ORAL ARGUMENT SCHEDULED FOR APRIL 14, 1993

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 92-5079 and Consolidated Cases

UNITED STATES OF AMERICA,

Plaintiff-Appellant,

v.

WESTERN ELECTRIC COMPANY, INC., et al.,

Defendants,

BELL ATLANTIC CORPORATION, et al.,

Appellants.

ON APPEAL FROM THE UNITED STATES DISTRICT
COURT FOR THE DISTRICT OF COLUMBIA

REPLY BRIEF FOR APPELLANT UNITED STATES OF AMERICA

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The AT&T antitrust consent decree provided a structural remedy for the anticompetitive conduct that had resulted from economic integration of regulated local telephone exchange monopolies with interexchange and manufacturing businesses in the Bell System. Thus, the Bell Operating Companies ("BOCs") were divested from AT&T, and section II(D) of the decree (as modified in 1987 and 1991) prohibits the divested BOCs from providing interexchange services, manufacturing customer premises

equipment, and manufacturing or providing telecommunications equipment "directly or through any affiliated enterprise."[1] This appeal involves the standard for determining whether an entity is an "affiliated enterprise," i.e., whether its activities are attributable to a BOC for purposes of the line-of-business restrictions.

ARGUMENT

1. As our opening brief explained (U.S. Br. at 12-15), the United States believes that "affiliated enterprise" is most commonly used and most reasonably understood to denote an ownership or control relationship. See also, D.C. Cir. Rule 6A. Thus, in the context of this decree, we have proposed that "affiliated enterprise" be construed to mean an entity in which a BOC owns more than a de minimis equity interest (five percent or more) or over which it exercises substantial management control.[2]

AT&T[3] denies that ownership and control are central to the common understanding of affiliation, asserting that "the term `affiliated' ordinarily encompasses any relationship that creates

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[1]United States v. Western Elec. Co., 552 F. Supp. 131, 227-28, 231 (D.D.C. 1982), aff'd mem. sub nom. Maryland v. United States, 460 U.S. 1001 (1983), modified, 673 F. Supp. 525 (D.D.C. 1987) and 714 F. Supp. 1 (D.D.C. 1988), aff'd in part and rev'd in part, 900 F.2d 283 (D.C. Cir.), cert. denied, 111 S. Ct. 283 (1990), modified, 767 F. Supp. 308 (D.D.C. 1991), appeal pending, No. 91-5263 (D.C. Cir., argued Dec. 1, 1992).

[2]"Affiliated enterprise" is a somewhat broader term than "BOC," as defined in section IV(C). (See U.S. Br. at 14-15.)

[3]Five other appellees filed a joint brief; they generally endorse AT&T's arguments. (See MCI et al. Br. at 3.)

a direct financial interest in the prohibited business." (AT&T Br. at 21.) But it cites no authority to support this sweeping definition -- which apparently would include major creditors and suppliers -- as common usage. At most, AT&T's citations (AT&T Br. at 25-27) illustrate that some statutes and regulations expressly expand the common meaning of "affiliate" to include relationships that do not involve ownership or control, or permit administrative agencies to adopt such expanded definitions by regulation. The parties to this decree did not expressly adopt or refer to any specialized or expanded definition, however, and appellees cite no case -- nor are we aware of any -- adopting a definition not based on ownership or control in comparable circumstances.

2. In the district court's view, section II(D) prohibits "those situations in which [a BOC] would have a substantial incentive and ability unfairly to impede competition by use of its monopoly position in the market it is . . . entering." Slip op. at 4 (J.A. 13) (internal quotation omitted). As the United States noted in its opening brief (U.S. Br. at 17), this holding confuses the unconditional structural prohibitions of section II(D) -- which apply regardless of whether the BOC's prohibited activity poses any competitive risk -- with the section VIII(C) standard for removal of line-of-business restrictions -- which requires "a showing by the petitioning BOC that there is no substantial possibility that it could use its monopoly power to impede competition in the market it seeks to enter."

Not only is an expanded prohibition based on transaction-specific predictions of competitive risk inconsistent with the basic structure of the decree, but it would leave the BOCs subject to a restriction of undefined scope. The assessment of competitive risk under the district court's standard presumably would require analyses of and predictions about market conditions, regulatory and technical constraints, and economic factors that could affect the BOC's incentives and ability to engage in discrimination or other potentially anticompetitive practices and the likely effect of such practices on competition in relevant markets. See United States v. Western Elec. Co., 900 F.2d 283, 295-305 (D.C. Cir.), cert. denied, 111 S. Ct. 283 (1990) (discussing VIII(C) standard). In contrast, as the United States construes the decree, whether an entity is an "affiliated enterprise" depends only on a few simple and readily ascertainable facts: whether a BOC owns stock or other ownership shares in another entity, and, if so, what percentage it holds; and whether or not BOC representatives direct or participate in the other entity's business decisions. (See U.S. Br. at 17-18.)

3. Although appellees endorse the district court's decision insofar as it rejected the United States' construction of "affiliated enterprise," they do not attempt expressly to defend the district court's formulation of the standard for identifying prohibited "situations." To the contrary, AT&T recognizes that a speculative competitive risk test would be inappropriate. (See AT&T Br. at 32.) Thus AT&T seeks to reformulate the court's

broad, nonstructural prohibition in terms of what AT&T calls the "`inherent attributes of the transaction,'. . . whether the RBOC would acquire a `direct financial stake' in the enterprise and `incentives' to discriminate in its favor." (Id.) Under its standard, AT&T concludes, the line-of-business restrictions would prohibit any "contractual arrangements in which an RBOC shares in the expenses of and the revenues from prohibited lines of business." (Id. at 29.)[4]

AT&T and the other appellees do not make clear whether they are proposing an absolute ban on all BOC "financial interests" in prohibited businesses, or whether they, like the district court, contemplate a case-by-case analysis of potential competitive risks. In either event, appellees have not shown that any alternative standard is more appropriate that the "affiliated enterprise" definition the United States proposes. As an initial matter, any "financial interest" or "revenue sharing" prohibition that extends beyond BOC participation in prohibited activities "directly or through any affiliated enterprise" is at odds with the decree language. The parties used only the more precise and limited structural terms. If they had intended a broader prohibition, they could have used the broader terms AT&T suggests, but they did not. (See U.S. Br. at 14.)

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[4]Similarly, the other appellees argue that "affiliated enterprise" "should be construed to include an enterprise in which a BOC's equity or royalty-type interest creates any incentive for the BOC to exercise its monopoly power to impede competition." (MCI et al. Br. at 4.)

Further, an absolute ban on BOC financial interests would conflict with the parties' expressed intent to permit the BOCs, in the normal course of their exchange and exchange access functions, to engage in a variety of business transactions in which they would derive revenues and purchase products from entities engaged in prohibited activities (without establishing an ownership or control relationship). For example, under the post-divestiture access tariffs, the BOCs "share" the revenues of interexchange carriers, because interexchange carriers pay BOC access charges out of their revenues from interexchange services. And BOCs have "financial interests" in interexchange carriers' volume of traffic since the access charges are usage-based. In addition, when a BOC purchases equipment under a contract that requires it to pay the supplier's costs plus some fixed or percentage fee (and we do not understand AT&T to contend that such transactions are prohibited), the BOC shares and would have a financial interest in minimizing the supplier's costs. Similarly, a BOC that markets branded customer premises equipment ("CPE") and has invested in promoting a particular brand could be said to have a financial interest in an unaffiliated CPE manufacturer's continued production and promotion of its products.

If, on the other hand, appellees are arguing that the affiliated enterprise prohibition of section II(D) covers only those financial interests that create an incentive to

discriminate,[5] their test, like the district court's, is not based on the "inherent attributes" of the transaction, and it provides no clear guidance to the parties about the scope of the prohibition. Rather, because a BOC's incentive to discriminate can only be evaluated in light of the likely costs and benefits of an attempt to discriminate, AT&T's standard would require essentially the same market-based analyses and predictions as the inquiry suggested by the district court.

4. AT&T's failure to explain or justify the "financial interest and incentive" standard it proffers is well illustrated by its own example of what it considers to be a permissible funding arrangement. According to AT&T, the decree would "allow the RBOCs to `fund' development efforts under contracts in which one RBOC is entitled to prevent free-riding by other RBOCs and receive royalties (or the equivalent) that would allow the RBOC to recoup its development expense (but no more)." (AT&T Br. at 38 n.20.) But AT&T does not suggest why an intent "to prevent free-riding by other RBOCs" is determinative of whether a BOC has either "a direct financial stake" in a manufacturer or an "incentive to discriminate." Nor does it explain why, under its

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[5]Contrary to appellees' assertion, the United States did not concede that the funding/royalty agreements proposed by Ameritech would be anticompetitive. While we said that "a BOC's right to receive royalty payments might give it the same incentive and ability to favor a manufacturer as would an equity interest" (U.S. Br. at 16), we concluded that the royalty arrangements at issue would satisfy the VIII(C) standard. But we did not address the VIII(C) question in any detail in our district court filings, and we do not ask this Court to decide that issue on the present record. (See U.S. Br. at 2 n.1, 8.)

criteria, royalty payments that would be permissible while a BOC is "recouping its development expense" would establish a prohibited relationship when recovery of that expense is complete,[6] despite the lack of any other change in the BOC-manufacturer relationship.

In short, AT&T's standard, like the district court's, is irredemably arbitrary and inconsistent with the fundamental principle that an injunction should give the affected parties adequate notice of the conduct it prohibits.

5. Contrary to the district court's conclusion, which appellees seek to defend, an expansion of the "affiliated enterprise" prohibition beyond the normal meaning of that term cannot be justified on the ground that it is essential to "the purposes of the [line-of-business] restrictions." Slip op. at 6 (J.A. 15). (See AT&T Br. at 30-32; MCI et al. Br. at 4-5.) The parties' contemporaneous statements as to the purposes of decree provisions may be taken into account in construing ambiguous decree language, but the Supreme Court and this Court repeatedly have held that a court may not extend decree prohibitions or add new ones to which the parties did not agree in order to further their expressed or implicit purposes. E.g., United States v. Armour & Co., 402 U.S. 673, 680-83 (1971); United States v. Atlantic Refining Co., 360 U.S. 19, 23 (1959); Hughes v. United

[6]In addition, this example itself raises practical questions. Detailed accounting, it seems, would be required to determine if a BOC had recouped or might recoup more than "its development expense," and AT&T provides no guidance on how that expense would be computed.

States, 342 U.S. 353, 356-57 (1952); United States v. Western Elec. Co., 894 F.2d 430, 435-37 (D.C. Cir. 1990); United States v. Western Elec. Co., 797 F.2d 1082, 1089-91 (D.C. Cir. 1986), cert. denied, 480 U.S. 922 (1987).

In proposing this decree, the parties explained that its purposes were to dismantle the integrated Bell System and to prevent the BOCs from recreating similar potentially anticompetitive corporate structures. See generally, United States v. Western Elec. Co., 552 F. Supp. at 165-66; Competitive Impact Statement, 47 Fed. Reg. 7170, 7173-74, 7176 (1982) ("CIS") (J.A. 96-98, 107); Response of the United States to Public Comments on Proposed Modification, 47 Fed. Reg. 23320, 23323, 23335 (1982) ("U.S. Response"). In doing so, they expressly eschewed judicial regulation in favor of structural relief, see 552 F. Supp. at 166-68; CIS, 47 Fed. Reg. at 7181 (J.A. 131-33), and they recognized that the decree would not remove all risks of anticompetitive conduct in the telecommunications industry. See U.S. Response, 47 Fed. Reg. at 23323.

To dismantle the old Bell System, the decree terminated its intraenterprise accounting arrangements -- known as "division of revenues," "standard supply contracts" and "license contracts" -- which arose from the common control and economic integration of AT&T, Western Electric and the BOCs. See §§I(A)(3), II(A), App. B §B(1), 552 F. Supp. at 227, 233, 196 n.271; CIS, 47 Fed. Reg. at 7174 (J.A. 100). But, contrary to AT&T's suggestion (AT&T Br. at 8-10, 29), termination of these contracts to effectuate

divestiture does not imply that the decree barred or required judicial approval of new, arms-length relationships between the BOCs and independent manufacturers or interexchange carriers (including AT&T) that were otherwise consistent with the decree.

AT&T's reliance on isolated statements by the Department of Justice to the effect that the decree would bar the BOCs from having any "financial stake" in entities engaged in prohibited lines of business (see AT&T Br. at 10-12, 29-30) also is misplaced. Given the language of section II(D) and the other indications that the parties did not intend to prohibit all BOC financial interests in prohibited activities (see pp. 2-3, 5-6, supra), these statements are insufficient to establish that the parties agreed to a broad prohibition based on ad hoc assessment of competitive risk such as the district court and appellees propose. See United States v. Western Elec. Co., 797 F.2d at 1090-91 (statements in decree history were consistent with prohibition on BOC extraregional exchange services but insufficient to establish that parties agreed to such a prohibition).

6. The issue presented on this appeal is purely a question of law. Definitive resolution is important to ensure that the BOCs have clear notice of the scope of the line-of-business prohibitions, to provide for effective enforcement of those restrictions, and to avoid unnecessary case-by-case judicial review and deterrence of legitimate and procompetitive business arrangements. Any allegations that particular BOC

funding/royalty arrangements diverge from the representations in Ameritech's motion and involve direct BOC participation in manufacturing or BOC participation in management of an enterprise involved in manufacturing (see AT&T Br. at 33-34) would raise factual issues that should be investigated by the Department of Justice and resolved by the district court in the first instance under the appropriate legal standard.[7] Speculation that such violations might occur is not relevant to the decree interpretation issue now before this Court.

CONCLUSION

The Court should vacate the district court's decision and should hold that "affiliated enterprise" as used in the decree's section II(D) line-of-business restrictions means an entity in

[7]We note, however, that a manufacturer's response to a BOC's demand for particular products or product features would not in itself indicate either direct BOC participation in manufacturing or BOC management control of the manufacturer, as AT&T may be suggesting (see AT&T Br. at 33-34). Rather, a decision to produce products that a BOC would be likely to purchase would be a normal market response to customer demand by the manufacturer's independent management.

which a BOC owns more than a de minimis equity interest, i.e., five percent or more, or over which it exercises substantial management control.[8]

Respectfully submitted,

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[8]An order construing "affiliated enterprise" as requested by the United States would eliminate the need for any rulings limited to the specific royalty arrangements proposed by Ameritech.

CERTIFICATE OF SERVICE

I hereby certify that on March 15, 1993, the foregoing REPLY BRIEF FOR APPELLANT UNITED STATES OF AMERICA was served by U.S. mail, first-class, postage prepaid, upon:

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