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Upon his reelection to the office for a second term, as well as the victory of a larger majority of conservatives to congress, President Bush has put implementation of tort reform as a priority on his agenda for the next four years. Even though the supporters of tort reform claim that its main purpose is to prevent the filing of excessive amount of lawsuits against physicians and consequently decrease what the proponents of reform call “defensive medicine,” a more thorough investigation of the current situation of tort law as well as the interests behind tort reform demonstrate that the parties that are likely to benefit most from the reform are multibillion dollar corporations and insurance companies that insure physicians. In order to understand the main purpose and future effects of tort reform, it is first important review the concept and justifications behind the idea of tort reform.

The main concept behind the idea of tort reform is to place a cap on the number of lawsuits which can be filed by the victims of wrongful injuries, or the relatives of victims of wrongful deaths, to obtain economic compensation for non-economic damages. These non-economic damages include those such as pain and suffering, or mental disorder caused by a tragedy. A cap is also placed on the amount of economic compensation which could be obtained. President Bush has supported this cap at $250,000. Tort reform is also going to limit the amount of compensation that individuals who have lost relatives and family members due to wrongful death could obtain from the damagers, including corporations and physicians.

One of the central justifications for the proposition of tort reform has been a supposed crisis, which the reform’s proponents refer to as the crisis of “defensive medicine.” This concept explains that “if fear of liability drives healthcare providers to administer treatments that do not have worthwhile medical benefits, then the current liability system may generate inefficiencies many times greater than the costs of compensating malpractice claimants” (McClellan 1996 p. 353).

McClellan, who was appointed by president Bush to head the Food and Drug Administration and the Center for Medicare and Medicaid Services, believes that the current liability rules have caused physicians to prescribe many medical tests which are supposedly unnecessary, and the doctors only prescribe those tests to reassure themselves that their medical decisions are not going to harm the patients. Physicians see their correctly made medical decisions a factor which would eliminate malpractice lawsuits filed against them. McClellan supports his argument by stating, “The previous empirical literature is consistent with the hypothesis that providers practice of defensive medicine, although it does not provide direct evidence on the existence or magnitude of the problem” (McClellan 1996 p.357).

Another one of the arguments of the proponents of tort reform is the idea that the current liability system and excessive lawsuits are driving up the costs of healthcare. When physicians, supposedly under the pressure of tort liability system and possibility of future lawsuits, advise patients to take additional medical tests that supposedly are not worthwhile, that would cause the medical costs for each patient to increase. This increase in costs of healthcare would consequently result in individuals in the society not being able to afford healthcare. Hence, the supporters of tort reform claim to support the reform because it would consequently result in bringing cheaper healthcare to the society.

The last major argument made by the proponents of tort reform is the claim that excessive lawsuits are driving doctors and healthcare providers out of business. They claim that many lawsuits which are being filed and won in courts of law have cost doctors millions of dollars. In addition, the tort reformers have pointed out that these lawsuits have also caused a drastic increase in the cost of malpractice insurance. Speaking before hundreds of doctors and medical workers in a St. Louis suburb in January of this year, “President Bush called attention to a neurosurgeon on stage
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with him in the small auditorium. The doctor, the president said, was paying $265,000 a year in premiums for insurance against malpractice claims.” President Bush, who has been one of the major supporters of tort reform, has repeatedly confirmed his belief that costs of lawsuits have gotten out of hand. Furthermore, supporters of reform explain that those costs have gotten to levels, which have resulted in costs to doctors to exceed their benefit, hence causing them to be operating at a loss. This phenomenon, proponents assert, has been forcing many doctors to leave their professions due to high costs, causing lack of enough physicians in the healthcare system, which would consequently hurt healthcare users and society as a whole.

The advocates of tort reform in Washington have repeatedly attempted to present the reform in a manner that would make them appear as champions of the public and middle class. They have claimed that the sole purpose of tort reform is to bring better and cheaper healthcare to public while simultaneously protect physicians from what reformers consider “frivolous lawsuits.” However, as one examines the evidence closely, it becomes apparent that research and data from various sources do not support the claims and theories made by the supporters of reform. In order to examine the claims of tort reform proponents, it is imperative to analyze them in light of existing relevant research, which is to be discussed.

Even though the proponents of tort reform have spoken about a so-called “crisis of defensive medicine,” available researches which have been done indicate that the existence of such crisis is a myth. This fact is demonstrated by a report that was issued in 2003 by the General Accounting Office, which is an independent and non-partisan agency. This report found that there was no evidence that would support the idea that the threat of malpractice lawsuits contributes to the practice of “defensive medicine” (GAO 2003 p.12). In fact, contrary to the argument of the reformers, the GAO report explains that doctors financially benefit from additional medical tests. Hence the reason for excessive medical tests could be explained by physicians’ own desire to maximize financial profit, rather than them being pressured by the tort liability system to advise additional tests.

Another major argument that is made by the supporters of tort reform is the presumption that malpractice litigations and lawsuits are driving up the cost of healthcare. The Congressional Budget office released a report in 2004 in which it recognized that legislation to cap damages in medical malpractice lawsuits would “do little to hold down health care spending” or eliminate the supposed practice of “defensive medicine” (The Committee for Justice for All). Additionally, evidence indicates that it is the insurance companies, HMOs, and pharmaceutical companies which are responsible for increases in the cost of U.S. healthcare. In an article published by Jacksonville Business Journal, a report indicates that in the year 2003, top American HMOs reported doubling their profits (Jacksonville Business Journal 2003). However, despite the drastic increase in their profit, since the year 2000, health insurers have raised health insurance premiums in America by 59 percent.

Despite the assumption made by the reformers of tort liability system that implementation of tort reform would result in a decrease in physicians’ malpractice insurance premiums, relevant data seems to indicate otherwise. In an article titled “Premium Deceit: The Failure of “Tort Reform” To Cut Insurance Rates,” Robert Hunter and Joanne Doroshow criticize “tort reform” for not having any element that would force malpractice insurance companies to lower their rates upon the implementation of tort reform. Hence, the authors believe that caps will not have any meaningful effect in terms of lowering insurance premiums (Hunter 2002 p.2). This notion is more apparent in data gathered by the agency of Medical Liability Monitor, which demonstrate that on the contrary to the assumption of reformers, average premiums are 16 percent higher in states that have caps in their tort liability system (The Committee for Justice for All). In fact, many corporate associates and insurance executives have repeatedly expressed the idea that caps proposed by tort reform will not lower caps (Center for Economic Justice for All 2005).

Supporters of the idea that tort reform would result in lower premiums ignore two very important facts. The first one is that increases in
malpractice insurance premiums are not the fault of greedy victims or their lawyers, but rather the insurance companies that pass along their investment losses to their policyholders. Historically, at the times when investment incomes have dropped, insurance premiums have risen. Not surprisingly, similar malpractice “crises” have also been brought up by firms and politicians during the same economic downturns as well (Americans for Insurance Reform 2002 p.4). The second fact is that as opposed to other brands of insurance, malpractice insurance companies do not have experience-based coverage. Therefore they do not take into account the qualifications and experience of specific physicians. Hence, many good doctors pay higher insurance rates because of a few negligent doctors that cause injury through malpractice. Therefore based on these two facts, the assumption that caps will lower insurance premiums has no substance or support.

Having established the lack of any connections between caps and increase of insurance premiums, it is important to investigate the real effects which tort reform would have on physicians. In October 2004, two journalists for the Wall Street Journal, Rachel Zimmerman and Joseph Hallinan, wrote a report titled “As Malpractice Caps Spread, Lawyers Turn Away Some Cases,” in which they explored the real benefits of caps to physicians. In this article, authors assert that caps are not intended to give doctors financial relief from such factors as high insurance premiums, but they are rather intended to immunize physicians from lawsuits (Zimmerman 2004). The reason that physicians want a $250,000 cap on pain and suffering is that in cases where there is no economic loss, it would be very difficult for patients to find lawyers to take their cases. The reason for that happening is that malpractice cases can cost lawyers hundreds of thousands of dollars out of pocket to prosecute, with no guarantee of obtaining enough economic compensation to recoup incurred expenses. Hence by supporting tort reform, physicians are attempting to decrease incentives for lawyers to take cases where there has been no economic loss.

The assertion of the advocates of tort reform that costs of lawsuits are driving physicians out of business does not have support. According to Medical Economics Magazine, “on average, doctors spend 1 to 5 percent of their gross revenues on medical malpractice insurance premiums” (The Committee for Economic Justice). Furthermore, doctors earn hundreds of thousands of dollars a year just by charging attorneys fees for providing “independent medical evaluations.” These facts indicate that premium increases do not seem to have imposed any major financial hardship on physicians. In addition, it is appropriate to note that most of the doctors who are affected by high premiums are high-risk specialists – the ones who also have the highest incomes. Hence premiums are not likely to create much of a financial burden for them.

One argument made by the proponents of the reform which is worth analyzing is the assertion that the number of frivolous lawsuits as well as the amounts paid out in malpractice cases have drastically increased over the past few years. Even though those amounts have in fact increased, if we adjust for high rate of healthcare inflation, total compensations in malpractice cases remained the same until the year 2001 (Americans for Insurance Reform 2002 p.1). In fact, data released by the Pennsylvania state Supreme Court indicate that filings for malpractice cases decreased by nearly thirty percent across Pennsylvania (Nepa News 2004). As far as the number of cases that could be categorized as “frivolous” is concerned, it is important to note that many states have taken variety of legal measures, eliminating most lawsuits which could be categorized as such. For example Pennsylvania now requires victims to obtain what is called a “certificate of merit” from a physician of same field as that of the physician who has caused injury. In fact it is also important to note that according to a study by Harvard University, 4 out of five victims of medical negligence never file a lawsuit. Hence the notion that frivolous lawsuits have overwhelmed the physicians is simply unfounded.

One aspect of the tort reform which one needs to keep in mind is that its advocates base their beliefs on very few “frivolous” lawsuits, while completely ignoring a much larger number which represents real cases of individuals being hurt as a result of real negligence. A report indicates
that as a result of preventable medical errors, 195,000 patients die per year in the United States alone (CNN 2004). That dramatically large number of wrongful death makes medical error the third leading cause of death in the U.S. following heart disease and cancer (Center for Disease Control). Hence, one is likely wonder what the total number of wrongful deaths and injuries per year caused by malpractice, faulty products, etc would add up to be. Despite the fact that proponents of tort reform have repeatedly undermined the importance of juries and lawyers in helping the victims of wrongful deaths and injuries receive fair compensation for their pain and sufferings, the real numbers such as the one reported here demonstrate how crucial is the role of juries and lawyers to hold responsible physicians and producers that cause these wrongful injuries and deaths.

Another major number which also appears to be shocking, but for being tragically low, is the cap of $250,000 that tort reform places on non-economic damages. The reason that this number is much lower than it should be is that non-economic damages could be extremely painful and cause extensive suffering for its victims. For instance, one of such victims may have undergone extensive surgery and had parts of his organs removed, simply because his physician mixed up the MRI test result of two of his patients. Economic damages would be negligible because he can still work and earn a living, therefore causing him to become eligible to receive only $250,000 of compensation for such lifetime pain and suffering caused by negligence.

Following the analysis of the arguments of the proponents of tort reform, it is necessary to proceed to examine the main reasons and interests behind tort reform.

The nature of caps such as those proposed by the advocates of tort reform is in conflict with the constitution. The U.S. constitution reserves individuals’ right to jury. The cap elements of tort reform however take away the constitutional right to have a jury to decide what is fair. One important criticism to make against the supporters of tort reform is that they have repeatedly underestimated the importance of legal system to assist victims of malpractice and negligence get the compensation they deserve. However one can’t help wondering what reasons proponents of tort reform have to think that while juries are well qualified to sentence to death individuals they consider guilty, they cannot be trusted to decide on damages which they would find fair in malpractice cases. The most likely response to that observation is that in cases of death sentences, there are no HMOs and multibillion dollar insurance companies incurring losses. Hence it seems that the main reason which reform advocates are supporting tort reform is not because juries will not be fair in estimating damages, but rather because they usually will be.

Another important aspect of tort reform could be understood by looking at it as a part of a larger pro-business, anti-consumer pattern of behavior which has been shaping the decisions of many legislators. In an article published by Washington Monthly, titled “false alarm,” Stephanie Mencimer has examined two important factors which have been promoting the myth of America’s “lawsuit crisis”: the media, and the GOP. Mencimer explains that the tort reform campaign by insurance industries and other multibillion dollar corporations is just the latest of such campaigns which started in the early 1950’s. She explains that since that time, when the victims’ lawyers succeeded in breaking some legal barriers that had previously protected the industry from responsibility for injuries caused by negligence, and opened jury polls to make them more representative of the general public, insurance industry has consistently supported any limitations to be put on victims and lawyers (Washington Monthly 2004). Hence it is critical to realize that the current tort reform movement which is shaping the policies of many legislators is not a new notion or one that HMOs and insurance companies have been neutral toward, but rather the reform campaign has been largely financed and supported by big business for the past fifty years.

Tort reform has resurfaced once again in the political arena and its campaign is being waged by HMOs, coalition of insurers and pharmaceutical companies, big business, rightwing political parties, and the president (Washington
Post 2003). Chamber of commerce has also contributed its share to help this anti-consumer, anti-jury, and anti-lawyer campaign by stating in August of 2005 that it will help for advertisements suggesting “dangers” associated with having trial lawyers aligned with the White House (Bloomberg 2005).

Although many arguments have been offered to justify the necessity of tort reform, thorough investigation of existing evidence and research indicate that most of those arguments are statistically unsupported. As advocates of tort reform shape current policies of legislators, the most important point to keep in mind is that this reform is not designed to save the middle class from a “lawsuit crisis,” provide the public with cheap and better quality healthcare, or help small businesses grow. But rather, this campaign is a continuation of assault on consumers, victims, juries and trial lawyers, led by HMOs, multibillion dollar corporations, and insurance industry to weaken the tort liability system, in order to serve their economic and political interests.
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Introduction:

The United States is a nation that prides itself on its upholding of perfect competition, attributing this system and structure to its success as the world’s richest country (Robbins 2001 p.58). Maintaining Adam Smith’s belief of the “invisible hand” driving markets toward producing the optimal quantity of a good or service at the optimal price, the United States’ government scarcely interferes with the economy. However, the notion prevails that while the U.S. is committed to the “invisible hand” and perfect competition there still exists situations in which the government has to step in to maintain and ensure economic efficiency, one of such situations involving intellectual property and the issuing of patents by the U.S. Patent and Trademark Office (Statutory 2000 par.1).

As Abraham Lincoln expressed, patents “add...the fuel of interest to the power of genius” (Hilts 2003 p.357). The foundation lying behind patents is the idea that if an inventor is not able to realize the gains from his or her own invention—not able to recover his or her investment in the invention and even make a slight profit from it—then the incentive to innovate, create, and produce disappears, resulting with production less than the efficient amount. However, while patents do foster advancement and economic growth, they also bestow monopoly power onto the inventor. This monopoly power prevents competition in the manufacture of the particular good and enables the maker to price their product well above the marginal cost of producing it, allowing the maker to realize above normal profits—profits greater than zero in the long-run (Baker 1999 par.4; Romer 2002 par.15). In this way, monopolies create deadweight loss and economic inefficiency.

The belief has always been that this monopolistic inefficiency is less than the inefficiency that would result without patent protection. While this understanding has held true for quite some time, in the present day the rights associated with patent protection have proved to be increasingly problematic. Patent rights are secured in the U.S. Constitution but the patents described were originally meant for inventors, individuals or small groups of people, not for what so commonly exists in the modern day—corporations (Hilts 2003 p.357).

At the time of the ratification of the Constitution its authors perceived no such object as a corporation—a sizable entity of people and affiliated organizations tangled together through technology in the effort to produce multiple goods and services, with influence over numerous facets of life such as media, health, education, and politics. In regards to corporations, patents create the heinous incentive for businesses to exploit resources and people to continue to receive above normal profit (Hilts 2003 p.358). The United States’ pharmaceutical industry, “the single most profitable industry group in the nation for the last ten years,” exemplifies this (Avorn 2004 p.227).

Through prescription drug patents, pharmaceutical companies have, and still continue to, utilize their legal monopoly power to (i) conduct illusory and dishonest research, (ii) distribute harmful medications to the public through false advertising and avoidance of drug experimentation, and (iii) to continually raise the prices of their products well above marginal cost of production—creating economic, social, and moral inefficiencies greater than what would result without patent protection—all in the effort to longer maintain their supreme power over the pharmaceutical market, making as large as an already above normal profit they can possible make.

The Underlying Principle:

Prescription drugs are commonly priced and purchased by consumers at values more than fifty times what it costs the manufacturers to actually produce the drugs (Should 2003 par.2). The belief that makes this inefficiency legally binding is that the profits companies receive will account for their research expenditures and induce them to innovate and create more medications, fostering economic growth. Following this underlying principle of drug patents, it is expected that pharmaceutical companies’ R&D costs will constitute the majority of their expenses (Should 2003 par.6). However, as seen in Exhibit I: 1999 Pharmaceutical Company Budgets, research and development costs are slender. Each of the five very successful companies shown—Pharmacia, Merck,
Pfizer, Schering-Plough, and Eli Lilly--devote more of their funds to marketing rather than innovation. Plus, the majority of companies retain as profit a larger amount of money than what they spend on development (Baker 2001 par.3). Additionally, a separate 2004 study confirms that pharmaceutical companies generally retained 17% of their sales as profit, nearly six times more than what “all Fortune 500 companies” retained (Avorn 2004 p.227).

These large profits and small R&D funds represent the pharmaceutical industry’s lack of dedication to innovation, completely disregarding the essential function of the patent. In fact, New York Times writer Alexander Berenson found in his study of the pharmaceutical business that the fraction of drug companies’ budgets devoted to innovation have become smaller over the past decade and continue to decrease (Berenson 2004 par.2).

**Illusory and Dishonest Research:**

Within the practice of pharmaceutical manufacturers to retain their extra earnings as profit instead of investing it in R&D, patent protection creates the incentive for drug companies to find ways to extend their patents, prolonging their command over the prescription drug market. To quote author M. Angell, drug companies have indeed been “highly innovative--and aggressive--[but not in research, rather] in dreaming up ways to extend...[their] monopoly rights” (Angell 2004 par.11).

Congress issues patents for a period of twenty years but it is not unusual for a company, upon petition to the government, to obtain specified periods of patent protection lasting more than twenty years (Baker 1999 par.6; Statutory 2000 par.2). While many drug companies extend their patents this way, many also engage in more underhanded behavior such as “evergreening” and the production of “me-too drugs” (Avorn 2004 p.224-225).

“Evergreening” is the common practice of a pharmaceutical company to take a drug and “give it a face-lift” come time of patent expiration. This can mean merely changing the color of the medication, adding or subtracting a new chemical element or compound, “switching from a capsule to tablet...or finding a new [and usually minor] use for the product” (India 2005 par.6). This hardly constitutes a new drug but it is deemed as so by Congress and granted a new patent, giving the producer another two decades of market reign. For example, the very popular allergy drug Claritin, composed 33% of Schering-Plough’s income and, because of this hefty amount of revenue, it was no surprise when it came time for the patent to expire to find that Schering-Plough “evergreened,” making Claritin into the “new” drug Clarinex (Avorn 2004 p.225; Angell 2004 par.36). The only difference between Clarinex and its predecessor, Claritin, is that Clarinex does not activate sleepiness in the user (Napoli 2002 par.4).

The production of “me-too drugs” is another widespread practice among drug manufacturers. “Me-too drugs” are simply slightly altered reproductions of already existing medications, granted patent protection in the same way that drugs are “evergreened”--through a change in color or ingredient. For instance, Crestor, Lescol, Zocor, Prarachol and Mevacor are all fundamentally the same cholesterol medication but in regard to their patents--by way of minor details--they are all separate drugs, each giving their maker further monopoly power and the ability to avoid research and development expenditures (Angell 2004 par.11).

The extensive use of such practices of “evergreening” and “me-too drugs” can be seen in respect to the seventy-eight newly patented drugs of 2002. While seventy-eight new drugs were introduced to the global prescription drug market, only seven were actual new drugs--all coming from foreign producers. Every drug belonging to an American pharmaceutical company that was newly patented was either a product of “evergreening” or a “me-too drug” (Angell 2004 par.38).

Not only are patents extended disingenuously through illusory and dishonest research, but drug companies also bargain with each other to avoid patent expirations--one reason why company merges so frequently take place (Berenson 2004 par.12). Not long ago Pharmacia and Pfizer merged and while there were various motives behind the integration, the patent
extension of the HIV drug Rescriptor is believed to have been a critical motivation for the fusion of these two corporations (Rubin 2003 par.10). Amalgamation, through the high costs it generates and the time and planning it requires, defers investment in innovation further (Berenson 2004 par.12).

Verily, bargaining between drug companies is in no way limited to the integration of companies. The design behind patents is that after the twenty-year period of monopoly power, after the originator has been compensated for his or her contribution to society and economy, competition is ushered into the market. However, oftentimes, as a firm nears its patent expiration date, it will bribe another to not produce a competing product, maintaining its control over the market (Avorn 2004 p.225). Also, by way of the pharmaceutical industry’s large political lobby, competing drug companies, even after a patent has been terminated, can be taken to court by the original developer if the latter finds the grounds to do so (Avorn 2004 p.224). “Companies [have even] succeeded in getting laws passed that [make] it illegal for a pharmacist to substitute a generic drug for the brand-name drugs” (Hilts 2003 p.121).

Through these exploits it is apparent that pharmaceutical companies do not devote their increased revenues by means of patent protection to research and development, but to “evergreening,” “me-too drugs,” bribes, lawyers, and various other methods of preserving monopoly power and the ability to earn above normal profits. Moreover, it is understood by those familiar with the industry that when it comes to patenting an authentically new and novel drug, the findings and breakthroughs to produce such are usually purchased from the National Institutes of Health, non-public institutions, charitable organizations, universities such as the University of Michigan and Johns Hopkins University (which obtain most of their funds from taxpayers), and even the federal government (Baker 1999 par.7; Bate 2001 par.18; Hilts 2003 p.121). Studies found that “at least one-third of drugs marketed by companies [were] licensed from universities” alone (Angell 2004 par.23). Thus, many of the discoveries that are legally attributed to specific drug firms and manufacturers are not truly of their creation or generated from their own investments, but purchased developments at the expense of others’ ventures in medical improvement and advancement. In such ways monopoly power for pharmaceutical companies is unlimited and improvement and advancement are lost--all in the name of economic efficiency.

**False Marketing + Avoidance of Drug Experimentation = Harmful Medications:**

Another perverse incentive for the drug manufacturer, generated by the monopoly power drug patents create, is the incentive to increase marketing, again, in the effort to increase profits. Referring back to Exhibit I: 1999 Pharmaceutical Company Budgets, a substantial amount of the budgets is devoted to marketing (Baker 2001 par.3). In fact, the Securities and Exchange Commission found that for the 2000 fiscal year 36% of sales were devoted to marketing compared to the 14% committed to R&D (Angell 2004 par.30). While the difference between marketing and R&D is already outrageous, it is speculated that the exact difference, with a 0% margin of error, is significantly greater. This is due to the fact that the only information available to the public as to how drug companies are managing their budgets is provided by the drug companies themselves. When releasing information, the motivation exists for firms to adjust their numbers to construct the impression that a major amount of funds, increased profits from patent protection, are going toward R&D (Angell 2004 par.31). Continuously, more resources, often more than double, are devoted to marketing than R&D in the effort of pharmaceutical corporations to realize greater profits--once again disregarding the rationale for prescription drug patents (Angell 2004 par.30).

Drug companies market to generally two groups of people: those who prescribe drugs and those who use them. To increase the number of people who prescribe their drugs, manufacturers direct a large portion of advertisement toward specific hospitals and doctors and the rest toward
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consumers to enlarge the collection of people who desire to consume their drugs (Berenson 2004 par.14). Spending considerable amounts of money on marketing toward these two groups of people increases drug companies profits tremendously, yet manufacturers are enticed by even more incentives to increase profits through patent protection, one of which being the incentive to conduct misleading advertisement campaigns.

Quite recently Pfizer was reprimanded for not making public in its commercials evidence that its popular painkillers Bextra and Celebrex cause serious negative consequences such as stroke, heart attack, and even fatality with minimal use (Herbert 2005 par.4; Reuters 2005 par.2-5). Also recently, Eli Lilly failed to make public that Prozac, one of its most successful medications, is linked to alterations of the mind, resulting in some cases with suicide of the user (Herbert 2005 par.6). Moreover, AstraZeneca is accused of insinuating a positive link between the use of its drug Iressa and life expectancy for users when, in reality, no such correlation has been found (Berenson 2004 par.5). Meanwhile, TAP Pharmaceuticals and Bristol-Myers Squibb were both found guilty of false advertising, the former for its drug Lupron and the latter for its drugs Buspar, Taxol, and Platinol. Both pharmaceutical firms faced trials in court and the cases resulted in payments of $875,000,000 for TAP Pharmaceuticals and $670,000,000 for Bristol-Myers Squibb (Avorn 2004 p.226; Angell 2004 par.41). The paying of litigation fees and transactions costs associated with such lawsuits are becoming quite routine in the pharmaceutical industry, not only decreasing the economic and social efficiency thought to be produced from patents, but moral efficiency as well, through the allocation of harmful medications and through reduced research expenditures.

Pricing Above Marginal Cost of Production:

The U.S. judicial system found that price differences between countries that employed patents and countries that maintained perfect competition in the pharmaceutical industry were as small as 18% and as large as 255% (Hilts, 2003 p.136). Looking specifically at annual packages of AIDS drugs, in America treatments run for approximately $10,000 while in non-patent countries the same packages of medications go for $200 (Baker 1999 par.2). The pharmaceutical industry’s power to price above marginal cost, the optimal price, is the reason why “Americans now spend...$200,000,000,000 a year on prescription drugs,” (rising at an annual rate of 12%), the figure “not [even] includ[ing]…drugs administered in hospitals, nursing homes, or doctors’ offices” (Angell 2004 par.2-16).

Another example of the pharmaceutical industry’s inefficient pricing power can be seen in regards to Claritin. “Before its patent ran out...Schering-Plough...raised [Claritin’s price] thirteen times over five years, for a cumulative increase of more than 50%--over four times the rate of general inflation” (Angell 2004 par.3). Also, Schering-Plough, Pfizer, and Merck all held constant the prices for their products containing prednisolone and prednisone for the last forty-nine years. No increases for inflation or decreases for competition were made for these products since the year 1956. Senator Estes Kefauver asked upon...
reviewing this data, “How is it, if you really want to be competitive, you don’t lower your price to get more of the business?” These companies’ constancy in their products’ prices verifies that the prices set in 1956 were already so much greater than marginal cost of production that it was not necessary to adjust according to inflation in later years and also that, by way of the sly systems and procedures that companies carry out to extend their patents, the companies faced no competition and therefore faced no need to lower their prices to attract more consumers (Hils 2003 p.135).

Data such as this explains why so many Americans lack the means to obtain sufficient healthcare and even why the United States is contending with one of the largest income inequality gaps in the world (Robbins 2001 p.58). As Michigan senator Debbie Stabenow said, “It’s not like buying…tennis shoes” (Angell 2004 par.14). Medicine is a dire necessity for each and every individual. While some people rely on medications every day, others need only know that prescription drugs are accessible if required. For this reason drugs need to be available to everyone. However, as long as pharmaceutical corporations take advantage of their legal monopoly power to gain more profits, the majority of Americans will continue to suffer. Unquestionably, these economic, social, and moral inefficiencies are greater than the economic efficiency of innovation created by drug patents.

**Possible Solutions:**

A much talked of solution to the problem of drug patent protection is the establishment of a public healthcare system, a system government-run that guarantees each individual living in the United States has access to healthcare (Avorn 2004 p.412). Public healthcare will mean increased taxes for taxpayers, but for many this tradeoff is worthwhile. Countries such as Spain, Canada, and the region of Hong Kong, for instance, maintain public healthcare quite successfully (Microsoft Encarta 1998).

However, like any good that becomes a common good, a “free rider” problem results. What will the government do with those persons who purposely abuse their health i.e. cigarette and marijuana smokers, binge drinkers, and individuals attempting suicide? (Szasz 2001 p.135-137).

Another solution is to shift the responsibilities and costs of research and development to universities, charities, private establishments, and the U.S. government. Since the majority of new developments in medicine already come from the research these organizations conduct, no significant decrease in the current rate of innovation will likely occur, everything else (like technology) remaining constant. Drug companies will then have no excuse to price their products above marginal cost because they will no longer be expected to innovate. Price will be equal to marginal cost, yielding the optimal price, and deadweight loss will disappear. More Americans will be better able to afford medications and treatments. The government will “save on Medicare and Medicaid payments” and the money saved on these federal government assistance programs will be transferable to federal government research programs (Baker 1999 par.7). Plus, by way of competition, the incentive to give misleading information about prescription drugs will vanish and safer drugs will be distributed to the public. Certainly, this will result in greater economic, social, and moral efficiency.

**Conclusion:**

The United States, a nation dignified by its implementation of perfect competition in its economy, is committed to anything but fair competition in the pharmaceutical market. Patent protection in the Constitution, based on the authors’ familiarity with the individual and small group inventors of the time, needs to be reconsidered. The dramatic changes technology has brought about in the business world need to be taken into account, especially in the pharmaceutical industry, for it is undeniable that a huge problem exists in regards to the prescription drug market. A lack of action in redefining its issue and use of patents--legal monopolies--will only increase the economic, social, and moral troubles the individuals and families of the U.S. face both at present and in the future. Illusory and dishonest research, harmful medications distributed to the public through the
avoidance of drug experimentation and the practice of misleading advertising, and unfounded escalation in prices are, in total, inefficiencies greater than the inefficiency a lack of patent protection would produce. How much greater will these inefficiencies become? Does the pharmaceutical industry’s hunger for profits--in the name of advancement, innovation, and economic growth--truly justify the exploitation of resources and people taking place everyday and at this very moment?
THE PHARMACEUTICAL INDUSTRY’S EXPLOITATION OF PRESCRIPTION DRUGS PATENT PROTECTION
Mynti Hossain

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Following his reelection to the office, Bush has kept the task of privatizing social security at the top of his agenda. With his republican congressional allies in power, he doesn’t have much to worry apart in terms of convincing the lawmakers to support his reckless plan. However, he has been traveling all over the United States trying to convince the public that privatization is a good idea. It is important to review the condition of Social Security and then proceed to learn what this administration is doing to mislead the public on this issue.

The Social Security program was implemented as an integral part of FDR’s “New Deal.” After the stock market crashed in 1929, the economy pushed millions of Americans below the poverty line. Such widespread economic devastation lead FDR to introduce a new opinion about the nature of poverty, which was, most poor individuals are not responsible for poverty, but they are rather its victims. FDR believed that the American society has the right to economic security. Out of that belief the “New Deal” initiatives and the Social Security program was born.

Social Security works in a very different way than people think. As opposed to what many believe, the social security does not work by way of taxing individuals a certain amount throughout their working careers only to pay them back the same amounts when they are retired. The program works rather in a way that at a certain point in time, there is a stream of money coming in (from social security tax paid by those who are currently working) and a stream of payout (going to those who are currently social security beneficiaries.) So if there is a large population of workers and a low population of retired individuals at a certain point in time, the amount of social security benefits that the retired will receive is higher than if there is a low number of workers and a high number of social security beneficiaries.

It has been known for a long time that the Social Security is going to be in trouble in twenty years down the road. The reason is due to the baby boom of the mid-twentieth century in the United States. At that time there was a sharp increase in the number of births in the United States, which was followed by a decrease of almost equal amount a few years following the original boom. Hence as baby boomers reach the age of retirement, their number would exceed those who will be working. Hence, the next generation would have to pay more social security taxes to cover the Social Security benefits of baby boomers.

The Social Security debate was one of the Topics of the 2000 presidential campaign. At the time while Bush did not have a clear plan as to what he was going to do to fix the problem of social security, Gore had a solution. At the time Clinton left office, the US was enjoying a large surplus in its treasury, which was enough to cover the amount of extra money needed to cover the benefits of baby boomers. Gore had the idea of putting that amount of funds in a “lockbox” and save it for the baby boomers. It would have solved the problem of social security.

However, as Bush became president, the Social Security talks were neglected as Iraq became the main focus. Now he and his allied lawmakers are proposing to privatize Social Security. They say that the main purpose of privatization is so that individuals would be able to have their own personal accounts and the social security tax they pay throughout their working days would be saved for their own retirement. What’s more, in order to implement privatization, they need to borrow billions from foreigners, pushing American economy into even deeper debt and causing dollar to get even weaker to euro and yen.

But what is the most important point to note is that as you may have noticed, privatization does nothing to solve the problem of social security. But the only philosophy behind privatization is to create a policy where the rich wouldn’t have to contribute to the general pool of social security, but rather get all of their social security payments back at the time of retirement. The philosophy behind the Social Security is the same as that behind the tax-cuts for the wealthiest which we have seen for the past five years.
Microsoft has gained its powerful market share over operating software and the web browser market by cleverly getting IBM’s approval for DOS as the standard IBM system. This tactic and other similarly dubious tactics that have allowed Microsoft to enjoy a more extensive market share on several fronts and have allowed it to wield substantial market power as a result. It was the expansion of these tenacious and devious stratagems that has led to the antitrust cases of the late 1990s that found Microsoft convicted for anticompetitive actions, suggesting that Microsoft does not fit the free-market hypothesis and moreover, would suggest that Microsoft’s actions do in fact harm the computing industries market system and society as a whole. This paper will attempt to examine the nature of these antitrust policies using the Microsoft Corporation as our main example, while keeping in mind the social and economic effects of the implementation and conviction of these regulatory policies.

The crucial seminal period for policies governing business was between 1890 and 1910. Before this time there had been a scattering of common-law rules and customs dealing with early forms of business, mostly at the local and state level. With the coming of age of the U.S. industrial revolution, railroads, utility companies, and other large corporations spread across the country, forming monopolies in some regions and charging discriminatory prices. These and other new developments transformed the economy toward large-scale manufacturing industries. Price rigging became common in many industries and great financiers like J.P. Morgan were busy forming trusts in many industries by merging scores of little firms into big ones (Chapter 15).

This time saw a rise in public agitation against these industrial changes. Farmers organized to fight price gouging by the railroad monopolies. They and other citizens increasingly denounced the new industrial trusts. Amid sharp debates in congress fueled by heavy lobbying from these new larger businesses to counter the complaints of the citizenry, two kinds of policy action were initiated. First, regulation standards were established in 1888, at that time with the explicit purpose of governing railroads (Chapter 15). This led to state regulatory commissions to regulate the new electricity and telephone systems, as well as railroad traffic within the states. These policies accepted private ownership of the basic utility operations, in contrast to public ownership of the railroads and the utilities that was common in other countries. It was the intention of these smaller, state regulatory commissions to control private utilities strictly, permitting only fair rates of return and just and reasonable prices. A second result stemming from these policy debates was the establishment of antitrust. Antitrust, the main focus of the remainder of our discussion was created in 1890 to reduce and constrain monopoly in the rest of the economy. Aptly named antitrust because it was aimed against the creation of industrial trusts, the Sherman Act of 1890 outlawed both monopolizing by one firm and collusion among competitors. The role of these antitrust policies has grown over the years into a uniquely thorough method for curing industrial monopoly and price fixing. However, before we can fully examine the role of these policies and their effectiveness from an economic standpoint we must first look at the details of the case in question, the Microsoft antitrust suits.

The claims being levied against the Microsoft Corporation, when evaluated on the basis of the question of whether or not Microsoft enjoys an overbearing market share in a number of its product fields, seem more than justified. Microsoft’s dominance was first established in the early 1980’s when it obtained control over programming IBM’s personal computers. Microsoft has since extended and deepened its monopoly, and it continues to extend into a number of adjacent markets. In general however, there is wide agreement that Microsoft’s relevant market is operating software. Among the vast array of software on the global market, operating systems are perhaps the most critical. When IBM was still dominant, it accepted the MS-DOS system provided by the new Microsoft company and ceded control over it. Microsoft soon enlarged its initial position with Windows, edging out Apple, Lotus, and other creative forces (Chapter 6). It was not long after this time that Microsoft emerged as
the dominant software company, with about 90 percent of the market (Chapter 6). It largely controls the evolution of new technology, partly by the aggressive actions it has taken to subdue rivals and in part due to its strong position and prospects having raised its market value above IBM’s and above nearly all other corporations worldwide.

Critics of antitrust and many of Microsoft’s attorneys would argue that there might be some “natural-monopoly” basis for Microsoft’s dominance since computers need to be reasonably compatible – this has been particularly true since the rise of the Internet. This feature is a hallmark of other “network” industries that link customers (as in telephones, electricity, and railroad) and in essence, users want a single standard. Although this natural-monopoly argument is compelling to a degree when first examining the groundwork of the Microsoft antitrust suits, the “network” basis argument that would allow Microsoft to continue operating in its domineering patterns over market have largely faded away with the innovations of alternative systems to Microsoft’s “Windows”. Although distinctly unique from the Windows platform, alternative operating systems such as Linux remain compatible for use with Windows software and have received better credentials in many regards than the often-bugged and hastily constructed Windows platforms. This has led to a slow erosion of the market dominance enjoyed by Windows and has attracted away just enough of Microsoft’s customers to negate the necessity for a natural-monopoly of the operating system industry.

More background on Microsoft and its history of dominance will reveal that Microsoft has tested – and sometimes exceeded – the limits of what dominant firms are permitted to do to their smaller rivals. Microsoft thoroughly copied IBM’s early basic strategies to deter competition. Like IBM in the 1960s, Microsoft controlled new technology so as to make competition difficult. It also used strategic price discrimination to compete especially hard in specific parts of the market. It also extended its monopoly into related markets by bundling different services. It has been this strategy in particular that has gotten Microsoft into some hot water. Microsoft used giveaways (Internet Explorer, MSN, and other on-line services) in its Windows 95 programs to extend its market control and promote the Microsoft name in all arenas of the computing industry market. In summary, Microsoft can accredit much of its success in gaining market dominance to the variety of questionable tactics it has employed to deter competitors. Because of this dominance, the plethora of antitrust actions against Microsoft has been inevitable.

Before discussing the economic implications of Microsoft’s antitrust suits let me first revisit the issue of software bundling or ‘giveaways’ as previously referred to. When Thomas Watson, Jr. took control of IBM from his father, he decided to push IBM into the computer age. IBM moved quickly to gain the lead in transistor technology and by 1957 its sales had reached $1 billion. Considering that its 1946 sales were a mere $116 million, this was a remarkable achievement (Chapter 17). Once business firms purchased an IBM computer, they quickly became dependent on IBM’s software. This phenomenon came to be known as software lock-in (Chapter 17). Until this point of purchase of a computer system, buyers had a choice about what brand to install. After the purchase on IBM’s software and programming, the cost of switching to another manufacturer often became prohibitively high. Once a large corporation had paid IBM thousands, or millions, of dollars to install and organize its database, there was little chance it would switch to a new system. With Microsoft largely in control of the basic programming and hardware and software productions for the IBM models after the firms signed agreements in late 1980, Microsoft was able to step in for IBM and put into practice many of the tactics for gaining market control that were previously discussed. The phenomenon of software lock-in was now being put into use by Microsoft, an event that had rather drastic consequences for the computing industry on the whole. In effect, the manufacturer (IBM) the hardware producer (Microsoft) and the operating software producer (Microsoft’s Windows and MS-DOS) were now all working for the same team. The market was theirs for the taking.

With a brief history of the policies
Governing Microsoft and its potential violations therein, we can now take a deeper look at some of the legal and economic impacts of the antitrust suits and their implications on the market. In the application software market Microsoft typically competes against companies that produce one major product, for example, WordPerfect in word processing, Lotus in spreadsheets, and Quicken in home financial management (Chapter 17). In the early 1990’s, Microsoft bundled several pieces of application software together and sold them as an application suite (Chapter 17). Today’s dominant application suite is the popular Microsoft Office bundle that provides users with applications that fall into many of the same categories (word processing, spreadsheets, etc.) in which some of Microsoft’s harshest competitors so desperately seek to squeeze out some semblance of a market share. The price of these bundled pieces of software in Office have been greatly discounted, a fact that is hugely beneficial to both the consumer and the longevity of Microsoft’s market dominance. The standard version of Office, including Word, Excel, PowerPoint and Outlook sells at approximately $400 retail. This represents a huge discount for the consumer when comparing the separate entities of the bundled package that sell for around $300 a piece. Office has not only resulted in a greatly increased market share for Word and Excel, but has established PowerPoint as a major factor in a market where Microsoft had previously played only a minor role (Chapter 17).

Microsoft also bundled its Internet browsing software, Internet Explorer, with Windows. Microsoft realized that the Internet provided a potential platform for weakening its operating system monopoly and at the time Netscape Navigator not only provided a superior product in the infancy of web browsing software, but it also provided some legitimate competition for Microsoft in an arena of the computing industry, a rare occurrence in today’s Microsoft-prevalent world. By bundling Microsoft’s Internet Explorer with its Windows operating systems and effectively controlling the browser market, Microsoft hoped to control use of the Internet and prevent the development of alternative PC operating systems that could be easily downloaded from the Internet. While Microsoft may well have used bundling of software applications to gain market share for its application software programs, it is unclear that the net effects on welfare were negative. For one thing, there is little doubt that the net impact of bundling was to lower the price of many Microsoft application programs. Furthermore, Microsoft has been unable to gain a large market share in markets where its application software is significantly inferior. The best example and perhaps one of the best defenses of Microsoft’s attorneys is this inferiority and the continuing dominance of Intuit’s Quicken software in the home financial management market. In this market, and unfortunately for Microsoft’s attorneys – seemingly, only this market – Microsoft’s Money has failed to gain a significant market share.

The first government antitrust action against Microsoft was started by the Federal Trade Commission but concluded by the Department of Justice. This is highly unusual. The FTC staff argued that once Microsoft’s basic control over operating systems was established, it continued to maintain power through a variety of illegal practices including the pre-announcement of products, exclusionary per-processor licenses for MS-DOS and Windows, unreasonably long-term licensing agreements, and restrictive nondisclosure agreements. The FTC staff presented its case to the full Federal Trade Commission and was met with deadlock on two separate occasions. Just as the FTC appeared as though it would drop the suit, however, the Department of Justice in an unprecedented action, decided to pursue the FTC case against Microsoft itself. The resulting investigation by the Department of Justice led to a consent decree by the Justice Department and Microsoft. The major points in this consent decree were as follows:

Microsoft agreed to stop offering large discounts for CPU licenses based on the total number of CPUs shipped instead of the number of copies of MS-DOS actually shipped. Microsoft agreed to end its use of long-term contracts that committed OEMs to purchasing large volumes of software in the future. Microsoft agreed to end its policy of requiring nondisclosure by software developers. This ended Microsoft’s practice of
requiring beta testers not to disclose details of Microsoft’s operating systems for three years after the systems came to market. The nondisclosure requirement had restricted the ability of programmers to move from one company to another, unless the programmer moved from another company to Microsoft (Chapter 17).

The consent decree did not, however, deal with a much more important economic issue, the bundling of Windows with Microsoft’s Internet Explorer. The Justice Department was of the opinion that the decree effectively banned the tying of the Internet Explorer browser to Windows and complained to the court that Microsoft was in contempt. On December 11, 1997, the District Court entered a preliminary injunction banning the tying of the Internet Explorer to Windows. Microsoft filed an appeal of this injunction, and on May 12, 1998, the Court of Appeals granted a stay of the injunction. Six days later, on May 18, 1998, the Justice Department filed a formal antitrust action charging Microsoft with attempting to monopolize the market in Internet browsers by tying the Internet Explorer to Windows (Chapter 17). On November 5, 1999, District Judge Thomas Penfield Jackson issued his findings of fact in the case. Judge Jackson found that Microsoft was a monopolist in the market for Intel-compatible PC operating systems. Furthermore, Microsoft had used its monopoly power to restrict competition and harm consumers. Judge Jackson concluded:

Most harmful of all is the message that Microsoft’s actions have conveyed to every enterprise with the potential to innovate in the computer industry. Through its conduct toward Netscape, IBM, Compaq, Intel, and others, Microsoft has demonstrated that it will use its prodigious market power and immense profits to harm any firm that insists on pursuing initiatives that could intensify competition against one of Microsoft’s core products. Microsoft’s past success in hurting such companies and stifling innovation deters investment in technologies and business that exhibit the potential to threaten Microsoft. The ultimate result is that some innovations that would truly benefit consumers never occur for the sole reason that they do not coincide with Microsoft’s self-interest (Chapter 17, p. 549-550).

Benefit, Cost ($) Marginal Cost

Marginal Benefits

Value Sought (greater competition)
Each antitrust case aims to restore full competitive results more quickly than natural market forces would, or antitrust tries to prevent a drop in competition by merger or price fixing. If antitrust can do that, then there is more competition, with its many benefits. The benefit-cost results of these cases are usually debatable. Many free-market advocates theorize, however, that monopoly power declines rapidly and cases are so slow that antitrust action brings little net gain in competition.

Antitrust actions have reduced the size of a number of important dominant positions, mainly through actions taken before 1950. The AT&T divestiture in 1984 was the biggest Section 2 result of all time, which even AT&T later fully agreed was appropriate and brilliantly successful (Chapter 15). Price fixing has been sharply reduced, although some has simply been driven underground. Secret collusion continues in many industries but for the most part has been greatly diminished since the implementation of antitrust regulatory policies. Altogether, antitrust policies have probably kept U.S. industrial concentration and the extent of price fixing much lower than they would have been otherwise. It is inconceivable that antitrust would be abolished, because its basic forms are so central to capitalism (Chapter 15). If antitrust were somehow removed, monopoly would rise markedly. An immense merger boom would immediately roar ahead, raising concentration sharply in thousands of markets. Dominant firms would become common in markets of all sizes, able to take actions to quell their small rivals. Formal price-fixing cartels, with official staffs and binding contracts preventing price competition and allocating output and profits are all possible outcomes that might arise from a total dismissal of the antitrust system (Chapter 15).

In summary, antitrust has created large economic effects and benefits, which continue quietly because antitrust itself continues. The fact of the matter is that with antitrust claims, a full evaluation of every case is necessary from both a legal and economic standpoint to determine both the benefits and the costs of filing such a claim, in addition to determining whether or not filing an antitrust claim is in the best interest of the affected society. Nearly all individual cases occur on the margins of policy and are generally two-sided and hugely controversial. Many have been mistaken in some degree, while the economic effects of antitrust also display some awkward imbalances that favor powerful, well-established firms. Dominant firms such as Microsoft are now largely free to set prices internally over their large shares of the market, while their smaller rivals can neither arrange to coordinate their price setting nor merge with each other. In this way, antitrust does seem to coddle the already-powerful, while attacking small business that would copy their dominant competitors. Once a firm has gained dominance, it is largely immune from antitrust actions, free to do things internally that lesser firms cannot.
At a time when the economy in the United States is undergoing drastic structural change, the law should serve an accommodating role in maximizing economic vitality. The “New Economy,” in which businesses compete globally in a competitive world marketplace, seeks to capitalize on technological growth and intellectual capital to produce high-technology, information-based goods and services. Substantial initial financial investment is required to achieve this level of growth, and fledgling firms are constantly in search of venture capitalists to front startup funds. Venture capital has played an increasingly important role in the United States’ economy, the world’s leader in venture capital funding, increasing from $1.2 billion to $70 billion during the decade of the 1990s. However, venture capital continues to be regulated by antiquated securities and investments laws rooted in legislation of the 1930s and 1940s which inadequately account for the newfound prominence of venture capital in today’s economy. Efforts to reform the system have attempted to rectify the situation, and despite limited success, the process has largely failed to yield effective, widespread reform.

Tracing the history of statutes regulating venture capital, one finds a patchwork of minimally effective and restricted legislation. The seminal act dealing with venture capital, known as The Investment Company Act of 1940, continues to serve as the basis of reform efforts. Venture capital firms, however, differ notably from the act’s definition of “investment companies” in that they take an active position in appointing and overseeing the management of the startup company typically for a span of seven to ten years. An exception to the act states that private investment firms of less than one hundred “accredited investors” are exempt from regulation under the act, resulting in the formation of a many closely-guarded and exclusive venture capital firms consisting of only the most wealthy investors. In 1958 and again in 1980 Congress attempted to rectify the exemption issue of the original act with minimal success, though the efforts ultimately led to a zero-sum end, with any benefits afforded by the acts being cancelled out by subsequent restrictions.

Recognizing the inadequacies of previous legislation, Congress passed The National Securities Markets Improvement Act (NSMIA) of 1996. The NSMIA allows for an exemption from regulation under the 1940 Act for investment funds that furnish financial or managerial support to startup businesses. Two primary strengths of the 1996 Act include increased thresholds for intrastate capital exemption from $100,000 to $10 million and an exemption for investors designated as “qualified purchasers,” individuals with a net worth of at least $5 million or institutions worth at least $25 million. As a corollary to the NSMIA, Congress urged action on behalf of individual states. California, with the largest amount of venture capital investment in the United States, promptly enacted The California Capital Access Company Law, which created a legally distinct classification for capital access companies and outlined the scope of involvement of these investors in the operations of the businesses. An important consequence of California’s legislation is that it allows for capital access companies to consist of up to five hundred accredited investors, greatly increasing the number of participants, thus total investment, in venture capital projects.

Though much progress has been made with regards to legislation regulating venture capital, the reform process is incomplete. By using the accredited investor criteria established in the Securities Act of 1933, participation in venture capital is severely limited. As the general knowledge of investments and different investment tools grows among the population, an increased number of individual investors are actively seeking to diversify their investment portfolios. Allowing this new wave of “armchair” investors access to venture capital markets will drastically increase the amount of capital available for startup companies, ultimately leading to higher economic growth. Incorporating this investment potential into widespread venture capital policy can serve as an essential vehicle for a more vital economy.
VENTURE CAPITAL LEGISLATION: IMPETUS FOR REFORM
By Michael Morosi

Works and Legislations Cited


The Investment Company Act of 1940,

Bristow, et al.

The National Securities Markets Improvement Act of 1996
On May 15, 1911, the U.S. Supreme Court ruled that the Standard Oil Company had violated the Sherman Anti-Trust Act and acted to form a monopoly on the oil industry. They forced the corporation to separate its various entities into individual companies. This decision ended the most extensive, costly, and lengthy antitrust suit ever taken by the federal government against a corporation. It ended the dominance wielded by John D. Rockefeller and his Standard Oil Company for almost 50 years. Never before had a single man or a single corporation dominated the American economy as Rockefeller had. He achieved this dominance through innovative techniques of improving efficiency, a well-structured business model, and several methods designed to cripple his competition. It was through these ground-breaking methods that Rockefeller was able to control an industry originally began like the chaotic Gold Rush.

During the 1850’s, only the wealthiest Americans could afford lighting for their homes or offices. The options available at the time, such as whale oil, lard oil, and cottonseed oil, were too expensive for middle to lower class Americans to afford (Chernow “Titan” 73). Scientists and potential entrepreneurs searched to find a possible method of providing an affordable source of lighting to Americans. Their search ended in 1855, when a renowned Yale chemist named Benjamin Silliman discovered that rock oil found in western Pennsylvania could be distilled into a clean and affordable source of light (Chernow 74).

Though Silliman’s discovery took the business world by storm, little could be done to follow up his work. It was already known that vast quantities of the oil were found in Pennsylvania. However, there was no way to transport the oil found in the ground to the surface to be refined. Researchers struggled with the problem for over four years, until the second major breakthrough of the oil industry in 1859. Edwin Drake was finally able to assemble a structure known as a “derrick” over a well drilled into the ground. As oil poured out of Drake’s derrick, chaos ensued, as hundreds poured into Pennsylvania hoping to make their fortune in the “2nd Gold Rush (Chernow 76).”

Even Silliman set up a well, which produced over 1000 gallons a day (Micheloud “Strategies”). By 1860, over 2000 new wells were dug; each producing over 1000 barrels a day and the oil industry was born (Micheloud).

As more and more men joined the hunt for oil, the natural production process from oil found in wells to a usable product sold in stores or to retailers was being formed. The first and most profitable step was pumping the oil from the ground. The biggest draw to the fortune-seekers was the small initial investment needed to become involved in the industry. Many purchased cheap property in Pennsylvania, and set up hundreds of derricks on their property (Chernow 76). Men pooled their savings together to purchase the necessary equipment and almost immediately saw returns on their investments. During the first years in Pennsylvania, many oilmen even saw a 100% return on their initial investment of capital (Micheloud).

The oil then needed to be transported from the wells and taken to the oil refineries. Initially, oil manufacturers carried their product in barrels, either pulled by workers or by horse and carriage. As the amounts of oil grew, trains and pipelines became the preferred method of transportation. Transportation of oil was a costly step for oil manufacturers, as railroads continually raised prices to meet the growing demand. From the onset, the railroad companies held great influence in the oil industry. From here, the oil was taken to large refineries to be processed. The oil was heated until the liquid oil evaporated. The remaining fumes were cooled, separated, and then chemically cleaned (Micheloud). The refining process was an inexpensive step for oil manufacturers, costing less than a $1000 for construction and labor (“less than the cost of opening a well-stocked store”) (Chernow 78). Thus, the refineries became another way for ambitious young men to make a quick fortune.

After being refined, the oil was sold to retailers and grocery stores for public consumption. Many uses were quickly found for the oil. It became the primary source of lighting and heating of homes and offices. Oil was sold at a much
lower price than whale or lard oil, making it affordable for most working-class Americans. The byproducts of the refining process also proved to be valuable for manufactures. Lubricants for metal machines and gasoline for automobiles were eventually found to be side products of the refining process. Both products became valuable assets for refineries (Micheloud). Within the first few years of operation, the stage for the oil industry had been set. Thousands had made fortunes in the business and hoped to continue doing so for the rest of their lives. However, the oil industry would soon be dominated by a young entrepreneur in Cleveland.

In 1862, John Davison Rockefeller was already a successful businessman. Only twenty-four, he and his partner, Maurice Clark, sold meat, grain, fish, and other groceries in a small store in Cleveland, Ohio (Chernow 63). Rockefeller and Clark had been witnesses to the booming oil industry in Cleveland, where twenty successful refineries were already running. They decided to work with another partner, Samuel Andrews, and join the oil industry. The group invested $8,000 to set up their first oil refinery in Cleveland, thinking the investment would be “a little side issue, we retaining our interest in our business as produce commission merchants (Chernow 77).”

Though initially wary of the project, Rockefeller soon became fascinated with the business, putting forth all his efforts to running his refinery more efficiently and expanding his business (Chernow 79). As Ron Chernow put it, Rockefeller “represented the second, more rational stage of capitalist development, when the colorful daredevils and pioneering speculators gave way (81).” A former accountant, Rockefeller poured over his company’s balance sheets, looking for discrepancies. Even when his company was at its peak of power, he once sent the following memo to one of his refinery’s managers:

“Last month you reported on hand, 1119 bungs, 10,000 were sent you beginning this month. You have used 9,527 this month. You report 1092 on hand. What has become of the other 500 (Micheloud)?” (a bung is a little cork used to close barrels)

In 1870, Rockefeller made the change from regional power to a national dynasty. He and his partner were already gaining power and influence in Cleveland. Though their profits were rising, Rockefeller desired for more control over the other refineries in the area (Goulder “Cleveland” 97). The original partnership of Rockefeller, Clark, and Andrews was terminated and he and his brother, along with Henry Flagler, decided to form a joint-stock corporation named the Standard Oil Company (Ohio) (Chernow 132). Rockefeller held the controlling share in the company, taking over a quarter of the original 10,000 shares.

His new corporation now set, Rockefeller turned his attention to gaining ground on the other refineries in Cleveland. He believed that the railroads held the key for Standard Oil’s dominance over its rivals. The expensive shipping process of the oil to the refineries and into retail stores was proving to be a thorn in Rockefeller’s side. His relationship with the railroad companies suffered as he saw them conspiring against the Cleveland refineries (Chernow 134). However, Rockefeller decided to strike a historic deal with the railroad companies, one which could theoretically be beneficial to both parties. Rockefeller desired to expand his dominance and eliminate his competition, while the railways desired a greater market share over their own rivals.

On November 30, 1871, Rockefeller and Flagler met with officials of the three most powerful railroad companies in the country, the Pennsylvania, the New York Central, and the Erie. The railroad companies were prepared to secretly offer Standard Oil, as well as several other refiners, large preferential rebates. The railroads agreed to offer reduced rates to Standard Oil, as well as raising their rates for all refineries not included in the agreement. Along with the decreased payments, which were as high as forty-five percent, Standard Oil would receive payments from the railways each time a competing refinery used the railroads’ increased rates (Chernow 136). On top of the payments, Standard Oil would also receive crucial information on the movements of their rivals. The railroads, meanwhile, would gain exclusive rights to transporting the oil from Standard Oil’s refineries.

Rockefeller and the other refineries agreed on the top secret deal with the railroad companies.
Under the cover of the “South Improvement Company,” the arrangement would benefit both parties. The three struggling railroad companies, beginning to face stiff competition, benefited from Standard Oil’s agreement to use each railway a set percentage each year. They also had been threatened by Rockefeller’s expanding array of tank cars (Chernow 137). Meanwhile, Rockefeller now had his weapon to destroy Standard Oil’s competition. His rivals would suffer from the increased rates and would be forced to join the South Improvement Company (SIC) or face bankruptcy.

The dominance of the SIC was felt immediately. The increased rates crippled Rockefeller’s competition, all while Rockefeller received payment each time they used the railways. A month after the contract had been signed, from mid-February until March 28th, Standard Oil took control of 22 of the 26 Cleveland oil refineries held by its rivals. Rockefeller purchased six of these in a 48 hour period alone (Chernow 143). Standard Oil’s daily production rose from 1,500 barrels to over 10,000 barrels (Tarbell “The Oil War”). Standard Oil had gained the premier position in the Midwestern oil refineries and appeared heading towards national dominance. However, a former rival of the Erie Railroad leaked word to the press about the secret agreement between the railroads and the refineries in the SIC (Chernow 138). Upon hearing about the true reason for Standard Oil’s growth, the public became outraged. Word spread quickly that a conspiracy was the cause of the rates, and Rockefeller was widely denounced as “The Anaconda” or as “The Monster” and his “Forty Thieves (Chernow 139).” Everywhere Rockefeller went, he was met by an angry mob calling for violence. Rockefeller stayed calm throughout the “trial,” correctly pointing out that (with no Sherman Act or other anti-monopoly law) the SIC contract did not violate any laws (Chernow 142).

The resulting actions of Rockefeller and his rivals became known as the “Oil War of 1872.” After an investigation by Congress, the oil producers which Standard Oil relied upon decided to freeze the company out. They agreed that no oil would be sold to any of the SIC refineries and that no oil would be transported on the three SIC railways. Rockefeller was forced to temporarily shut down Standard Oil’s operations as production ceased. The railways were then forced to publicly abandon their contract with Standard Oil and the other SIC companies. However, privately, the “South Improvement Company” simply merged its operations with Standard Oil’s and Rockefeller continued to receive special rebates from the three railroads. The Oil War had come too late to save Standard Oil’s competition, and Rockefeller had stood up to Congress and won the first battle between the two (Tarbell “The Oil War”).

Having secured dominance in the refining process, Rockefeller then set out to control all aspects of the oil industry. Previously, he had not attempted to control the other stages on production of oil. He had set out to expand his company horizontally, buying up all factors of production going into the refinery process. He now changed his focus towards integrating his company vertically, where he would control all aspects of the oil industry, from the time the oil was pumped from the ground until the time it was sold in stores. He desired to control “transport, research, marketing, and even the manufacture of barrels (Micheloud).” Rockefeller used several different methods to achieve his desired control over the industry. One important aspect was his reinvestment of profits. Rockefeller decided he needed to keep a low profile and keep his profits private. Standard Oil’s enormous profits were mainly invested back into expansion and improvement of the business. While his rivals transferred their profits to enjoying the fruits of their labor, Rockefeller was constantly reinvesting to improve his company’s position. Rockefeller was also not above using espionage on his rivals. He would place double agents inside of companies to provide him with valuable information. He also used spies to check that the railroads were charging his rivals the promised increased rate (Micheloud).

A third important method of Standard Oil’s dominance was Rockefeller’s use of economies of scale. He believed it was inefficient to operate hundreds of smaller refineries to handle work which could easily be done in several large stations. In 1875, he decided to shut down many of his refineries to focus the majority of his refining in
three enormous stations. This proved to be a valuable technique perfected by Standard Oil. Another technique used by Rockefeller was his efficient means of saving money. By controlling the factors of productions going into the refining process, he could save his company large amounts of money. In one year alone, he saved $9,000,000 by simply lowering his costs spent on barrels and metal boxes.

Rather than rely on other companies to transport his oil, Rockefeller desired for Standard Oil to control the prosperous pipe line system in the United States. In 1872, he purchased United Pipe Lines, a smaller company with a small amount of pipes. However, by 1876, United Pipe Lines controlled over half of the lines in the U.S, thanks to the pressure put on pipe companies by Rockefeller’s friends in the railways (Chernow 201). Three years later, he held virtually every pipe line in the country. Later that year, when independent producers in Pennsylvania attempted to build a separate state-wide pipe system, Rockefeller went behind the scenes and had his men buy the pipe company’s shares of stock until Rockefeller was the majority share-holder.

Rockefeller also used price fixing to gain control and increase his power. By 1872, over 80% of the oil refineries were united under Rockefeller in the National Refiners Association (Chernow 157). The oil producers responded to this group by forming their own Petroleum Producers Agency. The producers were willing to compromise with Rockefeller and asked him to set the current price of oil at $5 a barrel. Rockefeller initially consented for “the good of the industry.” However, several months later, he recanted and began to restrict his group from purchasing the producers’ oil. The producers, already in debt, were forced to consent to Rockefeller’s new terms and concede even more power to him (Micheloud).

From 1875 until 1878, Rockefeller’s control over the refining industry grew even stronger. During the three years, he was able to convince the top 15 refining companies in the country to join Standard Oil. They were shown the secret agreements with the railroad companies, still alive and well years after the railroads had publicly ended the deal, and promised the refiners vast amounts of wealth. Rockefeller even showed them Standard Oil’s true profits, which he had previously guarded under the greatest secrecy (Chernow 229). The refiners began to grasp Rockefeller’s true power and eventually consented to joining Standard Oil. Following these deals, he now possessed total control over 80% of the refining in the U.S.

The final sector of the oil process to come under Rockefeller’s control was the selling of the finished product to consumers. Many refineries carried private retailers, who purchased all of the refineries’ oil. Rockefeller took control of these retailers when he purchased the majority of refineries in the country, but was still not satisfied. He decided to set up private retailers for Standard Oil, creating a thorough system to persuade consumers to use their oil. Each time a major retailer purchased oil from a rival company, a Standard Oil representative, informed of the purchase through a system of spies, called the retailer and offered a cheaper price for the Standard Oil product. If he still refused, the retailer was then visited by a Standard Oil representative claiming to be an independent dealer offering an even lower price (Micheloud).

By 1881, Rockefeller had achieved virtually all of his goals. He held control of the entire oil process, from the time the oil was pumped from the well to the time the oil was sold in stores. He held complete power over the oil producers, and was able to set his desired price. Standard Oil now commanded the railroads and was still receiving the benefits from the secret 1872 deals. Rockefeller held virtually every pipe line in the country and had created a sophisticated system of selling his finished products to consumers. He had already stood up to Congress, and held many politicians and judges in his pocket. The final step for Standard Oil to achieve was formal organization.

All of these individual companies and organizations controlled by Rockefeller had previously been organized loosely in the Standard Oil “umbrella.” There was no formal organization of all the separate entities under Standard Oil’s control. This changed on January 2, 1882. Flagler and Samuel Dodd, a man officially listed as Standard Oil’s lawyer, but also one of Rockefeller’s most trusted advisors, drafted a trust agreement.
In this contract, the 40 companies under Standard Oil’s control (worth over $70 million and controlling 90 percent of American refineries and pipe lines) were formally brought together to form the “Standard Oil Trust.” The controlling shareholders in the group would elect 9 trustees to control the day-to-day operations of the company (Chernow 227). The trust’s headquarters was to be located at 26 Broadway, in an immense, intimidating building fit for the king of the oil industry, John D. Rockefeller.

The Standard Oil Trust was run like a well-oiled machine. The transition of the companies from separate entities to one united empire was seamless, as the various levels of production kept in perfect communication. The operation was always run at its most efficient levels of output. They had perfected every aspect of their product, and continually updated their company through exhausting research. Rockefeller and Standard Oil did not even need to increase their prices to record levels to take advantage of their monopoly status. Their knowledge was so vast and their control over the industry was so complete that they only needed to produce as much oil as was needed to keep prices constant.

Not all were impressed with Standard Oil’s operations, however. Many worried about the political ramifications of such a powerful company. Others distrusted Rockefeller and believed that Standard Oil would someday raise oil price to catastrophic levels. Still others cried out that independent oil producers and refiners had a right to exist as well. In 1888, a New York senate committee spent several months investigating the trust and eventually brought the case to the courts (Chernow 294). The court spent several hours grilling Rockefeller, who skillfully avoided true perjury by providing half answers as he wowed the assembled crowd and media with his savvy. (Most memorably, Rockefeller was asked about the Southern Improvement Company, as opposed to his South Improvement Company. He truthfully responded that he was not involved with any such company) (Chernow 296).

Public pressure to tame Rockefeller’s growing power resulted in Congress’s passage of the Sherman Anti-Trust Act in 1890. The law forbade any “contract, scheme, deal, or conspiracy to retrain trade,” as well as forbidding corporations to secure monopolies in a given industry. However, the wording of the act was far too vague and was too poorly enforced to have any real effect on Standard Oil. The act was publicly chided as the “Swiss Cheese Act” for its numerous loopholes. The only real change for the company was to reincorporate the group again, this time in New Jersey (Micheloud). The Standard Oil machine simply dismissed the Sherman Act as a nuisance, and continued operations. (Never one to hold a grudge, Rockefeller even supported the reelection of Senator John Sherman, the bill’s namesake and author, in 1891) (Chernow 298).

The pressure, though, continued to rise in 1892. The Ohio Supreme Court ruled that the Standard Oil Trust had violated its charter by transferring control to its New York headquarters. The Court ordered Standard Oil to dissolve the trust immediately. Rockefeller, again, appeared unfazed and agreed to dissolve the trust, while remaining optimistic about his company (Chernow 332). The shares of the trust would be broken up into proportionate shares of twenty companies. The allocation of money, control, and dividends would remain unchanged. Rockefeller received over 25% of the stocks and remained firmly in control. The transition from a trust to a holding and operating company was again seamless, and little change was seen in the operations (Chernow 333).

Standard Oil reached its peak in overall production in the 1890’s. Despite growing pressure from Congress and several court-ordered reorganizations, the company was stronger than ever. They now marketed 84% of petroleum goods in the U.S. and pumped over a third of the oil produced in the country. The dominance in the pipelines, railroads, and refineries remained unchanged. The demand for oil products, such as oil stoves, continued to rise. Henry Ford’s automobiles were beginning to explode in popularity, as Standard Oil fueled the automaker’s engines (Chernow 430). Though the future looked bright for the company, the fortunes of the empire were about to be changed drastically by two
antitrust Presidents and a woman struggling to make ends meet as an author.

In 1901, Theodore Roosevelt took over as President, following the assassination of William McKinley. This turn of events disappointed Rockefeller greatly, for he had held great hopes for McKinley and despised Roosevelt (Chernow 432). Aside from political ramifications, Rockefeller felt that McKinley would support Standard Oil, while realizing that Roosevelt had been speaking out against the trusts during the election. Rockefeller further strained the relationship between the two by refusing to compromise with the President as his fellow tycoon J.P. Morgan had done (Chernow 433). Roosevelt was gaining popularity in the press with his war on monopolies and was determined to take out Rockefeller and Standard Oil.

At the same time as Roosevelt began planning to confront Standard Oil in the courts, a woman writing a series of biographical sketches on Rockefeller would forever turn the public firmly against him. Ida Tarbell began work in 1901 on a series for McClure’s Magazine about the practices of Standard Oil (Chernow 435). Her research on Rockefeller spanned from his 1st job as an accountant in Cleveland until the anti-trust suits. All of the skeletons in Rockefeller’s closet, which he thought would never be exposed, would soon be told to the American public (Tarbell “The History). She would transform America’s most powerful and private men into one of its most public figures (Chernow 438).

Tarbell’s work exposed many of Standard Oil’s disreputable practices. She portrayed his takeover of Cleveland refineries as “an orchestrated atmosphere of intimidation (Chernow 444).” She exposed Standard Oil’s abuses of power by their pipelines and their use of the railroads. She accused Standard Oil of sabotaging rivals’ plants and accused Rockefeller of shady dealings with a blind factory owner in Cleveland. Though he would never give Tarbell the satisfaction of knowing it, most hurtful to Rockefeller was the way she described his painful disease, alopecia, as a sign of moral weakness (Tarbell). Portraying Rockefeller as a man intent on winning at all costs, regardless of repercussions, her work formed the first biography many Americans had ever read of the reclusive millionaire. The American public now began to turn against Rockefeller as many of his secret practices were exposed (Chernow 455).

Now backed by strong public support, President Roosevelt felt the time was right to bring Standard Oil to justice. In 1906, the federal government launched a lawsuit in Minnesota against Standard Oil of New Jersey and other branches of the company (Chernow 537). Citing violation of the Sherman Anti-Trust Act, the government began to build its case. By the summer of 1907, Standard Oil was facing six state suits, seven federal suits, and 939 indictments brought against Rockefeller and his company in Ohio. In August, Standard Oil was forced to pay $29.2 million dollars to the government, the maximum fine allowed in the case. Rockefeller himself was forced to pay $8 million of the fine, the total of which worked out to $457 million in 1996 dollars (Chernow 541).

The lawsuits continued to mount for Standard Oil the following year. They finally attempted to compromise with the government, allowing the government to view all of its financial books and promising to comply with the Sherman Act if the federal lawsuit was dropped (Chernow 545). The compromise did little to save the sinking ship. During the first set of federal lawsuits from 1906-1908 alone, “444 witnesses delivered 11 million words of testimony; swollen by 1,374 exhibits, the proceedings filled 12,000 pages in 21 think volumes…some 21 state antitrust suits from Texas to Connecticut (Chernow 545).”

By 1908, Roosevelt was replaced in office by William Howard Taft, who Rockefeller had supported during the elections. Rockefeller hoped to work with the new president; however, though Taft liked Rockefeller, he also detested trusts as much as his predecessor (Chernow 553). Taft actually brought more antitrust suits to trial than Roosevelt, and started work early in his Presidency to bring down Standard Oil. The company’s bad luck continued in 1909, when a federal circuit court in St. Louis ruled that they had violated the Sherman Act. In one state after another, courts ruled that Standard Oil had violated the Sherman Act by continuing its former practices of monopolizing the industry (Chernow 554).
The final act against Standard Oil was delivered on May 15, 1911 by the Supreme Court in Washington, D.C. Chief Justice Edward White upheld the lower courts’ decision to dismantle Standard Oil, giving the company six months to separate its subsidiary companies (Chernow 554). Rockefeller acted with his normal indifference to bad news, thought he did tell his partners, “Our splendid, happy family must scatter (Chernow 555).” However, even prior to the decision, Standard Oil’s position as the dominant power in oil had been falling as international competition took a large portion of their market. Its share of domestic oil pumped had fallen to 14%, while its share of refining had fallen to 70% in 1911 (Chernow 555). The Anaconda appeared to have been slain.

However, in true Rockefeller form, the suit turned out to be the luckiest event of his life. The shares of the entire Standard Oil Company were to be divided into separate companies. Rockefeller, however, held on to all of his shares in his companies. As Wall Street debated about the true value of the newly independent companies, the public began buying up as much of the new companies as they could. The prices of Standard Oil stocks soared and Rockefeller was richer than ever. His net worth exploded, from $300 million after the suits in 1911 to $900 million in 1913 (over $13 billion 1996 dollars). Rockefeller’s net worth was $185 million more than total federal spending in 1913, and he could have paid for almost all of the $1.2 billion debt that year (Chernow 557). Newspapers kept daily announcements of his estimated wealth. Taft and Roosevelt were distraught at these results, as Rockefeller had outwitted the Federal Government once and for all.

For the next decade, the Standard Oil companies slowly transitioned to meet the government’s standards. Though they publicly met government regulations, many of the various companies’ heads still met, sold the same brands, and refused to compete on prices. The New Jersey and New York both kept their headquarters at 26 Broadway, and often worked hand-in-hand. Rockefeller slowly separated himself from the various branches of Standard Oil, more content with his other investments and charitable donations. Today, the remainders of the Standard Oil Empire dominate the national oil industry. Rockefeller’s “children” are among the most well-known and profitable oil companies in the world: Exxon (Standard Oil of N.J.), Mobil (N.Y.), Amoco (Indiana), Chevron (California), Arco and Sun (Atlantic Refining), Sonoco (Continental Oil), British Petroleum (eventually took over Standard Oil of Ohio) (Chernow 559).

John Davison Rockefeller left two separate economic legacies still felt today by every large corporation. His unparalleled dominance in the oil industry set a precedent for other entrepreneurs to reach. His well-organized business sense, his thoroughness and attention to detail, his use of economies of scale, and his horizontal and vertical integration perfected the way a large-scale business should be run. At the height of its power, the Standard Oil Trust was a well-oiled machine, controlling every aspect of its product from its initial finding to its consumption. Never again will a single corporation be allowed to wield as much control and power as Rockefeller possessed during Standard Oil’s peak. However, he also left the economic world struggling to determine the proper relationship between industry and government. His dominance left questions about the appropriate balance of wealth in the country. His company’s unquestioned power worried Americans about the ability of the wealthy to affect elections. Most of all, Standard Oil showed that the government would need to take a greater role in regulating its economy. Rockefeller’s legacy is felt when a corporation’s actions are said to be an attempt to monopolize the industry. He did not create the trust or the monopoly, but he did perfect the way an organization should be run. John D. Rockefeller set a perfect business model which will never again be reached.
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