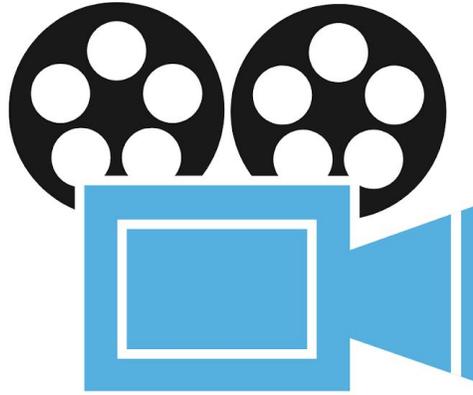


Strategic Effects of Vertical Markets Structure: Accessing the narrative Paradigm



The Motion Picture Industry

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Introduction

A glance at the recent market structure of the motion industry, makes it different, from what inventors like Thomas Edison had created with the moving pictures to a stunned public. However, one unique feature coincided with the emergence of the motion picture industry, the introduction of antitrust laws. Like other traditional industries, the history of the motion picture industry follows a recurring pattern of early confusion, patent wars, horizontal or **vertical integration**, antitrust lawsuits and a standard of operation.

After the early years of ignoring its rampant unhealthy competition and trade practices cited by the Sherman Act, the Justice Department wades in with antitrust lawsuits to introduce competition, breaking the motion's industry business structure in order to reduce the influence of famous players. The aftermath of various lawsuits levelled against the industry significantly impacted its current nature. According to MacCarthy (2018), this solved the chicken and egg problem of the industry.

This paper will assess the strategic effects of vertical integration in the motion industry while looking to understand, the competitive, innovative, cultural and corporate histories of major movie studios, also following the narrative shift that each decision created.

History and Brief Overview

No other industry in the world evokes the glamour, magic of show-business like Hollywood. The story of this industry started in the 20th century to portray the then modern American society and

innovation, using Motion pictures. The ¹origin of motion pictures is often a conflicted one, some believe Edward Muybridge, invented the first true motion picture, in 1872 by rigging cameras to capture a 'sequence of horse crossing,' others tend to disagree with this tale.

According to Gil (2008), Thomas Edison felt the need to begin work in motion pictures saying, "I am experimenting upon an instrument which does for the eye what the phonograph does for the ear, which is the recording and reproduction of things in motion". ²Some writings attribute the talents of W.K Dickson to the design and invention of the picture devices used in the motion picture. In 1882 Edison files for patent right and released the Kinetoscope. The Kinetograph commercialised in 1883, took into consideration, the principles of photography; taking rapid photographs that could be replayed as a moving image when viewed through a peephole.

However, due to his lack of entrepreneurial skill, Edison cannot be said to play a role in the development or other improvements in motion picture technology. Despite Edison's lack of contribution, he is credited to have made the industry attractive to new entrants, also creating the phantoscope and produced a narrative film, *The Great Train Robbery* (1903) which advanced the future of film³. As is prevalent in other industries, during this period other companies began to make film devices to compete with Edison but his wit, patent rights and copyright to the new motion picture technology, gave him 'virtual monopoly' (Gil, p. 8)

In the years that followed Edison's virtual monopoly of the film industry, more technology revisions were made to film devices, which became Nickelodeons. In 1905,

¹ See <https://www.britannica.com/art/history-of-the-motion-picture> , also <http://historycooperative.org/the-history-of-the-hollywood-movie-industry/> where Edison is suggested to have invented the technology for the basis of motions picture.

² <http://historycooperative.org/the-history-of-the-hollywood-movie-industry/>

³ Paul Starr, *The Creation of the Media*,

nickelodeons were pushed to the mainstream market for audience consumption having improved methods, thereby increasing its popularity.

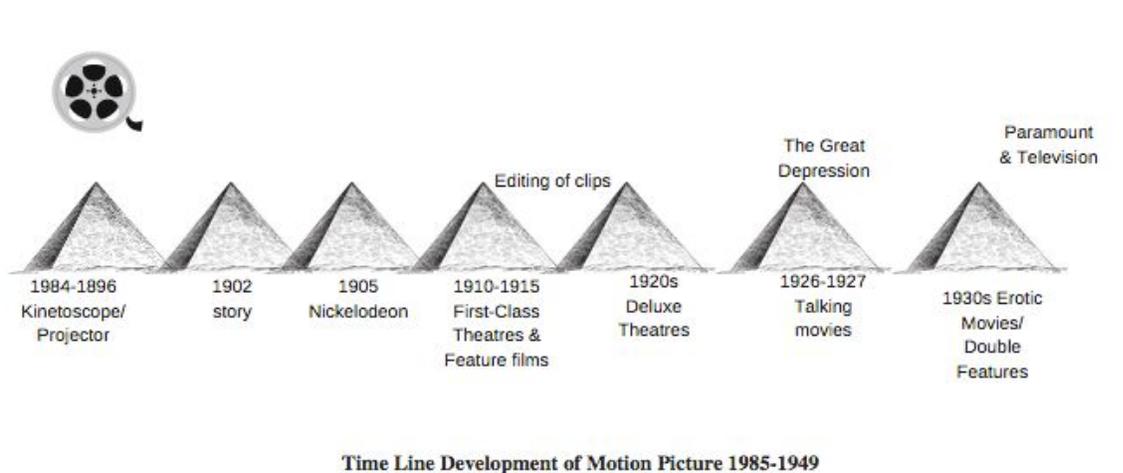


Fig. 1

Patent Pooling

As is notable with most new industries, the major players used the patent process to control the motion industry. ⁴The Motion Picture Patents Company (MPPC) was created by Edison and nine major motion picture patent owners, to resolve adversarial relationships in the emerging motion industry.

Following what seemed like self-regulation, the industry was allowed to focus on creating content. But there were barriers for independent movie producers, to acquire essential equipment for producing film content, example the 'Latham Loop Patent'. MPPC made it difficult by bringing "patent enforcement suits against competitors" (Gil, p.92) who failed to use

⁴ Gil p. 92 explains Edison had gone to court between 1904-1907 to maintain production rights, over the film device with his competitor biograph, Also see Litman, p.61

the MPPC patented-film equipment, it also standardized many of its practices. Consequences of this action meant the MPPC was responsible for the distribution of film content and technology, through its affiliates. ⁵Meanwhile, the court found no antitrust claims by the company against its competitors, therefore stripping them of the unreasonable restriction to trade. The MPPC had monopolized most of the commerce and accessories associated with film production and distribution. Simultaneously, the exchanges occurring at the time became profitable in advancing the course of ⁶vertical integration.

Merger Madness, the rise of Paramount and Vertical Integration

Although, the decision of the court in the case of MPPC v. Laemmle and MPPC v. Pantograph brought an end to the MPPC era. Notwithstanding, distributors and producers, had formed an independent grip on the film industry while other surviving companies set off to start an independent distribution and exhibition company. The demise of MPPC gave rise to the new studio system. Between 1912-915, the competition in the motion picture industry had waned, due to the intense cost of film production, barriers to entry and the increasing budget it required to produce film content.

Also, Kriag (1992) explains that from MPPC, emerged Paramount Pictures Corporation ('paramount') founded by ⁷W.W Hodskin. In "an attempt to control national distribution," Zukor

⁵ see United States v. Motion Picture Patents Co., 225 F. 800 (E.D. Pa. 1915 and Hofstra Law review, Vol.21, Iss. 2 (1992), Art. 6

⁶ see Gil, p. 94 "with vertical integration companies acquire those above and below it" using this analogy to understand the workings of the motion picture industry, vertical integration, refers to a company that produces, distributes and exhibits.

⁷ See IZOD, supra note 2, at 45

merged with Paramount, and the company became a studio, being the first to control national distribution and production.

The industry had tipped in favour of Paramount, and it began to use its star advantage, distribution and production capacity in creating a mechanism of network effects for ⁸block booking.

Exhibitors were angered by the competition methods of Paramount and the independent film producers, and in 1917 through an exhibition merger, the National Exhibitors Circuit was formed. Merging proved to be a defence, against dominant producers and. The National Exhibitors ⁹Circuits by the 1920s had gained dominance from their first-run exhibition of films and concentrated from the tipping of the market due to natural forces, but also by unfair ¹⁰ antitrust practices. Then, this led to Paramount's acquisition of more theatres to ensure the exhibition of their films. The merger rattled the feathers of the Federal Trade Commission (FTC), citing the violation of ¹¹No. 5 of the FTC Act. FTC main crux was it believed the acquisition would give Paramount Pictures 'unprecedented access to all three faces of motion pictures business: production, distribution, and exhibition. Following this move, large companies began to acquire and merge in each stage of production to ensure the success of their films through 'supply or reasonable terms' (Litman, 1998). According to Litman, by the end of

⁸ "Block-booking is a license given out to exhibitors under conditions that distributors would score a chance to be featured during another release for a given period" (see *United States V. Paramount*), *also* see Gil p. 98

⁹ *Interstate Circuit v. United States*, 306 U.S. 208, 226, 227, 474; *United States v. Masonite Corp.*, 316 U.S. 265, 275, 1076. That was shown here

¹⁰ these practices included giving exhibition preferences to their own pictures and to those of other major studios by using extended clearances

¹¹ consumer protection act against unfair and unlawful practices

the merger madness, a handful of large companies were vertically integrated creating an oligopoly.

The market was allowed to determine the profits and returns for exhibited films through pricing. The distributors worked in uniformity, fixing high **prices** for their product. But despite this individual freedom, there were unwritten codes as to the sharing formula, to reduce rivalry. There was a fixed minimum percentage across the board which meant films could achieve a certain box office plateau, say \$90, \$150, \$200 million, the final share of money amongst distributors is believed to be at equilibrium parity. Whereas, most of the films, were allowed to dictate pricing, based on demand and supply.

As in the Microsoft case, the motion industry was distracted by the court order of 1926, restricting Paramount use of block booking, when the Waner Brothers Western Electric introduced 'the first sound film' named the Vitaphone (Gil 1998, p. 100). By 1927 the Warner Brothers made history with Jazz singers, the movie was the first sound production changing the nature of the film industry. ¹²The advent of sound disrupted the industry and brought about a new cycle of competition as explained by (Tim Wu, 2011). Fox and Warner Brothers were the main players, also theatres began to instal sound equipment at their exhibition centres.

Below is an illustration is culled from Litman (1998), showing the revenue flow of the motion picture industry.

¹² (C.C.S.D.N.Y. 1910); Motion Picture Patents Co. v. Laemmle, 178 F. 104



Revenue Flow for Motion Picture Industry

Famous Antitrust Cases: The Paramount Litigation

Litman (1998), explains that the vertical integration of big studios in the motion picture industry stifled competition, and was 'an impenetrable barrier to entry,' (p. 13) causing price fixing of first-run films, threats of block booking, ownership of theatres, production, and excess profits.

In 1938 the vertical organization of the industry was attacked by the Antitrust Division of the DOJ, under Section 4 of the Sherman Act. The major defendants, in this case, were Loew's Inc., Paramount Pictures, In., Twentieth Century-Fox, Warner Bros, Radio-Keith-Orpheum and they all produced, distributed and exhibited motion pictures while the minor defendants Columbia Pictures Corp and Universal Corp. both of who 'produced and distributed motion pictures, and the United Artist Corp, which only distributed motion pictures.

Remedies

Both the Supreme Court and the Lower Court had remedies to curtail the monopolistic tendencies of Vertical Integration.

The courts addressed this as it did in the antitrust cases of other industries, example the phone industry. The complaints charged that the defendants through unfair trade practices of block-booking, franchises, first-run had attempted to monopolise and did monopolise the production of motion pictures. The court's resolution in 1940 through a consent decree agreed on (1) Block-booking wasn't illegal but issues should be addressed on individual bases, limited to no more than 5 pictures; (2) blind bidding was illegal; (3) Unreasonable clearances that had created price fixing was prohibited; (4) forced rentals were abolished giving agency to theatres, to allow differentiated pricing between the first-run and second-run theatres; (5) limits were placed on licensed film distribution to exhibitors; and most importantly (6) the court prohibited the defendants from engaging in any type of theater acquisition but left its existing structure. At the end of its three-year period, the arbitration had failed to enforce any of these changes and the structure and control of the motion industry remained the same.

By 1944, the Justice Department re-opened the case, this time calling for a structural change of the vertical ownership bonds. There were disagreements in the rulings by the court, while the Justice Department won at the district level, the court found anticompetitive conduct violations of the Sherman Act rather than 'the actual existence of monopolization an issue. However, the court did not take the recommendations of the government to 'divorce exhibition from production and distribution.

On remand from the higher court in 1949, the district court ordered the vertical divestiture of the exhibition level from the production-distribution level and theatres obtained illegally, be sold off. The lower court still carrying on grievances from the previous order, appealed to the Supreme Court, this time the court affirmed some of the trade practices by the

defendants were illegal and reversed the competitive bidding procedure. The divestiture process went through a consent process, RKO and Paramount consented to divorce ownership of theatre circuits and got more favourable terms than other companies who could on enter the exhibition business and upon appeal distribution.

The Aftermath of Paramount

The source of the antitrust action by the Department of Justice was to allow competition and reduce the dominance of major players in the motion pictures industry. However, there was less time to assess the impact of antitrust structural remedies, before the arrival of television. Nevertheless, some changes in the industry can be attributed to divestiture.

With the disintegration of vertical structure, the industry was open to competition and independent producers were welcomed. Films were also exhibited based on their quality and barriers to entry in the motion picture industry was lifted.

Impact of Television

According to Litman (1998), the initial reaction of the motion picture industry to television was 'one of ridicule', in regards to the nature of the product. As noticed with other emerging technologies, the television worked its way up into peoples homes with the influence of the two-sided **network effects**. When the FCC failed to issue TV licences between 1948 and 1952, it provided an opportunity to analyse the impact of the television. A later report showed that cities with more television penetration had a drop in cinema attendance.¹³ Now, the motion industry realising the strength of the television industry called for a boycott

¹³ No programming from the motion pictures was authorised to go on air and creative personnel associated with the television were stigmatized

The method of dealing with their apparent competitor (television) did the motion picture industry no good, with the revenue-generating capacity of the television production. Warner Brothers were the first to break the boycott of the motion picture industry in 1955, by agreeing to produce weekly series for TV, example Kings Row, Casablanca. Soon after other production studios saw the benefit of pitching their tent with the TV industry, releasing rerun of film content for the television. The studios were quick to go back to old trade practices, considered illegal by merging as a way to become significant competitors. Time Inc.'s acquired Warner Communications, Viacom International Inc., merged with Paramount "outlets in search of content" and Disney with the ABC merger "content in search of outlets," forming part of the present day media conglomerates.

Other Exhibition Windows

The television industry became an exhibition window, also prompting the creation of accessories like Video Cassette Recorder (VCR). However, the development of VCRs rattled major production studios in the motion picture. Most production studios feared the taping of TV programs would reduce re-run revenues.

"Universal and Disney challenged Sony in the late 1970's claiming VCRs infringed copyright. The court rule found no illegal behaviour a similar suggestion in the telephone accessory ruling in the Caterfone (1968). By 1992, standardization of the VCRs and its potential to "time-shift" had tipped the market balance to their favour and they provided 50 per cent of movie revenue by acting as distributors. However, the standards war between Sony's Beta versus Matsushita's VHS challenged the notion of network effects that initial entrance of a product into

an industry, results in continued product success. The difference was in the manufacturing of its production, and VHS became the industries favourite.

Home Box Office (HBO) a Cable distribution starts in 1972, offering a "pay-cable program service consisting of recent uncut, uninterrupted movies" Litman, (1998) points out that it also helped in generating revenue for second-run films and soon became a dominant and reduced licence price. In April of 1980, ESPN cable network was introduced a "joint venture with four major of the major motion picture distributors (Fox, Universal, Paramount, and Columbia). HBO, for failure to get an assured means of the content source, folded up and vertically integrated to become CBS, continuing the cycle of mergers. An important aspect to note with this change is it provided another financial revenue source for the motion picture industry also the movie industry depended on rentals both domestic and abroad. However, new mediated technologies have reduced the influence of recorders to about 11.8 per cent (Digital Entertainment Group, 2014)

Conclusion: Current State of the Industry

The marketplace for the film has changed dramatically between the 1900's and presently. The new wave of online streamline services poses a formidable challenge for companies who have long dominated the production and distribution sectors of the US entertainment markets. In recent years most of the market gains of the motion picture industry has come from its international market. Notably, there has been no major decline in moviegoers despite the presence of streamline services but in this new technological era, consumers are key drivers, through their network effects impacts, in industries. One question one tends to ask with the

paradigm shift of the motion pictures industry is when is antitrust the right answer and when does forcing an alternate structure in an industry useful for antitrust purposes?

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