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The Sherman Act and the Rise of the Large Business Enterprise: Failures in Law and Theory

Introduction
Societies periodically encounter major transformations that substantially alter the future conditions of the inhabitants. Whether these transformations result in crisis and great tragedy or great progress is largely a matter of how the society interprets, responds to and shapes the changing circumstances. Societies will always intervene in the face of massive change, as change will have disastrous consequences to some groups of peoples as old customs and institutions are challenged (Polanyi 1944). Members of society facing the negative consequences of the changing circumstances motivate interventions, although the enacted solution may fall short. In order for said interventions to shape the newly developing institutions in a desirable way, they need to be grounded in the facts of the situation and carried out by an institution capable of producing desired consequences. The rise and dominance of the large business enterprise transformed society in a substantial way and one of the most influential interventions to shape this transformation was the Sherman Anti-trust Act of 1890.

In the late 19th century great fear surrounded the power and control of the newly arising large business enterprise. Rather than understanding the facts surrounding these new markets, and placing legitimate constraints on enterprises, the Sherman Act was passed in an attempt to return to the days of isolated local competition—days which had long since passed. The Act was written without creating an institution capable of dealing with issues of the large business enterprise; rather, issues of enforcement and interpretation were to go through the judicial system. The Supreme Court is charged with interpreting the laws written by Congress, not successfully shaping transforming societies. The combination of basing the Act on distorted conceptions of reality, while handing responsibilities of interpretation over to an institution not free to practically address the facts at hand with the flexibility required of changing circumstances, resulted in the very outcomes the Act was intended to prevent. The Sherman Act encouraged the development of fully united enterprises of a never-before-seen size and power.

Background
Previous to the massive scale of production prevalent by the dawn of the 20th century, production took place on a much smaller scale and for the purpose of providing a livelihood. In the era of petty-trade, profits were the means of providing a living, as opposed to the more modern large
business enterprises producing for a return on investment (Veblen 1904). Prior to the emergence of the business enterprise, output was dependent on the skills, time and dedication of the owner, and price was ‘governed’ by the personal nature of the transactions involved as well as the need to dispose of output. While those engaged in production may have taken pride in their work and mastered their skills or trade, output was still limited to what they could produce themselves, or, at most, with the help of a few ‘employees’. Since trade took place at the community level, prices were limited by the desire to maintain relationships within the community as well as a moral sense of fairness reinforced through social relationships. Small-scale production, when involving hired labor, still required the direction, support and skills of the owner, whose concern over personal reputation and character constrained prices (Ibid.).

Moreover, in a market characterized by petty production and trade, demand will influence prices, as sales are more or less episodic. If, after production takes place, output is transported to the market, to be sold by the close of the market, demand will play a large role in the determination of price—if all output is to be disposed of by the close of day, much price negotiation will take place. According to Means, it can be imagined that such small-scale production occurs at an increasing marginal cost, since the few individuals involved become tired and strained after some point as output increases, thereby enabling a role for supply and demand interaction (Lee 1998). The next ‘round’ of production, would result in approximately the amount of output that could be produced and sold at the previous day’s price (Ibid.). Since producers would have had limited resources and technology, and were driven by the desire to make a livelihood—meaning, they were lacking the desire and capability to grow indefinitely—‘markets’ were characterized by numerous independent, insignificant producers (Veblen 1904). ‘Market forces”—episodic sales—and cordial social relationships ‘regulated’ prices and production in the handicraft era.

As technology advanced, thereby advancing production techniques, factories became increasingly common and employers hired substantially more employees than that experienced under handicraft economies. As the size of factories grew, so too did the geographic size of the market, which resulted in a loss of what once had been an enduring community relationship between seller and buyer. Moreover, the larger scale of production led to the development of ‘continuous’ markets—product was no longer brought to ‘market’ to be sold by end of day; sales and price-setting did not take place simultaneously. While community relationships and episodic
sales were conceivably incapable of regulating prices and output, the ever-growing scale of production and size of enterprises spurred competitive behavior. This newly developing competition was to ensure market stability and low prices in what was to become orthodox economic theory.

According to competitive theory\(^1\), ‘natural’ market forces will result in the best possible outcome so long as there are a sufficient number of enterprises in the market, relative to the size of the market. If these conditions hold and enterprises do not collude to set prices, no one firm can have any influence at the level of the market. It is assumed that firms will undercut each other until, inevitably, a minimum price is established. Any sort of government regulation interfering within the market is an intrusion and will distort efficient outcomes, while infringing on the freedom of market participants as well. The state is seen as necessary to the extent that property rights are to be protected. Agents are to be free to exercise unhindered liberty, guided only by the natural forces of the market. It was the beginning of this dramatic change, from petty industry, during which economic theory—consistent with what is now known as ‘mainstream’ or ‘orthodox’—began to take shape (Veblen 1904).

Common sense perceptions developed within the handicraft era provided the foundations of natural law theory and, later, conceptions of markets and the economy as a self-regulating system, efficiently allocating resources (Veblen 1904). Liberty has persistently been idealized in the United States, but essentially is understood as freedom from restraint or coercion. While the freedom to contract is not to be restrained by man, it is to be regulated by ‘natural market’ forces. As long as an individual’s freedom to contract does not interfere with the same freedom held by others, the individual is to buy and sell without restriction. Where natural law demands liberty, economic theory, utilizing natural market forces, exalts liberty for the efficient outcomes that result from its expression. The most efficient outcome results from ‘natural’ market forces, and interfering with such forces, or the liberty of individuals that put such forces in motion, will result in public harm. The unrestrained forces of supply and demand, within a competitive market, will bring about the lowest possible prices for the public, and incidentally, require the

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\(^1\) There will be no specifics, such as maximum utility, profit maximization, &c, because (1) much of ‘neo-classical’ theory was yet to be settled, in fact, Marshall’s first edition was not published until 1890, the year the Sherman Antitrust Act was passed, and (2) many of the court opinions refer vaguely/generally to competition/monopoly and the consequences thereof—the public is harmed by higher prices, which tend to exist under monopoly/price-fixing arrangements, &c.
fewest restraints\(^2\) to ‘liberty.’ Under such habits of thought, anything interfering in the market, other than that which is required to maintain competitive conditions, is seen as unnatural, restraining to individual liberty and harmful to the public. However, as was to become apparent in the 19\(^{th}\) century, competition was not always beneficial to the public, desirable, or even an achievable goal.

**Issues of Governance: Large Enterprise**

With the advent of stable and reliable transportation, new production technologies, financial innovations as well as other general technologies such as refrigeration came what Veblen labeled the machine process and the birth of the large business enterprise (Veblen 1904; NICB 1929). The machine process involves highly interrelated business enterprises within and between industries. As production processes as well as output became more complex, interactions among enterprises sweepingly overwhelmed interactions between enterprises and the public. Not only did businesses have to deal with any ‘external’ changes which could influence production processes, profits, &c.; the demanded output, costs, production time, measurements, &c., of one enterprise was becoming intertwined with and dependent on aspects and strategies of enterprises in other markets, or even other industries. A disturbance in any one industry would set off a domino effect through virtually every other industry (Veblen 1904). With the advance of technology came the large business enterprise and thereby, dependence: it had become necessary for the business community to develop mechanisms that enable cooperation and organization among related enterprises (Campbell et al. 1991).

In addition to the dependence on enterprises in other markets—suppliers, buyers, transportation and communication companies, &c.—the owners of the new form of enterprise were finding the theory of ‘isolated’ competitors ceased to ring true. Within markets there had developed fierce competition, but rather than stable beneficial outcomes, competition was essentially harmful. In the new era of large-scale production, production took place for the purpose of return on investment—continuous growth of the business enterprise. Given that initial investments were large, it was necessary to be able to identify a consistent market share and price, without which returns would be insufficient. While it is not hard to imagine keeping up with the costs of ‘fixed’ and ‘circulating’ capital during the handicraft era, owners of a large

\(^2\) It should be specified here that natural law theory, as well as many free market proponents, focus solely on the negative aspects of freedom or liberty—freedom from restraint rather than freedom to live a fulfilling life, &c.
business enterprise must raise and maintain substantial funds in order to sustain the enterprise. This requires a stable and predictable market. Enterprises faced with direct competition, a new phenomenon, had yet to develop social rules and customs to restrain destructive behavior (Fligstein 1990). Mass production, national markets and a need to sustain a return on investment led to extremely destructive competition as enterprises attempted to maintain a market share and destroy competitors wherever necessary for their own survival and growth (Fligstein 1990; Campbell et al. 1991; Massimo 2004). Enterprises continuously sought to establish successful mechanisms to stabilize the market and establish a stable price, without which no enterprise could survive (Lee 1998). Not only were institutions constructed to deal with adversarial aspects of competing enterprises, enterprises within a market also realized the benefits of united coordination when dealing with enterprises in other markets or industries, labor groups and politicians.

The dramatic changes taking place in the economy affected different social groups in different ways. Public outcry toward the latter half of the 19th century led many states to enact laws limiting the powers and capabilities of corporations; however, the nationalization of markets made most state reforms futile (Massimo 2004). As markets changed from local and personal to national and impersonal, state politicians, small business owners and citizens alike, felt powerless over the newly formed economic giants (Wiebe 1967). Additionally, labor groups were forming as a reaction to these newly formed economic giants. Concerted action at the level of the market or industry, on the part of the involved enterprises, was likely to be more effectual in dealing with a common adversary (Campbell et al. 1991).

In the era of handicraft, episodic sales, personal relationships and production for a livelihood were the institutions that governed and regulated the market. Out of this era, developed the theory of isolated competitors and natural market forces, which was out-dated by the time it infiltrated the American psyche. Old institutions could not govern the large business enterprise, and associated interrelated economy. The process of putting in place governing mechanisms to deal with these obstacles evolved over time through trial and error, being shaped by an interaction of common and divergent interest groups as well as legal sanctions and constraints. The state has great influence over business and can be of great benefit to society, although when informed by misguided conceptions of reality, the state can be a source of great harm.

Attempts at Governance
There have been many forms of governance for many different reasons. Some attempts have been declared illegal, while others turned out to be ineffective. It is typical for numerous types of governance mechanisms to exist in one market at the same time, as various institutions are created to deal with specific obstacles. While some of these institutions have been entirely private, others have been public institutions, and still others are private but are aided by public institutions.

*Predatory Competition as Governance*

By the end of the civil war, it became apparent that the corporate form was the best legal structure through which to engage in large productive ventures. In accordance with such thinking, by 1875 states had replaced specific incorporation laws, where the legislature would approve or deny specific persons the privilege of incorporation to carry out a specified business, with general incorporation laws offering “the privilege of incorporation to all members of a specified class on the same terms” (Liebhafsky 1971: 159). General incorporation laws removed the requirement of legislature approval prior to incorporation, making incorporation substantially easier.

With the growth of corporations and mass production came fierce competition as social norms and customs regulating interaction among competing enterprises had yet to be established. One of the first responses to competition was destructive to all parties involved.

Predatory trade practices were the most common form of direct control. Their major purpose was aggressive: destroy your competitors. Managers and entrepreneurs consciously undercut their competitors’ prices; undertook to deny access to raw materials, essential technologies, and customers; secretly purchased their competitors’ stock, and in the extreme, engaged in illegal disruption of production and sales. (Fligstein 1990: 34)

This mechanism of governance was a source of constant instability and financial failure even for firms emerging victorious at the conclusion of a price war as new competitors continued to arise in the place of the old (Campbell et al. 1991; Fligstein 1990). Business leaders came to understand what had eluded economists: competition that ensues in the presence of large business enterprises is not of the harmonious and stabilizing type predicted in mythological theories of property and economics, but rather is a one-against-all, winner-take-all battle among competitors that turns into a persistent war for each successive ‘victor’.

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3 In fact, the government has aided businesses since the First Congress met (Liebhafsky, H. 1971).

4 While some aspects of general incorporation had been adopted as early as 1795 in Massachusetts, it was not until about 1850 that “a number of states had adapted general incorporation statues”; by 1875, most states moved from specific to general incorporation (Liebhafsky 1971: 158).
Cooperation as Governance Mechanism

Given the failure of predatory practices, it is not surprising to find that enterprises attempted to engage in cooperative mechanisms of governance. After the civil war, pools became a popular form of governance, especially among newly formed corporations in an attempt to achieve market stability. Agreements among member businesses were made regarding price, output or both, with the intention of stabilizing the market. While pools could potentially stabilize destructive competition, because of the ‘extra-legal’ status of the arrangements, pools commonly broke down over enforcement issues.

Pools arose in industries that were facing destructive price competition and were successful in the short term, although they commonly broke down when member businesses failed to adhere to the agreements and punishments could not be enforced. Pools, essentially, were no more than voluntary agreements where violating members could not be punished. Situations encouraging violations led to the destruction of the pool—precisely when these agreements were most important, they tended to break down. However, while pools tended to fall apart, new agreements were made almost immediately after, as the destruction of a pooling arrangement most often led to a revival of predatory competitive practices in order to sustain sales (Liebhafsky 1971). Given that these practices were harmful to all involved enterprises, it is not surprising that destruction of a pool agreement almost immediately led to a new cooperative arrangement. Even though members of pools had failed to make their agreements legally enforceable, and post-1890 many of these agreements became illegal, the associations, through which these agreements were made, have continued, although their scope and purpose have evolved (Fligstein 1990).

In response to the failures in governance brought on by pooling arrangements, as well as issues of legality, business enterprises, many of which were formerly arranged as pools, began forming legally enforceable governance mechanisms known as trusts (Liebhafsky 1971; Mund 1950). In a trust, rather than having an extra-legal agreement, a board of trustees holds majority stakes in each involved corporation. The former stockholders hold trust certificates which entitle them to a dividend while control is conceded to the trustees. Agreements as to prices, allocation of output among the corporations, capacity utilization, &c., became strategies of the trustees,

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5 ‘Pools’ as here discussed could be a price-fixing arrangement within an association, or a cartel arrangement, wherein output is allocated.
6 For example, the Distillers and Cattle Feeders’ Trust, or “the Whiskey Combination” (Liebhafsky 1971: 160)
thereby helping put an end to destructive competition. While the everyday operations continued as before, one united body set the general policy of the trust, thereby ending price competition among members. Trust agreements successfully overcame the problem of enforceability or ‘cheating’ which members of associations or pools encountered; they failed, however, to form a fully united corporation with united purpose, culture and function. Members of each corporation remained separate and viewed themselves as members of a specific corporation, rather than as members of a single enterprise (Liebhafsky 1971).

Unification as Governance Mechanism

While trusts were popular for a few years, the holding company was the next attempt among business enterprises to govern the market while implementing a unified strategy among several former competitors. In a holding company, one corporation holds majority stakes in several corporations. The holding company was not utilized popularly as a governance mechanism as it was outside the blessing of the law of several states until the 1890s. During the 1870s and 1880s there was much public outrage and concern over the large combinations, and state legislatures answered the cries. However, without uniform state laws, corporations were attracted to states with relatively lax laws, making it more difficult to regulate them and more likely to lead to competition among states. In 1888, New Jersey passed “the holding company act, allow[ing] corporations ‘of this state or any other state, doing business in this state, and authorized by law to own and hold shares of stocks and bonds of corporations of other states’ to do so” (Mitchell 2006: 1496). However, it was not until 1893 that the law made it clear that a corporate stockholder could vote and participate in the same way as an individual. Such recognition in the legal structure allowed the various corporate enterprises involved in the holding company to unite into one functional enterprise (ibid). A holding company potentially allows for a more general fusion of interest and function of former competitors (Fligstein 1990; Liebhafsky 1971). The move from a less to a more unified form of governance was a result of the need to consolidate industry in order to enable coordination and end destructive competition. While some coordination may require a more unified form of organization—closing inefficient plants, investing in new technology and expansions, &c.—transforming several independent corporations into one is not the only form capable of achieving necessary coordination.

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7 States competed with each other by relaxing the restrictions and laws regulating corporations and corporate activity, which essentially led several states to bless whatever actions a corporation deemed necessary in an effort to retain business enterprises—a regulatory ‘race to the bottom’.
However, it was found that without a unified organization, many forms of market governance were held to be illegal (Mund 1950; Liebhafsky 1971; Fligstein 1990; Campbell et al. 1991). In fact, many of the former trusts that changed their legal status to holding company did nothing more in function than change names on a sign, in an effort to remain within the bounds of the law (Liebhafsky 1971).

The trial and error attempts at market governance in combination with the legal responses of the federal government led to a move away from the less unified structures of governance and helped inspire the merger waves of the latter part of the 19th and early 20th centuries.

**The Law and the Business Enterprise**

In an effort to develop coherent and comprehensive laws regarding corporations and competition, thus answering the call of the public and confusion of business enterprises, the Sherman Antitrust Act of 1890 was passed, with every House member and all but one senator voting in the affirmative (Mund 1950). The intent of the act was to quell worries and fear over the increasing influence and number of large business enterprises as well as the power and excessive profits resulting from anti-competitive behavior (Mund 1950; Evans 1911; Liebhafsky 1971; 221 U.S. 1). Fear of monopoly and love of competition has long existed in the cultural memory of America. Had conceptions regarding property, freedom and markets been influenced by what was becoming increasingly common—the ever-pervasive large business enterprise and the realities that come with such an institution\(^8\)—legal responses to a drastically changing society would have been more effectual and outcomes more desirable. Instead, the statute enacted to deter monopoly and monopolistic tendencies, discouraged cooperation through associations, which disperse power among firms and have relatively less power than monopolistic firms, while encouraging mergers and monopolistic—and, eventually, oligopolistic—markets.

**Sherman Anti-Trust Contextual Background**

In feudal times, “monopoly, in its broad sense, was everywhere the rule”, and even as cultures moved away from feudal life, and petty craft and trade became increasingly common, monopoly privileges persisted (Evans 1911: 61). English history is full of instances where exclusive privileges to monopolize trade, granted by the sovereign, have severely harmed the general population. Prior to the passage of the Monopoly Statute in the 17th century, monopoly

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\(^8\) Rather than, as was the case, informed by common sense perceptions acquired and spilling over from the handicraft era (Veblen 1904).
grants were so pervasive in England that a great majority of the English population paid “exorbitant” prices, for many of the social necessaries of life (Evans 1911: 62). The idea that monopoly is harmful to the public—that it results in higher prices—as well as restricts freedom has pervaded our institutions ever since. Not only has monopoly been one of our culture’s ‘dirty’ little words, competition has been exalted to a status so high in American culture that the outcomes of the Sherman Act regarding associations have been more harsh and strict than can be seen elsewhere (Evans 1911).

**Sherman Act**

The Sherman Act of 1890, declares “Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations is hereby declared to be illegal,” and “Every person who shall monopolize, or attempt to monopolize, or combine with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a misdemeanor...” The act empowers (1) the justice department to file criminal charges or civil suits requesting dissolution, divestiture, &c. and (2) private enterprises to pursue compensation in civil court for damages brought about by violations of the Sherman Act. The intention of the Act was to create and maintain competition; rather than addressing the issues at the heart of so-called anti-competitive behavior, the Act assumed a pro-competitive stance from the start.

The purpose of anti-competitive behavior instituted though trade associations and other governance mechanisms was maintenance of the large business enterprise. While the goal of the legislation may have been to deter excessive profits and power while achieving market stability, the realities of competition should have shown: not only was price competition not a savior, it was, moreover the main cause of market instability. If the legal system was to act as a countervailing power to the desire of private business to govern by combination, it was of necessity to base the statute and interpretations on the realities of modern competition. That businesses do not compete over prices but set them in an effort to avoid destructive competition has been a fact since the emergence of the large business enterprise and has been ignored in the American legal system as long. The courts consistently ruled against forms of market

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9 Sect. 1 and 2 respectively
10 Price agreements were thought to be anti-competitive as they were believed to be arranged to secure monopoly profits rather than provide necessary stability.
stabilization enacted by former competitors, through associations and the like, while persistently making exceptions for unified firms. As is shown below, regardless of original intent, by outlawing cooperation between competitors, while blessing most every merger, the outcome of the law was to encourage the growth of the large business enterprise to sizes previously unseen.

Sherman and Associations

Associational activity greatly varies and associations arise with a number of divergent purposes. While much of the activity and information coordinated under associations is not illegal, activities that were harmful to price competition were declared illegal by the Sherman Act. Associations are most commonly comprised of businesses in the same line of industry and are most successful in dealing with those issues on which all involved enterprises agree. While the main purpose of associations was avoidance of destructive price competition, they have evolved into institutions capable of fulfilling many purposes, many of which have nothing to do with price competition or avoidance thereof. While most legal cases involving associations and the Sherman Anti-trust Act revolved around whether circumstantial evidence of price-fixing could be demonstrated, from 1890 to 1897 cases had yet to be ruled upon by the Supreme Court and the lower courts were inconsistent (Mund 1950).

In the 1897 U.S. v. Trans-Missouri Freight Association et al. case, it was ruled that while the restraint may very well have been a reasonable one, restraints to trade are per se illegal. Given that price-fixing was found to be a restraint to trade, even a reasonably justified price-fixing arrangement was deemed illegal. The association was comprised of railroad companies attempting to avoid destructive price competition and sustain reasonable profits. According to the association’s statement, the association was formed “For the purpose of mutual protection by establishing and maintaining reasonable rates, rules, and regulations on all freight traffic, both through and local, the subscribers do hereby form an association to be known as the "Trans-Missouri Freight Association” (166 U.S. 290). In spite of knowing the ‘reasonableness’ of the price agreements, the Supreme Court ordered the activities cease as it was an agreement among competitors to set prices. Businessmen and journalists began questioning whether the precedent set in the Trans-Missouri case would remain as it caused ‘great upheaval’ in the business community. The following year, in US v. Joint Traffic Associations, the Court upheld their

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11 Non-price activities range from lobbying government for beneficial policies to R&D and implementing the results of R&D into the production process.
previous ruling while explicitly reiterating the established precedent of the *Trans-Missouri Freight* case (171 U.S. 505). The *Joint Traffic* case was incredibly similar and gave the Court the perfect opportunity to mitigate the previous *per se* ruling; instead, the Court explained that if the law was to be restricted to unreasonable or undue restraints, then it was a matter for Congress (*Ibid.*; 221 U.S. 1). The job of the Court was not to provide enterprises with necessary market stability, but to interpret the law as Congress intended. Enterprises were forced to assume that if price-fixing agreements were going to be necessary, an association was not going to be an acceptable route.

Perhaps realizing the precarious situation in which the Court had placed the large business enterprise, the *per se* ruling was relaxed, although negligibly, in the 1889 case of *US v. Addyston Pipe and Steel Company et al.* In the case, the Court still held price-fixing arrangements, division of sales and other restraints of trade to be *per se* illegal, but only if restraint is the end-in-view. If price-fixing or other forms of restraint of trade are simply *a means to another legitimate business end*, then this is to be considered an *ancillary* restraint, and was deemed legal (175 U.S. 211). The ancillary restraint lies somewhere between the strict *per se* ruling against restraint of trade and the rule-of-reason interpretation. It is however fraught with restriction, thereby making associational price-fixing an illegitimate form of ending and preventing destructive price wars.

…if the restraint exceeds the necessity presented by the main purpose of the contract, it is void… But where the sole object by both parties in making the contract as expressed therein is merely to restrain competition, and enhance or maintain prices, it would seem that there is nothing to justify or excuse the restraint. (Taft in Hartley 1999: 42; italics mine)

The next pertinent ruling regarding associational governance occurred in 1921 and involved an open-price association, *American Column and Lumber*. An open price association (OPA) rather than explicitly setting prices, involves enterprises that ‘share’ prices with other members of the association. Prices can be stabilized and ‘cheating’ enterprises can be quickly identified through the requirement that all enterprises publicly communicate past prices. The incentive to cheat is diminished when other enterprises match or beat the reduced prices quickly. If an enterprise is finding it difficult to sustain sufficient cash flows to remain solvent, decreasing prices should increase sales, at least temporarily. The goal is to sustain higher sales until other enterprises realize the prices have been reduced and match or ‘beat’ the new prices. If the reduced prices are matched almost immediately there is no incentive to ‘cheat’ on the stabilized market price and destructive price competition is avoided. The *American Lumber* case was a
rather extreme OPA wherein prices were reported daily, a significant amount of other information was required to be reported and the association was allowed access to the books of all involved enterprises (Liebhafsky 1971). The Court ruled that while there was no explicit agreement regarding price-fixing, the extent of information sharing and access of the association to enterprise information was obviously an attempt to restrict competition while avoiding the intent of the Sherman Act. Lack of an explicit agreement was not enough to avoid the sanctions of Sherman. The Court’s stance in the American Column and Lumber case made most OPA activity illegal, while still leaving open the possibility of some minimal price-sharing activity.

While in 1923 in a case similar to American Lumber the Court upheld the previous ruling, by 1925 in the Maple Flooring and Cement Manufacturers Protective Association case, the Court ruled that some amount of price sharing was an acceptable process for gathering information about the market, and as such was a necessary component of competition and business. A now-majority of the Court agreed that a necessary component of price-competition was awareness of competitor’s prices and the government had not shown there was any evidence that price or output was determined or shaped by the association. The case differed in the extent of information shared and the frequency of sharing; additionally, the information was gathered not only for the involved enterprises, but was also turned over to the Department of Commerce (Mund 1950; Liebhafsky 1971).

The following conclusions can be drawn from the above rulings regarding associational activities: (1) price-fixing arrangements are everywhere and always per se illegal and in violation of the Sherman Act; (2) price-sharing does not provide sufficient evidence of a price-fixing arrangement, however there is a very fine line between price-sharing which is a component of gathering market information and an implicit agreement to avoid or discourage price-competition; (3) if prices are to be made available to other sellers, then buyers must have access to the same information. Market stabilization would seemingly be difficult to pursue through associational activity alone (Mund 1950; Liebhafsky 1971)12.

Sherman and Restraint through Combinations

12 Specifically, according to Mund, legal associational activities include “sales promotion work, public relations, standardization of products, technical research, collection of statistics, formulation of just and equitable trade practices, and reporting of prices at which goods in the past have actually been sold,” while the following has been ruled illegal: “collusive price-fixing, the use of price-reporting systems which serve to restrict price competition, the use of boycotts, black lists, ‘peaceful persuasion,’ or other forms of coercion to injure or restrict the freedom of suppliers, competitors or customers, and collective activity to keep newcomers to the field” (1950: 167).
The first case involving combinations to make it to the Supreme Court on the grounds that the combination violated the Sherman Act was extremely encouraging to manufacturing industries seeking combination as a form of market governance. In 1895 the Supreme Court handed down their ruling in what has come to be known as the Knight or Sugar Trust case, which served as a catalyst for the following wave of manufacturing mergers over the next decade (Mund 1950). In U.S. v. E. C. Knight Co., at issue was American Sugar Refining Co.’s entering into combination with four former competitors—all four of which were based in Pennsylvania—giving the trust ninety-percent of the sugar-refining market in the United States by the time of the case (156 U.S. 1).

The Court held that while American Sugar Refining Co. could be said to have a practical monopoly in America, the company cannot be said to have violated the Sherman Act as Congress has no jurisdiction over the combination. The mere fact that the sugar—once refined—will be sold to other states and international territories is insufficient to justify jurisdiction under the Interstate Commerce Clause. The combination consisted of sugar refineries; corporations acting legally under the laws of the states in which they were incorporated.

Manufacture is transformation -- the fashioning of raw materials into a change of form for use. The functions of commerce are different. The buying and selling, and the transportation incidental thereto, constitute commerce, and the regulation of commerce in the constitutional sense embraces the regulation at least of such transportation. . . . If it be held that the term includes the regulation of all such manufactures as are intended to be the subject of commercial transactions in the future, it is impossible to deny that it would also include all productive industries that contemplate the same thing. The result would be that Congress would be invested, to the exclusion of the states, with the power to regulate not only manufactures, but also agriculture, horticulture, stock raising, domestic fisheries, mining -- in short, every branch of human industry. For is there one of them that does not contemplate more or less clearly an interstate or foreign market? … The power being vested in Congress and denied to the states, it would follow as an inevitable result that the duty would devolve on Congress to regulate all of these delicate, multiform, and vital interests -- interests which in their nature are, and must be, local in all the details of their successful management. . . . The demands of such supervision would require not uniform legislation generally applicable throughout the United States, but a swarm of statutes only locally applicable and utterly inconsistent. (156 U.S. 1)

Interstate commerce is secondary to the purpose of the business: refining sugar.

Doubtless the power to control the manufacture of a given thing involves, in a certain sense, the control of its disposition, but this is a secondary, and not the primary, sense, and, although the exercise of that power may result in bringing the operation of commerce into play, it does not control it, and affects it only incidentally and indirectly. Commerce succeeds to manufacture, and is not a part of it. … Nevertheless it does not follow that an attempt to monopolize, or the actual monopoly of, the manufacture was an attempt, whether executory or consummated, to monopolize commerce, even though, in order to dispose of the product, the instrumentality of commerce was necessarily invoked. (Ibid.)
According to *Knight*, production was primary over commerce; the merely incidental nature of sales nearly removed productive enterprises from the jurisdiction of Sherman, thereby relegating regulation of manufacturing monopolies to the state legislatures. The *Knight* case brought about the first ‘loophole’, which effectively instituted a single form of legal governance.

However, by 1905 in the *Swift* case, the Court narrowed the exemption of productive enterprises from Sherman. The *Swift* case involved several dealers who bought livestock, transformed the livestock into consumable meat products and sold it. The Government provided proof of an agreement between the dealers, who covered sixty percent of the market, to fix and establish uniform prices for both livestock (purchases) and consumable meat (sales). Following the *Knight* precedent the defendants could conceivably argue, the process of transforming livestock into consumable meat was their primary purpose, whilst purchase of inputs and sales—commerce—were of secondary concern. Rather than accept such an argument, the Court attempted to draw a distinction between the two cases in a way that would give Sherman jurisdiction over some anti-competitive policies of productive enterprises (196 U.S. 375).

In the *Knight* case the ‘object’ of the combination was monopoly of manufacture, over which the Court had no jurisdiction: “However likely monopoly of commerce among the states in the article manufactured was to follow from the agreement, it was not a necessary consequence nor a primary end” (*Ibid.*). Since control over the refining market was the object of the sugar combination, Congress lacked jurisdiction. The resulting monopoly over commerce was indirect. In the *Swift* case restraining and attempting to monopolize commerce among the states—sales price—was the primary end of the agreement (*Ibid.*). “Here the subject-matter is sales, and the very point of the combination is to restrain and monopolize commerce among the states in respect to such sales” (*Ibid.*). Owning and controlling enough refineries in multiple states to control ninety percent of the national market—and consequently the market price—does not fall under the Interstate Commerce Clause, while a combination among companies who constitute sixty percent of the consumable meat market and have an explicit agreement regarding price falls under the Clause and is in violation of the Sherman Act. In the former case, prices of outputs were considered ‘incidental’ to the manufacturing combination, whereas here prices were deemed primary. The two cases further illustrate the inconsistencies of the Court and the difficulty and uncertainty involved in administering industrial policy in such a way.
The *Northern Securities* case in 1904 made it illegal to restrain trade through the ‘veil’ provided by a holding company. The case involved a pure holding company, Northern Securities, which owned stock in two railroad companies, Great Northern Railway Co. and Northern Pacific Railway Co., former competitors with parallel lines offering passage through a great part of the U.S. There were three opinions in the case making the ruling fairly complex. Although the majority opinion found Northern Securities in violation of the Sherman Antitrust Act, Justice Brewer was the deciding justice—the fifth—and while he agreed with four other justices that the company had violated the Act, he did so for reasons other than those given by the ‘majority’\(^\text{13}\). Four of the justices, in the majority, found the holding company to be no different than associations that had been ruled upon previously, and following precedent, found the holding company to have violated the act by restraining trade and suppressing competition. Justice Brewer concurred that the holding company had violated the Act, although he held that the company had *unreasonably* restrained trade, and therefore had violated the Act. Justice Brewer, standing alone, believed common law to contain the correct precedent\(^\text{14}\), rather than more recent Supreme Court interpretations of the Act\(^\text{15}\) (193 U.S. 197). The pure holding company appeared unsustainable on legal grounds as a form of market governance and began falling in popularity relative to ‘fusion-mergers’ after 1904 (Mund 1950: 164). The large combinations were being pushed by the Anti-trust statute to unite in a more functional form at the same time that businessmen were realizing the difficulty of managing the large combinations where all involved corporations maintained an independent identity.

In the same year as the passage of the Sherman Act, *American Tobacco* was born through merger of several former competitors. In 1911, rulings in the *Standard Oil* and *American Tobacco* cases were handed down, both of which encouraged combination as a legal and enforceable form of price stabilization. The American Tobacco company was a holding company which had near-monopoly shares of various tobacco markets: ninety-five percent of cigarette business, eighty-five percent of plug tobacco, seventy-five percent of tobacco manufacture and eighty percent of snuff tobacco (Mund 1950: 153). Standard Oil was a trust comprised of

\(^{13}\) This adds to confusion when the case is utilized as precedent in the *Standard Oil* and *American Tobacco* cases.
\(^{14}\) Common law holds *unreasonable* restraints of trade illegal.
\(^{15}\) The four dissenting judges argued the case fell outside of the jurisdiction of Congress given that there was no interstate commerce involved in the construction/ownership of the holding company—simply purchasing or exchanging stock/titles do not constitute interstate commerce and therefore, actions should be judged on the basis of New Jersey law, which allows such ownership activities.
seventy-one corporations at the time of trial and controlled “ninety per cent of the business of producing, shipping, refining, and selling petroleum and its products and thus was able to fix the price of crude and refined petroleum…” (221 U.S. 1)\(^{16}\). While both companies were broken into several smaller companies at the behest of the Court, market share and absolute size were not responsible for the dissolutions. Rather, the rulings made acceptable any combination, aside from those formed with the purpose or intention to monopolize, and additionally, made general restraints of trade subject to the rule of reason\(^{17}\).

Standard Oil and American Tobacco were partaking in drastic and destructive measures in order to secure their market share and establish dominance and a uniform price in the market. Standard Oil and American Tobacco were shown to have engaged in discriminatory pricing in order to drive competitors out of the market or draw them into the trust/holding company, priced higher in areas of greater market share, allocated sales among subsidiaries, used their monopoly to control required processes and/or inputs utilized in production in an effort to disadvantage competitors, bought competing plants only to immediately close them and used railway employees to spy on competitors (Standard Oil) among other things (221 U.S. 1; 221 U.S. 106). Either of the massive combinations could easily have been found in violation of the Sherman Act for countless reasons. Rather than strengthen or maintain the Sherman Act in light of such egregious violations and vastly wealthy companies, the Court radically departed from any interpretation giving the Act purpose.

In the Standard Oil Case, the opinion focused on the ‘unreasonableness’ of the malicious acts done to competing enterprises and the intent to monopolize, which appeared to have existed since at least 1879 (221 U.S. 1). The opinion begins with a clarification of the interpretation of sections one and two of the Sherman Act, relying on common law rather than more recent Supreme Court decisions. According to the majority opinion, trade under common law had come to be modified specifically because reasonable restraint of trade was deemed not only necessary but also beneficial to trade (\textit{Ibid.}). As Crown-monopolies disappeared out of everyday life, monopoly in common sense language as well as law came to be affiliated with the consequences

\(^{16}\) Standard Oil controlled ninety percent of the oil-refining market since 1882 (Mund 1950: 151)

\(^{17}\) Formerly, in common law, when restraints of trade were judged on the basis of ‘reasonableness’, these were merely partial restraints and most commonly revolved around restraints which kept men from acquiring employment (Mund 1950; Evans 1911).
common to the days of Crown monopolies rather than an actual monopoly\textsuperscript{18}. When writing the Sherman Antitrust Act, Congress had in mind\textsuperscript{19} unreasonable restraints of trade and intentions to bring about the fruitful consequences of monopolies, which result from unreasonable restraints of trade (\textit{Ibid.}). The second section is merely a “compliment” to the first: the means by which the attempt to monopolize is carried out—or consequences thereof. While the opinion admits this interpretation is in \textit{slight} contrast with the decisions in the \textit{Trans-Missouri Freight} and \textit{Joint Traffic} Association cases, the ‘majority’ of the Court believed this to be consistent not only with common law but also with Supreme Court rulings on the Sherman Act.

The \textit{Standard Oil} case represented three radical departures in interpreting the Sherman Act (1) sections one and two were taken to be complimentary rather than distinct; (2) restraint was from then on to be considered in violation of the act only if it was ‘undue’ or ‘unreasonable’—mostly malicious activity towards competitors; and (3) rather than holding monopoly illegal \textit{per se}, practical monopolies were only to be considered in violation of the Act if the position was intentionally attained through \textit{unreasonable} means—acting in violation of the first section (221 U.S. 1). Justice Harlan in a dissenting and concurring opinion addressed these issues. Of the new ‘reasonableness’ standard: “In other words, we are asked to read into the act by way of judicial legislation an exception that is not placed there by the lawmaking branch of the government…This we cannot and ought not do” (\textit{Ibid.}). Justice Harlan provided numerous excerpts from more recent Supreme Court cases to illustrate what a radical departure from precedent this opinion was—given the ‘majority’s’ attempt to shield the change by referring to common law applications of reasonableness and intent to monopolize (\textit{Ibid.}).

As was the case with Standard Oil, American Tobacco was found to be in violation of the Sherman Act and was ordered into dissolution\textsuperscript{20}. However, the violation resulted from the practice of destructive—‘unreasonable’—restraints to competition and intent to monopolize through illegal means. In the \textit{American Tobacco} case, Justice Harlan wrote an opinion in which

\textsuperscript{18} Specifically, “(1) The power which the monopoly gave to the one who enjoyed it, to fix the price and thereby injure the public; (2) The power which it engendered of enabling a limitation on production; and (3) The danger of deterioration in quality of the monopolized article which it was deemed was the inevitable resultant of the monopolistic control over its production and sale. As monopoly…embraced only a consequence” (221 U.S. 1).

\textsuperscript{19} Since the Court originally could not refer to anything more recent than common law interpretations of restraint of trade, precedent shall be found there.

\textsuperscript{20} The dissolution was ordered solely because of the intent to monopolize, i.e., position gained through unreasonable/unsound competitive restraints. Moreover, while the combinations were split up (divested from the dominant company) the same small group of capitalists retained ownership positions and remained non-competitive on price (Mund 1950: 152-53).
he concurred and dissented, once again. Although he agreed that the combination was formed with the intent to monopolize and was in violation of the Sherman Act, he questioned the legitimacy of applying the ‘rule of reason’ to restraint of trade (221 U.S. 106). While the Standard Oil opinion admitted a slight departure from the 1897 and 1898 railroad precedents, the American Tobacco opinion declared consistency with precedent since the Act was established, including Trans-Missouri Freight and Joint Traffic (Ibid.).

According to Standard Oil and American Tobacco, in order for an act to qualify as a restraint of trade it needed to be of a predatory nature, and mere size was not sufficient as a violation of the Act. As long as a single unified company set the price of only their output and did not engage in acts harmful to whatever few competitors remain, the enterprise was not in violation of the Act. This view has been labeled the ‘Abuse Theory of Mergers’, wherein “in the absence of predatory acts, the Court appeared to be willing to accept mergers and such price policies as the giant corporations might pursue” (Mund 1950: 210). As long as the great enterprises do not abuse the power they acquire, they are free from prosecution under the Sherman Act. The rulings in the U.S. Steel (1920) and International Harvester (1927) cases further articulated the Court’s new stance on the Act; thereby giving businesses a clearer idea of what was illegal, practically speaking. U.S. Steel ‘only’ comprised fifty percent of the steel market21, and according to the Court did not constitute a monopoly and did not engage in predatory acts. U.S. Steel had previously sponsored what came to be known as Gary Dinners, wherein price agreements were made with competitors; however, by the time of the case the dinners no longer occurred. The Court believed the dinners were proof that U.S. Steel was not a monopoly, and since the dinners had ceased, the company was not in violation of the Act (Mund 1950).

International Harvester Co. purchased several former competitors, gaining control of what was once independent pricing power to an extent sufficient to gain a price-leadership role. The price-leader “controlled some 64 percent of the output of harvesting machinery,” (Mund 1950: 184) and was ordered to sell two lines of harvesting machines to independent manufacturers (274 U.S. 693). In spite of following the orders of the court, the enterprise retained two-thirds of the market and its role as price leader (Mund 1950: 184)22. Moreover, the Court repeated the claim “The law does not make the mere size of a corporation, or the existence of unexerted power on

21 ‘Only’ as compared to the near-monopoly shares of American Sugar, Standard Oil and American Tobacco
22 According to Mund, the role of price-leader had been maintained as of publication of Government and Business in 1950 (184).
its part, an offense, when unaccompanied by unlawful conduct in the exercise of its power,” while adding “The fact that competitors may see proper, in the exercise of their own judgment, to follow the prices of another manufacturer does not establish any suppression of competition or show any sinister domination,” (274 U.S. 693). It was not acceptable to ‘conspire’ with competitors in an effort to establish a uniform price; it was however acceptable for a single enterprise to purchase other competitors in order to grow large enough to establish a uniform market price (Mund 1950: 184). In ‘gobbling up’ multiple competitors, the large business enterprise establishes a cost advantage and an implied threat of punishment to any enterprise attempting to undercut the established price. The enterprise need not follow through on the threat often, as other enterprises are aware of the cost advantage as well as the larger enterprise’s ability to sustain losses for a substantially longer period. Even if the enterprise is ‘broken up’ through the judicial process, past cases have shown that these dissolutions are more formal than functional and substantial. From these series of cases the new form of governance was born, which continues to this day: that of price-leadership.

**Market Governance and Sherman**

Markets are constructed within society to meet the needs of the large business enterprise and shaped by the motivations of businessmen. Aside from the structural aspects of the current economic system, governance mechanisms are constrained only by social institutions. These mechanisms will be shaped by the successes and failures of the past, changing economic circumstances and will reflect the motivations of businessmen. The assumption made by the government of the late 19th and early 20th centuries, and by orthodox economic theory, that competition, not society, shapes markets, takes society out of the process or results in counter-intuitive policies—such as is the case with the Sherman Act.

Great technical innovations led to the development of a new sort of competition, wherein the activities and strategies of one enterprise set in motion consequences upon other enterprises and in turn, led to reactive-strategies. Attempts to destroy or push other enterprises out of the market were one of the first strategies put in place. Upon recognizing the inadequacies and constant battles required by such a strategy, enterprises searched for new, more effective options, one of which was combination with other enterprises. The 1901 publication of the Industrial Commission on Trusts and Industrial Combinations included interviews with countless businessmen. The commission found that the causes of combination were the same in nearly
every case: combinations resulted from excessive competition and price wars, which were considered “the death instead of the life of trade” (1901: 30).  

When determining a form of governance, enterprises must act within the constraints of society, most directly, of the legal system. At a time when enterprises were becoming ever larger and more powerful, society desired a restriction or check to this new power. The answer was the Sherman Anti-trust Act and, as has been shown, it was a massive failure in addressing the fears and concerns of the public in that it shaped market governance towards unified combination and an increasingly powerful business enterprise. The result was undesirable, given what motivated the Act. Fear of the power of the large business enterprise was to be addressed by the legislation. The legislation then encouraged ever-larger combinations.

Given that elimination of competition through combination did not have enforcement difficulties and adverse interests to overcome, and came to be blessed by the law that intended to prevent it, combination grew in popularity relative to cooperation. An enterprise could not make an agreement over pricing policy with another enterprise, but can purchase another enterprise and take over the pricing policy indefinitely. The goal of Sherman was to prevent suppression of competition, which was to limit and constrain the large business enterprise. Instead, the law encouraged destruction of competition through the purchase of competitors. Instead of keeping power dispersed among several businesses, the need to eliminate competition in the only legally blessed way—growth through combination—resulted in “a great restructuring of industry” (NICB 1929) wherein dominant firms developed and flourished (Liebhafsky 1971; Fligstein 1990). The rulings against collusion, exemptions for manufacturing firms and apparent successful stabilization through combination gave rise to a merger movement, involving predominately horizontal mergers, which slowed with the stock market crash and Northern Securities ruling of 1904 (Markham 1952: 167). Especially after the Steel and Tobacco rulings in 1911, monopolistic tendencies were replaced with oligopolistic markets, wherein a few relatively large firms controlled most of the market and maintained a uniform market price, leaving competition to areas of business other than pricing policy (Fligstein 1990; Becketti 1986).

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23 More specifically “Where there is no general understanding among producers there is a strong tendency to overproduction, so that markets become demoralized and competition excessive. The combination is able so to fit the supply to the demand that while customers can be fully supplied at reasonable prices there is no danger of overproduction. It is thus a means of preventing panics and periods of depression” (Industrial Commission 1901: vi)  
24 While cooperation is beneficial to all involved enterprises, given varying cost structures and capacity limits, it may be difficult for enterprises to come to a voluntary agreement through an association which lacks powers of enforcement (Campbell et al. 1991).
process of market governance had developed and was mostly successful, although constraints to
the large enterprise were never realized.

Conclusion

There were two great faults in the attempt to deal with the newly forming large business
enterprise at the turn of the century: the Act was informed by a common sense habit of thought
developed out of a reality of the past and was not interpreted by an institution capable of basing
decisions on practical real-world consequences. The realities of industry required stabilizing
destructive price competition, while society desired a check to the power of the ever-growing
enterprise. A false sense of understanding led Americans to look to competition to limit the
power of the large business enterprise. After the Courts allowed ‘reasonable’ restraints of trade
and encouraged price-leadership markets to continue, the first issue with Sherman had been
solved, albeit in a manner that allowed larger enterprises and greater concentration than ever
seen before. This roundabout solution to the problem of market governance left the second issue
completely un-addressed, while making it ever more important. Though distorting Sherman has
allowed the business enterprise to develop a uniform market price, as long as American faith in
competition reigns, the exalted and vast power of the large business enterprise will continue
unabated.


Polanyi, Karl. 1944. *The Great Transformation: The political and economic origins of our*

Standard Oil Co. of New Jersey v. U.S., 221 U.S. 1 (1911).


U.S. v. Trans-Missouri freight Association, 166 U.S. 290 (1897).