be made that suppliers will be especially tempted to collude when they are facing tough times and have substantial excess capacity.

36 More specifically, consider a claim that a proposed merger between close competitors will benefit consumers by reducing competition, thereby elevating profits and reducing the merged firm’s cost of capital. Under the Horizontal Merger Guidelines, §4, this would not appear to be a cognizable efficiency, since it results from a loss in competition. “Cognizable efficiencies are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service.”
their rate of return, any more than sound competition policy should intervene to deprive successful firms of their upside returns when times are good.\textsuperscript{37}

These days, it is unlikely that well-counseled firms will explicitly argue that they need to be saved from “ruinous” or “cutthroat” competition. But, under one name or another, this idea is likely to resurface. For example, two merging firms may well argue that ongoing competition will leave them with insufficient profits to make valuable and necessary investments to serve consumers. This is effectively a version of the “ruinous competition” argument that should be treated skeptically.

C. The Failing Firm Defense

A recession causes more firms to experience financial distress. There are likely to be more bankruptcies in 2009 than in recent years when the economy was stronger. Some firms may otherwise be viable but have made financial mistakes that combined with the recession have driven them into bankruptcy. Others will limp along until the economy recovers. All in all, it seems reasonable to expect that there will be an increasing number of mergers and acquisitions in the months ahead involving weak or failing firms or divisions. There may also be an element of opportunism at work, as some firms attempt to use the current economic conditions as a pretext to secure approval of what would otherwise be judged an anticompetitive merger.

While I am always open to new evidence and new arguments, and while judgment certainly must be exercised in cases involving weak or failing firms, so far I have seen no evidence, and heard no arguments, that would lead me to conclude that the current circumstances require a fundamentally different test than has been applied

\textsuperscript{37} Again, one can hope the lesson was learned during the Great Depression. On this point, one need look no further than the Supreme Court’s unfortunate ruling in \textit{Appalachian Coals v. United States}, 288 U.S. 344 (1933).
in the past to failing firms and divisions, as outlined in Section 5 of the Horizontal Merger Guidelines.\textsuperscript{38} If a merger involving a failing firm or division really will benefit consumers by generating cognizable efficiencies, that merger will meet the stringent standards of the failing firm test in the Guidelines.\textsuperscript{39}

Importantly, the failing firm defense automatically incorporates the possibility that the merger will generate cognizable efficiencies. The key point is that there would be no good economic reason for a successful firm to pay a premium to buy a truly failing rival in the absence of any such efficiencies: acquiring the failing rival would not protect the successful firm from competition, since (by definition) the failing firm’s assets would otherwise leave the market. So it must be some synergy that makes the failing firm’s assets especially valuable to the acquiring firm. These arguments apply regardless of whether the overall economy is in recession or not.

The fact that a firm has been losing money does not mean that it is a “failing firm” in an antitrust sense. To begin with, accounting loses do not necessarily correspond to true economic losses from ongoing operations, especially for firms that have taken on substantial debt. Beyond that, the requirements of the failing firm defense are designed to identify those limited circumstances in which the firm’s assets would exit the market but for the proposed acquisition. If the firm owns important assets whose value is greatest in their current use, these assets are unlikely to exit the market, even if the firm cannot meet its financial obligations in the near future. One signal of this situation is that investors place greater value on


the firm or division as an ongoing concern than in liquidation. Other evidence regarding the value of incumbency is also relevant to this inquiry.

One can also ask whether some mergers may be pro-competitive, even if the acquired firm does not meet the failing firm test, because the acquired firm is financially weak. This is sometimes called the “flailing firm” defense. In principle, of course, there can be efficiencies when one firm acquires its financially weak rival. However, following Section 4 of the Horizontal Merger Guidelines, to invoke an efficiency defense, the merging parties would have to establish that these efficiencies are large enough so that consumers are not harmed by the loss of competition resulting from the merger. While it is possible that a merger will generate efficiency by improving the acquired firm’s access to capital, this is a very delicate argument, for several reasons: the acquired firm may soon have improved access to capital as the economy improves; the acquired firm may be able to gain improved access to capital through other means, in which case the claimed efficiency would not be merger-specific; the merged entity may well have less incentive to make investments, due to diminished competition, even if its cost of capital is lower than the financially weak firm; the acquiring firm’s cost of capital may go up as lenders look at the overall credit risk of the merged entity; and, if access to capital is generally restricted, even for projects with an above-normal rate of return, entry to provide competitive discipline may be difficult. In any event, these are some of the factual considerations that could come into play in a given merger investigation.

**D. Exclusionary Conduct**

As noted above, a recession can be especially tough on firms that are already weak in some respect, e.g., because they have higher costs than their rivals or a weaker balance sheet going into the recession. Likewise, a recession can be especially tough on smaller firms that are struggling to survive and compete against larger,
more-established rivals with much stronger balance sheets. Yet today’s smaller, newer firms may have the strongest incentives to disrupt the status quo. They also may offer innovative new products and services, so long as they can gain a presence in the market and grow large enough to reach minimum viable scale.

For all these reasons, new and innovative firms may be especially susceptible during a recession to exclusionary tactics by dominant firms. Under the leadership of Assistant Attorney General Christine Varney, the Antitrust Division will vigilantly enforce the antitrust laws to prevent monopolists from maintaining their monopoly power by engaging in predatory or exclusionary behavior, especially during tough economic times when their smaller rivals are most vulnerable.

5. **Conclusions**

History teaches us that reducing antitrust enforcement during economic hard times does not promote economic recovery. The most striking example of this is the ill-fated National Industrial Recovery Act of 1933, which effectively legalized cartels covering a wide swath of American industry. These cartels delayed economic recovery during the Great Depression. By the late 1930s, the lesson had been learned: antitrust enforcement was reinvigorated by Thurman Arnold, who took over leadership of the Antitrust Division in 1938. Let us not forget that lesson.

We at the Antitrust Division are dedicated to vigorous enforcement of the antitrust laws during these challenging economic times.