Gerla
Antitrust
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Question I (60 points)

Lawnomat Inc. ("Lawnomat") is a franchisor of professional lawn care services. Lawnomat thus operates through independently owned franchisees. Lawn— omat has a standard franchise agreement with each of the franchisees. Under the agreements each franchisee is assigned an exclusive geographic "area of responsibility" and may only service customers' lawns in that area. The franchise agreements also impose on franchisees strict standards for the types and quality of service they render to customers.

Under the franchise agreement Lawnomat furnishes to the franchisee training on how to maintain lawns using the Lawnomat "system" and advertising materials. With respect to advertising, Lawnomat agrees to supply at its expense all television, radio and print media advertising (both local and national) for the franchisees as well as advertising brochures for local distribution. To supplenient the advertising efforts of Lawnomat each franchisee is required by the agreement to hold free semi yearly lawn care "seminars" (in which the homeowner-participants are given hints on lawn care and told of the "virtues" of the Lawnomat "system") and to make regular phone solicitations of potential customers in its area.

The franchise agreements have one other noteworthy feature--- Lawnomat franchisees are forbidden to extend credit to customers. This provision, unlike the previously described provisions, was not in the original Lawnomat franchisor/franchisee agreements. The origin of the "no credit" provision was a series of franchisee bankruptcies. It seems that a few years ago a number of franchisees, in an effort to compete with other lawn care firms, began offering customers a 90 days same as cash policy" allowing the customers up to 90 days to pay without incurring interest charges. When an economic downturn came, a large

number of credit customers defaulted which in turn drove 20 franchisees (almost 7% of Lawnomat's total number of franchisees) into bankruptcy. In the case of ten of these franchisees Lawnomat has never been able to reestablish a presence in their former areas. Instead, the business of the former franchisees is now firmly in the hands of Lawnomat's principal rivals. As a consequence Lawnomat has insisted on including the "no credit" provision in its franchise agreements and all of its present-day agreements have the provision.

The bankruptcy of the franchisees was not a total loss for Lawnomat. In the case of ten of its bankrupt franchisees, Lawnomat was able to buy out and operate the businesses of its former franchisees. Much to their surprise, Lawnomat found these ten operations to be even more profitable than its franchisee-owned businesses and has therefore continued to own and operate them to this day.

The management of Lawnomat is concerned with respect to the status under the federal antitrust laws of the "area of responsibility" and "no credit" provisions of its franchise agreements. You have been retained as a consultant to study the situation. Discuss any problems under the federal antitrust laws that the two provisions might engender and how an antitrust court would resolve them if their legality were litigated.

Question II (60 points)

For purposes of this question you are to assume that the relevant market is Material Emissions Analyzers ("MEAs") sold nationwide. The market shares of the firms in the market are shown in the following Table:

Firm	Share of Market
Hightech, Inc.	27%
Digisystems, Inc.	19%

Superscan, Inc.	19%
Data King Inc.	17%
Measurement, Inc.	10%
Readout, Inc.	5%
Feedback Specialties, Inc.	3%

MEAs are devices which can detect materials failures through measuring their electrical emissions. The devices were invented by Measurement, Inc. ("Measurement") just 15 years ago. For a while Measurement dominated the MEA market (as recently as 7 years ago it had a 90% share of the market). The company, however, has within the past three years fallen on hard times.

The MEA market is characterized by extremely rapid technology change. Firms already in or seeking to enter the MEA market are continually inventing new types of MEAs which make previous MEAs almost obsolescent. This characteristic has had a number of interesting effects on the market. First, firms tend to enter or leave the market extremely rapidly. For example, of the seven firms currently in the market, only two (Digisystems, Inc. and Measurement) were in the market four years ago. Second, the pace of technological change has caused the market shares of the participants to fluctuate tremendously. A comparison of Hightech Inc.'s ("Hightech") position in the market today and just eighteen months ago provides an excellent illustration of the impact of the above developments. Just two years ago Hightech had an 11% market share and was the fourth largest firm in an eleven firm market (the top four firms having an aggregate share of 50% of the market). Hightech's position today can be gleaned from the above table.

The board of directors of Measurement, alarmed by the firm's steadily declining market share, commissioned a noted management consulting firm to analyze Measurement's position. The report (which you are to <u>assume</u> is accurate) blamed Measurement's decline on its failure to develop new types of MEAs. The consultants noted that the key to future success for all the firms in the market was the development of new more advanced MEAs by innovative scientists and

engineers. Measurement has been unable to retain such personnel because it lacks the money needed to pay their escalating salaries and because Measurement's management has historically been unreceptive to new ideas developed by innovative scientists and engineers. The consultants concluded that unless Measurement Inc. came up with a source of funds to attract talented scientists and engineers and had a change in management's attitude toward technological innovations, the firm would become unprofitable and collapse in five years (give or take a year). The report concluded by noting that it was unlikely, given Measurement's condition, that the company could obtain new equity financing of loans from conventional sources.

The board of directors of Measurement concluded that merger was the only way to save the stockholders' investment and immediately contacted Hightech with an offer to sell Measurement to it. Hightech, which had previously expressed an interest in a merger, believed it would be a perfect "marriage." Hightech was rich in financial resources and had a tradition of technological innovation both in and out of the MEA market. Measurement, in spite of its problems, had the oldest name in the MEA market and did retain a degree of customer loyalty.

Hightech, therefore, has now agreed to acquire Measurement. You are to evaluate the legality of the acquisition under §7 of the Clayton Act.

Question III (60 points)

Note: For purposes of this question you are to assume that the relevant geographic market is the entire United States.

There are only two types of speed control and counting units ("C+C units") for canning machines. One type is the mechanical unit. It still accounts for 70% of all C+C units sold. The second type of unit is the electronical digital computer control unit. The electronic unit does not do anything that the mechanical unit cannot do. The electronic C+C unit does, however, have several advantages. Itis faster, more reliable,

more flexible and quieter that its mechanical counterpart. Thus, even though the electronic C+C unit costs approximately three times as much as the mechanical unit and has been in production for only three years, it now accounts for 30% of all C+C units sold.

When electronic C+C units were first developed, all of the more than a dozen makers of mechanical units began to manufacture the electronic units. Now, however, there are only three firms which manufacture electronic C+C units. The largest of these is Compcon, Inc. ("Compcon"), a wholly-owned subsidiary of the giant conglomerate Envelop, Inc. ("Envelop"). Compcon accounts for 70% of all sales of electronic C+C units and 21% of all sales of all types of C+C units. Compcon only makes electronic units.

Electronic and mechanical C+C units must be manufactured in totally different types of plants. They are, however, distributed through the same independent distributors. Compcon has attempted to induce distributors of its C+C units to carry only Compcon electronic C+C units (Compcon did not care about distributor sales of mechanical units because the firm felt the latter "were simply not in the same league" with electronic units). For various reasons Compcon's attempts along these lines have met with little success. No more than 2% of all distributors (both in terms of numbers and volume of sales) have become "exclusive" Compcon dealers.

A number of factors may account for Compcon's 70% share. First, while in terms of price and quality Compcon units do not differ from those of their competitors, Compcon, thanks in large part to the financial resources of its parent Envelop, has always maintained a vastly superior service network. Thus, if a Compcon unit failed it would take only five hours on the average for Compcon to repair or replace the unit. Compcon's competitors require 24 to 48 hours to complete the same task. The competitors simply lacked the financial resources to match Compcon's service network.

Second, Compcon units also are by far the most heavily advertised C +C units. Compcon' s advertising budget is almost twice as large as

those of its competitors combined. Compcon not only gives generous promotional allowances to the distributors of its C+C units, but engages in massive trade media advertising. Before Compcon began marketing C+C units, advertising for them had been limited mainly to small promotional allowances for distributors, trade shows, and occasional trade publication advertisements. Massive advertising was simply not the norm. Compcon, however, was a subsidiary of Envelop. The other divisions of Envelop were in consumer products markets where massive advertising was the rule. The management of Envelop believed that its Compcon subsidiary should utilize the advertising techniques which had proven so successful for Envelop's other divisions.

Compcon has recently been involved in some non-antitrust litigation. It was sued by a number of present and former makers of electronic C +Cs for falsely disparaging their products. The outcome of all the cases was the same. Compcon was found liable, but its competitors were awarded only minimal damages because they were unable to prove that they had lost any significant numbers of sales because of Compcon' s disparagement.

_ Assuming the above facts can be proven, discuss whether Compcon would be liable for monopolization in violation of §2 of the Sherman Act.

End of examination