Antitrust, Dynamic Competition and Business Ethics

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ABSTRACT. The American Antitrust Institute, a Washington, D.C. think tank, recently completed a study that concludes that competition law and policy plays little if any role in business ethics courses taught in U.S. business schools. To fill this intellectual void, this article makes a case for the development of a business ethics sub-field of antitrust ethics that is synonymous with the ethics of competitive strategy. After reviewing Paine's *Five Principles of Positive Competition* and Boatright's and Hendry's views on the *Moral Manager Model* and *Moral Market Model*, the need for ethical decision-making in a dynamic, innovative environment is explained through a Federal Trade Commission antitrust case involving the Dell Computer Corporation. The author argues that the contributions of Paine, Boatright, and Hendry provide an initial foundation for further research concerning the moral theories, principles, and rules pertaining to antitrust ethics, especially as it pertains to dynamic competition and "fair and competitive" executive behavior.

KEY WORDS: antitrust, competitive strategy, dynamic competition, ethics, innovation, static competition

The American Antitrust Institute, a Washington, D.C. competition policy think tank, recently concluded a study of what future decision-makers are taught about the nature of competition and the constraints of the antitrust laws in business schools. This project was initiated in the wake of a year-long litany of scandals involving financial fraud and mismanagement in some of America's most renowned corporations. Regarding the role of antitrust in the teaching of business ethics, the results of this study reveals that competition law and policy plays little, if any, role in the business ethics courses.

> This (business ethics deficiency) is a particular shame, because as any antitrust expert knows, there are very few blacks or whites in this field. While ethical concerns do not play a role in formal antitrust analysis, judgement plays a very large role in business decisions, and the ethical component of judgement should be explored within the context of the corporation's responsibilities to its various stakeholders, which may include customers, suppliers, and even (according to some ethicists) competitors (Foer et al., 2002).

To fill this intellectual void, this article makes a seminal case for the development of a business ethics sub-field of antitrust ethics that is synonymous with the ethics of competition strategy. After reviewing Paine's Five Principles of Positive Competition and Boatright's and Hendry's views on the *Moral Manager Model* and *Moral Market Model*, the need for ethical decision-making in a dynamic, innovative environment is explained through a Federal Trade Commission (FTC) antitrust case involving the Dell Computer Corporation. The author argues that the contributions of Paine, Boatright, and Hendry provide a theoretical foundation for further research concerning the moral theories, principles, and rules pertaining to antitrust ethics, especially as it pertains to dynamic competition and "fair and competitive" business behavior. However, before proceeding to this explication of antitrust ethics, it will be necessary to frame the discussion within

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the legal and economic environment that underpins antitrust policy.

Antitrust law and economics

The ethical aspects of antitrust policy compliance have never been a serious consideration of the professional antitrust community. Theirs is a world of legal rules and economic analysis focused on the maintenance of efficient markets. The enactment of antitrust statutes was a reaction to what economists refer to as "market failure" in capitalist economies. Market failure is described as "the failure of a more or less idealized system of price-market institutions to maintain and sustain desirable activities, or to stop "undesirable' activities" (Bator, 1958). In the case of the antitrust statutes, this includes unfair business practices. Since the U.S. Congress passed the Sherman Act in 1890 (and later, the Clayton Antitrust Act of 1914 and the Federal Trade Commission Act of 1914), managers have had to concern themselves with various forms of predatory business conduct, such as price fixing and discrimination, divisions of customers and markets, refusals to deal, and product tie-ins, all considered *per se* violations of the nation's antitrust laws. Other forms of business conduct may or may not be considered unlawful under Section 1 of the Sherman Act; in these cases the courts apply a *rule-of-reason* analysis to ascertain legality. From an organizational perspective, many corporations and industry associations include antitrust provisions in their business codes of conduct (Manley, 1991; Hemphill, 1992). Furthermore, it is not unusual for corporate and industry association counsel to provide written *Antitrust Guidelines* (or a layman's interpretation of business conduct considered *per se* violations of the antitrust laws) for executives to follow when interacting with competitors. Nevertheless, while managerial policy direction (including restrictions) is important, the act of ethical decision-making ultimately rests with the individual manager.

The recently evolving nature of competitive markets has significantly altered business conduct that was once viewed as *per se* violations of federal antitrust laws. For example, the idea of competitors colluding to engage in research and development (R&D), manufacturing, or marketing alliances, once legal anathema to executives, has now become commonplace in the global economy.[1] Furthermore, since the mid-1990s the U.S. Department of Justice, Antitrust Section (DOJ) and the Federal Trade Commission (FTC), the nation's enforcement compliance agencies, have been encouraging innovation as a primary driver of national competitiveness.[2] This emphasis on encouraging innovation is also found in the 2000 DOJ case brought against Visa and MasterCard. The Antitrust Division's position was not that these two credit-card companies were artificially maintaining prices; rather, that they had colluded to restrain the adoption of innovations such as *smart cards* (i.e., ones with embedded chips that could make health and other data available) that might pose a competitive threat to their market dominance.[3]

A sub-field of economics, industrial organization, has provided the primary analytic basis for the judicial interpretation of antitrust law. There are three acknowledged antitrust "schools" of competitive analysis: the *structural school*, which incorporates economic, political, and social objectives, and is identified with the static (i.e., point-in-time) *structure-conduct-performance* paradigm developed by Harvard University economist Joe Bain (1956); the *Chicago school*, which concentrates exclusively on the static economic objectives of efficiency, including industrial concentration, mergers, and contractual restraints, with a focus on prices (Kovacic and Shapiro, 2000); and the *new industrial organization approach*, which concentrates on static and dynamic (i.e., "evolving and innovating") efficiency, and emphasizes game-theoretic methods (Kovacic and Shapiro, 2000). More recently, a *dynamic competition approach* has emerged, whose theoretical models are process-based, involve market and technological innovation over a truncated timeframe, and depend less on price competition and more on a firm exercising a first-mover advantage (Ellig and Lin, 2001). This approach, not surprisingly, has applicability to analysis of high-technology industries manufacturing complex

products and, quite often, possessing network attributes requiring interoperability and the corresponding issues surrounding intellectual property rights, i.e., patents and copyrights.

The law and ethics of competition

While the law and economics behind the federal government's concerns with anti-competitive business behavior has a vast and growing literature, the same cannot be said for the ethical behavior of managers when engaged in anti-competitive conduct. The various sub-fields of business ethics, including accounting ethics, financial ethics, marketing ethics, and information technology ethics, have been the subject of much scholarly research over the past decade; not so for *antitrust ethics*.[4] Internationally, the term used synonymously with *antitrust* is *competition*. While a term such as competition would include antitrust concerns, the *ethics of competition* would also include business practices ranging from competitor intelligence (e.g., industrial espionage) to managerial decisions pertaining to advertising strategy (in this case, of the deceptive variety). Thus, the ethics of competition would be considered synonymous with the ethics of competitive strategy.

The recent federal antitrust case concerning the Microsoft Corporation – and more importantly, the final holding of the U.S. District Court for the District of Columbia on November 12, 2002 – has reaffirmed the relevance and importance of antitrust policy in the New Economy (interestingly, with both the plaintiff's and defendant's counsel citing the relevance of "innovation" in their arguments). While U.S. antitrust policy requires further evolution in light of experience and new knowledge (as was the original intention of the statutory language) to accommodate for the recent emphasis on innovation, the questions of managerial decision-making that violate the laws' anti-competitive provisions require an ethical framework to guide managers. This is where the development of a sub-field of business ethics, i.e., antitrust ethics, is needed.

Where does antitrust ethics fit into the field of business ethics? While certainly many of the *per se* violations of the antitrust laws are considered in marketing ethics, there is a tendency for the decision-making to be at mid-to-upper-levels of corporate management and involve cross-functional coordination. If not considered within a functional area of business operations, could antitrust ethics belong with the ethics of corporate or competitive strategy (Freeman and Gilbert, 1988)? This appears to be a better fit, as it straddles both the market and non-market environments of the firm (Baron, 1995). Yet, as briefly discussed above, antitrust ethics (unlike the ethics of competition) does not include the same breadth of cross-functional areas of ethical decision-making that characterizes business strategy. Moreover, while antitrust policy emphasizes the impact of anti-competitive behavior on consumer welfare, the primary stakeholder affected by such behavior is the offending firm's competitors. Thus, while antitrust ethics can be considered of strategic importance, it occupies its own managerial niche within the business environment, and sub-field of business ethics.

Antitrust ethics: a new perspective

Many scholars believe that U.S. antitrust policy has been an important factor in preserving the American public's support for market capitalism. Combining economic objectives with non-economic objectives, vigorous federal antitrust enforcement has successfully staved off "the rule of the jungle" in American business for over a century. As Hayek (1945) sagaciously recognized, private managerial decisions designed to eliminate competition are not the types of decisions that any democratic society would allow to continue for any significant length of time.

Depending on the analytic prism, antitrust law is viewed differently; for example, Bork (1978), an attorney by training, views it as a form of regulation, while Stelzer, trained in economic science, sees it as "one of the most effective tools for avoiding regulation, for leaving the job of resource allocation to competitive markets rather than assigning it to regulators" (Stelzer, 1997). Stelzer makes a strong case that the absence of

competition is more likely to produce direct regulation of prices and profits or direct government provision of a good or service. When antitrust policy fails as a prophylactic (i.e., to prevent the creation or maintenance of private monopoly power through unfair business practices), direct regulation is the usual government response in a society built on democratic capitalism. Contrarily, when antitrust policy is effectively implemented, direct regulation becomes unnecessary as the competitive market forces driving efficiency prevail. In conclusion, Stelzer posits that antitrust policy should not be classified as regulation, but instead,

> one of the most effective tools for avoiding regulation, for leaving the job of resource allocation to competitive markets rather than assigning it to regulators. For when markets are insufficiently competitive, we are apt to get that conservative horror of horrors, price regulation (Stelzer, 1997, p. 88).

In an attempt to address the ethics of competition and what Stelzer describes as "one of the most effective tools for avoiding regulation," Paine (building on the law of unfair competition as a starting point) (1990) offers her *Five Principles of Positive Competition* as a legal and ethical vision of competitive ideals. Her "ideal of competition" is found in traditional law governing how business competes and in the common consciousness about fair competition that exists in competitive enterprises. The first principle, *independent initiative*, requires competing units to work individually in producing the artifacts or performances upon which they are to be judged and prevents them from exploiting or appropriating certain efforts of fellow competitors. This principle envisions competitors as distinct units (e.g., individuals, teams, firms) working separately in their endeavors to outperform one another. The second principle, *constructive effort*, is based on the notion that the best competitors are those who succeed by their own positive efforts (i.e., focusing on their own strengths) rather than by undermining their competitors (i.e., exploiting their weaknesses). Furthermore, they see their rivals not as obstacles to be eliminated but as fellow seekers after a common prize. The third principle, *respect for the rules* (that govern competition and shall be followed), includes those that are explicit, some understood, some that define the activity, some that regulate its performance, some that govern relations among competitors, and some that govern relations among cooperators. The fourth principle, *the level-playing field*, is concerned with certain types of inequities among competitors and prevents them from using certain advantages, such as economic size, in their competitive efforts. The fifth principle, *respect for officiating parties*, concerns the relationships between competitors and the referees and judges of a competitive activity. In the case of business, this principle prohibits efforts to influence or mislead consumers, government officials, and officials of self-regulatory agencies in certain ways.

According to Paine, the "ideal of competition" is transmitted through the legal system and informally through a variety of attitudes and judgements found in the socialization occurring in families, schools, churches, and the workplace. If the ideals of positive competition are to survive and prosper, says Paine, they must find expression in the competitive marketplace, inform the law, be reinforced in business school education and rewarded in the workplace.

Two contrasting models of ethical business behavior that involve a self-regulation-government regulation dichotomy relevant to the discussion of antitrust ethics (and supporting Paine's "ideal of competition") are the *Moral Manager Model* and the *Moral Market Model*. According to the *Moral Manager Model*, managers both act and think morally when engaged in business decision-making. In this non-market model of an ethical code of managerial behavior, the goal of business ethics is to train managers as skilled moral reasoners. Such a manager is engaged in what Goodpaster (1991) describes as "Type 3" thinking, or an integrated approach where economic considerations, legal limitations, and "respect for the rights and concerns of all affected parties is given independent force in the leader's operating consciousness." According to Boatright (1999), since the business organization is the fundamental unit of analysis for business

ethics and it is directed by its top executives, the central task of business ethics is to introduce ethics into the thought processes of these managerial decision-makers and organizational designers. Therefore, the moral manager takes individual responsibility for his/her decisions and becomes more fully human, favoring informal modes of social control and a trust approach to regulation.

The *Moral Market Model* alternative is a business ethics focusing on individuals operating in a marketplace; therefore markets, not bureaucratic organizations, should be the focus of business ethics. The fundamental problem thus shifts from developing moral managers to creating moral markets. This shifts the onus to all participants in the markets exchange by emphasizing more efficient markets and effective regulation. Such a market system is characterized by role responsibility in corporations and a system of corporate governance that minimizes individual discretion, favors rules, and offers wider participation on boards of directors, thus giving each group an opportunity to achieve its ends through market participation. Furthermore, in the *Moral Market Model*, the ideal business relationship is a fully defined contractual relationship. Similarly, non-legal relationships exist only to the extent precise contracts cannot be written; in these cases (e.g., where there is complexity of business exchange, incomplete information, and a high level of risk), integrity and trust may be effective alternatives. This non-contractual relationship is a major challenge for managers and a central concern of agency theory.

In the 21st century global economy, Hendry (2001) does not view the *Moral Manager Model* and *Moral Market Model* as mutually exclusive in their application. Hendry believes that Boatright's observation that economic markets and economic modes of behavior characterize the citizen's life inside and outside the domain of the business firm is accurate. Furthermore, Hendry believes that many business ethicists may be uncomfortable with the concept of employing market incentives to solicit ethically desirable behaviors; therefore, a theoretical strand of business ethics needs to be developed that corresponds to the Moral Market Model. Yet, says Hendry, the moral ideal, which is embodied in the Moral Manager Model, is too important for business ethicist to abandon, arguing that "the moral regulation of markets is achievable and sustainable only in the presence of popular political support based on a continuing appreciation of traditional moral values." Moreover, Hendry believes that political support for these traditional moral values will have to come from the moral manager, especially when markets replace relationships, which only weakens the moral basis of society on which regulatory approaches to morality depends. Other critics also argue that markets are incapable of satisfactorily addressing ethical issues, and that direct institutional interventions are thus needed (Johnson, 1991). Thus, Hendry sees both the Moral Manager Model and Moral Market Model as interdependent and necessary for business organizations to successfully address the moral challenges resulting from globalization. The following example, involving the FTC and Dell Computer Corporation, illustrates the ethical issues that arise in the realm of antitrust enforcement in a dynamic and innovative business environment.

The FTC and Dell Computer Corporation

In traditional, static analysis of markets, numerous competitors with identical access to the same or similar technologies and resources compete on price. Furthermore, static analysis assesses the effect of corporate conduct (i.e., exclusionary practices) given the current state of products, sources of supply, production technologies, marketing practices, and management practices. From the vantage point of the courts, traditionally applied static analysis of markets has resulted in a tradeoff between consumer benefits and costs; therefore, the judicial decision rests on whichever emerges as the winner in this exercise in benefit-cost analysis. But in a growing number of high-technology industries, competitors with different technologies and resources compete on the basis of product attributes and performance as well as price. But how do we know when a firm in an innovative industry possesses market

power that harms consumer welfare? The dynamic nature of modern competition affects the nature of potential competition. For example, sunk costs, in the form of intellectual property rights, trade secrets, and tacit knowledge all combine to make it difficult for potential entrants to possess the same technology as the incumbent.

The critical antitrust issue is not just whether a particular exclusionary practice produces some identifiable consumer benefit in the present, but also how that managerial conduct will affect the path of innovation in the future (Ellig, 2001). Under dynamic competitive analysis, the courts will again practice rule-of-reason analysis, but must consider the different paths that innovation might travel. The linear, sequential model of industrial innovation has given way to *chain-linked* and *concurrent* models that include complex, simultaneous flows of information (including *feed-back* loops) and cooperation (Kline, 1995; Ministry of International Trade and Industry, 1992). Thus, *exclusionary practices* will need to be evaluated based on whether thy produce superior innovations; subsequently, such market power can be assessed by a careful analysis of the current case being judicially reviewed. This has been the case in the trial of Microsoft: What are the benefits and costs to economic welfare of management's decision to integrate its Web browser with its Windows operating system? Over time, general rules on innovative behavior may accumulate based on industry conduct and performance, allowing the courts a stronger empirical basis for its antitrust decision-making, while again, weighing the costs and benefits of such business behavior.

The importance of innovation and antitrust is highlighted in a 1996 FTC case involving the important issue of intellectual property rights. In *Dell Computer*, a computer hardware standard was designed for the Video Electronics Standards Association (VESA) for a local bus (VL) to transfer instructions between a computer's CPU and peripherals.[5] VESA is a voluntary standard-setting organization composed of almost all of the major computer software and hardware manufacturers. During the standard-setting process, VESA twice asked its members to certify whether they had any patents, trademarks, or copyrights that conflicted with the proposed VL-bus standard. On both occasions, Dell certified that it had no such intellectual property rights. After VESA adopted the standard, Dell sought to enforce its patent against firms planning to follow the standard (this is referred to as patent *holdup*). The FTC charged Dell with an unfair method of competition, a violation of section 5 of the FTC Act. The FTC's complaint specifically alleged that industry acceptance of the standard was delayed, that uncertainty about the acceptance raised the cost of implementing the new design, and that the patent dispute had negatively impacted industry standard-setting efforts. Agreeing to a FTC consent order, Dell was required to relinquish its rights to enforce its patent against any computer manufacturer using the new design in its products. Furthermore, the order prohibits the company from engaging in comparable behavior in future standard-setting activities.

In this case, the FTC was concerned with a firm (Dell) that had intentionally failed to disclose its intellectual property rights during a standard-setting process where such disclosure was required. Public comments received by the FTC were generally supportive of the Commission's position on this case (Balto, 2000). However, there was a divergence of opinion when it came to what duties the antitrust laws imposed on firms involved in a standard-setting process in the absence of intentional nondisclosure or misrepresentation and what duties should be imposed on the standard-setting organization. Certain organizations do not require disclosure, pointing out that imposing such a duty could deter many pro-competitive standard-setting activities. For example, a strong disclosure requirement involves important trade-offs, since many firms may be reluctant to participate if they must disclose potentially conflicting intellectual property rights. On the other hand, disclosure provides a greater assurance to members of the standard-setting organization that there will not be delayed assertion of intellectual property rights and that they can make the investments necessary to build equipment compatible with the standard without fear of unanticipated liability.

The *Dell Computer* antitrust case bring up

several questions that are of an ethical concern. For instance, what motivated Dell's management to lie to VESA, an organization of which it is a member? Why would Dell management wish to poison their reputation among competitors and suppliers for future cooperative standard-setting activities necessary for the commercialization of innovative technologies? When there are no written requirements to disclose intellectual property rights in a standard-setting activity, is there an ethical requirement to disclose to the best of management's knowledge? If such a patent or copyright is legitimately missed in a company's search, is it company management's duty to waive the royalty fee requirements that could be charged against users of the new standard? The focus of these questions leaves little doubt of the strategic nature of antitrust ethics.

Summary and conclusions

In this essay, an effort is made to present an initial case for the development within business ethics of a sub-field of antitrust ethics. As the American Antitrust Institute has noted, managerial judgement is of paramount importance in the realm of anti-competitive behavior and the antitrust laws. Yet there has been little rigorous study of the moral implications of this area of competitive strategy by business ethicists. As Stelzer informs us, antitrust law avoids the need for direct government regulation of many business practices. By doing so, however, this places a greater burden of responsibility upon private sector management to self-regulate itself. In practice, the legal profession has provided most managerial guidance on the antitrust laws. While these legal rules are important for managers to follow, they are insufficient without corresponding explicit moral rules to buttress the procedural guidance of legal strictures. As Soule (2002) argues, moral principles are necessary to generate specific moral rules. Paine makes an attempt to provide principles of positive competition that blend law with ethics. Her first and the fifth principles have little direct relevance to issues of antitrust and are of a more general nature as pertains to business conduct. However, the second, third, and fourth principles have relevance for managerial guidance on antitrust issues relating to customers, suppliers, and competitors. Furthermore, because of the unique nature of the antitrust laws (as noted by Stelzer), both the moral market model and the moral manager models of ethical business behavior are necessary to be exercised by society to protect consumers from the harm that anti-competitive behavior engenders. The contributions of Paine, Boatright, and Hendry can provide a valuable foundation for further research concerning the moral theories, principles, and rules pertaining to antitrust ethics.

In the Microsoft case, the federal judiciary has recently upheld the relevance of antitrust policy in the formation age. With the emergence of recognition of the importance of innovation in national competitiveness, the antitrust enforcement authorities are moving away from their most recent focus on efficiency and price as their primary, if not exclusive, consideration in their antitrust analysis of anti-competitive behavior. Dynamic competition brings with it new interpretations of what is "fair and competitive" business behavior. The example of the FTC's case against Dell Computer, Inc. offers an indication of the importance of ethical behavior toward one's competitors. The increasing complexity of products in the high-technology marketplace also requires a greater need for standardization and interoperability among technological systems for commercialization to take place. The issues of trust and ethical behavior are important if firms operating in cooperative arrangements are to accelerate the innovation and commercialization processes. Consequently, the practical need for the development of ethical principles of competitive behavior (in relation to antitrust issues) is also a great practical importance in the New Economy.

Harkening back to the electrical equipment price-fixing conspiracy of 1959, one hopes that there has developed an increased awareness in the American business community to the importance of "fair and competitive" business practices to the health of our capitalist economy. Some four decades ago, many of the same electrical equipment-manufacturing executives who were found criminally guilty of antitrust violations

were readily offered equivalent jobs with other corporations in the industry after serving their prison sentences. While recognizing that similar offers of employment are less likely today, an ethics of antitrust may help ensure that a cavalier managerial response to antitrust transgressions will be an even less viable option for management consideration.

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Notes

[1] This is reflected in federal antitrust enforcement policy and legislation, such as the National Cooperative Research and Production Act of 1993, reducing the legal and financial risk to competitors participating in R&D and manufacturing strategic alliances.

[2] See *Antitrust Guidelines for the Licensing of Intellectual Property*, U.S. Department of Justice and the Federal Trade Commission, April 6, 1995, and *Antitrust Guidelines for Collaborations Among Competitors*, Federal Trade Commission and the U.S. Department of Justice, April 2000.

[3] See U.S. Department of Justice, U.S. v. Visa U.S.A., Inc., MasterCard International, Inc., and Visa International, Inc., No. 02-6074(L), the United States Court of Appeals for the Second Circuit, August 30, 2002.

[4] See for example, L. A. Ponemon, M. J. Epstein and J. Gardner (eds.): 1995, *Accounting Ethics* (JAI Press, Stamford, CN); W. M. Hoffman, J. B. Kamm, R. E. Frederick and R. Petry (eds.): 1994, *The Ethics of Accounting and Finance: Trust, Responsibility, and Control* (Quorum Press, Westport, CN); L. V. Liedekerke and J. M. Gerwen (eds.): 2000, *Financial Ethics* (Peeters, Louvain, Belgium); D. K. Davidson: 2002, *The Moral Dimension of Marketing: Essays on Business Ethics* (American Marketing Association, Chicago, IL); J. N. Sheth and A. Parvatiyar (eds.): 1999, *Theoretical Foundations in Marketing Ethics* (JAI Press, Stamford, CN); R. T. DeGeorge: 2003, *The Ethics of Information Technology and Business* (Blackwell Publishers, London, U.K.); and R. O. Mason and M. J. Culnan: 1995, *Ethics of Information Management: The Ethical Challenge* (Sage Publications, Thousand Oaks, CA).

[5] See *Dell Computer Co.*, C-3658 (May 20, 1996), Federal Trade Commission.

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