Unit 10: H&R Block/TaxACT

CLASS 17 SLIDES
For October 31, 2019

Part 2. Anticompetitive Effects

Merger Antitrust Law

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H&R
BLOCK®

TaxAct®

Typical structure of a formal merger analysis

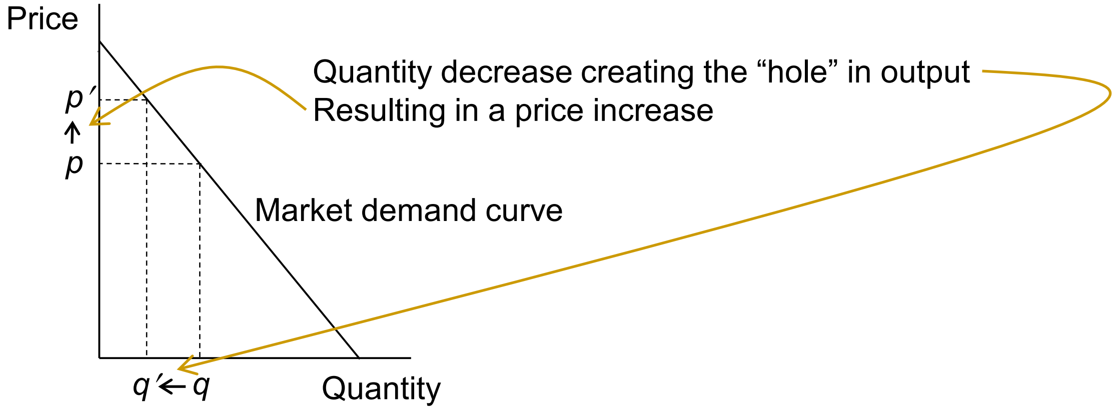
- Step 1: The prima facie case
  - Relevant market
    - Brown Shoe “outer boundaries” and “practical indicia”
    - Merger Guidelines hypothetical monopolist test
  - *PNB* presumption
    - Market participants and market shares
    - Application of the *PNB* presumption
  - Other evidence of anticompetitive effect
    - Unilateral effects
    - Coordinated effects
    - Elimination of a maverick
- Step 2: Defendants’ rebuttal
  - Challenges to prima facie case (no upward pressing pressure)[1]
  - Traditional defenses (offsetting downward pricing pressure)
    - Entry/expansion/repositioning
    - Efficiencies
    - Countervailing buyer power (“power buyers”)
    - Failing company/division
- Step 3: Balancing

[1] Often addressed in Step 1.

Defendants' Rebuttal Arguments
Part 1. Entry/Expansion/Repositioning

Entry/Expansion/Repositioning

- The story
  - General idea
    - Think of a merger's anticompetitive effect being achieved by a reduction in market output



Quantity decrease creating the "hole" in output
Resulting in a price increase

Market demand curve

    - The defense depends on showing that the "hole" in the output will be filled by—
      - New firms entering the market and adding new output
      - Incumbent firms expanding their output over premerger levels, or
      - Incumbent firms extending or repositioning their production in product or geographic space to replace output loses resulting from unilateral effects

Entry/Expansion/Repositioning

- The story
  - Proof of likely actual postmerger entry/expansion/repositioning is not necessary to make out the defense
  - The mere *threat* of entry/expansion/repositioning may be enough to deter incumbent firms from acting less competitively for fear of inducing new competition
  - Illustration
    - Say that there are four firms in the market of equal size (each selling 100 units = 25% shares)
    - Two firms merge: Proforma market share = 50%
    - Combined firm decreases output by 40 units to raise prices (anticompetitive effect)
    - A new firm quickly enters selling 40 units (fills the "hole")
    - Market returns to premerger prices
    - Merged firm post-entry market share = 40%
    - → Merged firm has lost 10% points of share with no gain in price
    - → If the merged firm could anticipate this entry, it would not have reduced output in the first instance

Entry/Expansion/Repositioning

- The Merger Guidelines: The formalities
  - 1982 and 1992: Depended largely on actual entry having a significant impact within two years of the merger
    - This allowed for a short-run anticompetitive effect
  - 2010: Requires entry to "deter or counteract" any anticompetitive effects "so the merger will not substantially harm customers"
    - Does not allow any grace period

Entry/Expansion/Repositioning

- Guidelines requirements—Entry must be:[1]
  - Timely

    > [E]ntry must be rapid enough to make unprofitable overall the actions causing those effects and thus leading to entry, even though those actions would be profitable until entry takes effect.

  - Likely

    > Entry is likely if it would be profitable, accounting for the assets, capabilities, and capital needed and the risks involved, including the need for the entrant to incur costs that would not be recovered if the entrant later exits.

  - Sufficient

    > Entry by a single firm that will replicate at least the scale and strength of one of the merging firms is sufficient. Entry by one or more firms operating at a smaller scale may be sufficient if such firms are not at a significant competitive disadvantage.

- Courts have adopted these requirements

[1] References to entry in this section also include expansion and repositioning.

Entry/Expansion/Repositioning

- Defendants' argument
  - 18 companies offering DDIY products
  - Argued that the two largest— TaxHawk and TaxSlayer—were poised to replicate the scale and strength of TaxACT

Entry/Expansion/Repositioning

- TaxHawk—
  - Had infrastructure to expand by 5-7 times current size
  - BUT had been in business for 10 years and never grew beyond 3.2%
  - Functionally more limited than the Big Three
    - Does not service all federal tax forms
    - Excludes two states' forms in their entirety
    - Does not service major cities with income taxes (e.g., NYC)
  - Co-founder testified that it would take another decade for the TaxHawk to support all forms
    - Reason: "Lifestyle" company—don't like to work too hard
    - Court: Compare with TaxACT—very entrepreneurial and impressive rate of growth
      - Citing to Dunn's testimony
  - Run to "deliver a sufficient income stream to sustain its owners' comfortable lifestyle, without requiring maximal effort on their part."

Entry/Expansion/Repositioning

- TaxSlayer—
  - Established in 2003
  - Family business
  - Relies heavily on sponsorship of sporting events (e.g., the Gator Bowl and NASCAR races)
  - 2.7 market share
  - No meaningful growth in market share (had 2.5 share in 2006)

Entry/Expansion/Repositioning

- DOJ evidence: Significant barriers to entry and expansion
  - Successful entry/expansion beyond a few percentage points of markets share requires a brandname reputation
    - Customers need trust in their tax service provider
    - Costly to build needed reputation
      - HRB testimony: takes millions of dollars and lots of time to develop a brand
      - Big Three (really Big Two) spend over $100 million/year in advertising to build and maintain their brands
      - Dwarf expenditures by smaller companies
    - TaxACT CIM identifies reputation as a barrier to entry
    - TaxHawk and TaxSlayer lack the reputation and the incentive and funds to build one
  - High new customer acquisition costs
    - Market has matured considerably and there is not the “low hanging fruit” of manual customers who are natural customers of DDIY products
    - Instead, TaxHawk or TaxSlayer would have to acquire customers from Intuit or HRB
    - Very high acquisition costs → entrenched market shares → low growth for other firms
  - High switching costs
    - Data cannot be imported across products of different companies
- Court: Defense rejected

Entry/Expansion/Repositioning

- Concluding comments
  - Almost impossible to make out the defense in an agency investigation
    - The agency starts by insisting that the potential entrants be identified by name
    - It then calls them and asks: “Would you enter this market if prices increased by 5% to 10%?”
    - The company almost always answers “no”
      - Can be a kneejerk reaction
      - Can be a “go away staff” reaction
      - Can be an informed “no”
  - Some business realities
    - As a general rule of business behavior, firms do not enter existing markets just for margin
    - They almost always require some nonprice competitive advantage against incumbent firms to cause them to entry
    - The problem is that entry can too easily precipitate a price war and destroy the pre-entry margin that made entry attractive in the first instance

Defendants' Rebuttal Arguments
Part 2A. Coordinated Effects

Introduction

- Definition
  - Coordinated effects (or coordinated interaction) is a theory of anticompetitive harm that depends on the merger making oligopolistic interdependence more effective:

> Merger law "rests upon the theory that, where rivals are few, firms will be able to coordinate their behavior, either by overt collusion or implicit understanding in order to restrict output and achieve profits above competitive levels."[1]

  - Terminology: May use "accommodate" rather than "cooperate"

- What can firms do if the merged firm seeks to increase price?
  1. "Do nothing"—Just continue doing what they were doing
  2. Compete more aggressively/expand production/maybe even lower price to gain market share
  3. "Accommodate" the price increase
     - Need not match it

[1] FTC v. CCC Holdings Inc., 605 F. Supp. 2d 26, 60 (D.D.C. 2009); *accord* United States v. H&R Block, Inc., 833 F. Supp. 2d 36, 77 (D.D.C. 2011).

Merger Guidelines history

- 1982 Guidelines
  - Accepted an unspecified theory of oligopoly as the underpinning of the *PNB* presumption
  - Did not require more for a prima facie case
- 1992 Guidelines
  - *Problem*: There exist highly competitive markets with only a few firms (e.g., Coke and Pepsi)
  - *Solution*: Require proof that the "Stigler conditions" for (tacit) coordination were satisfied in the relevant market: Market conditions must be—
    1. Conducive to firms (tacitly) reaching terms of coordination that are individually profitable to the firms involved
    2. Conducive to firms detecting deviations from the tacit terms of coordination
    3. Conducive to firms punishing deviations from the tacit terms of coordination

Merger Guidelines history

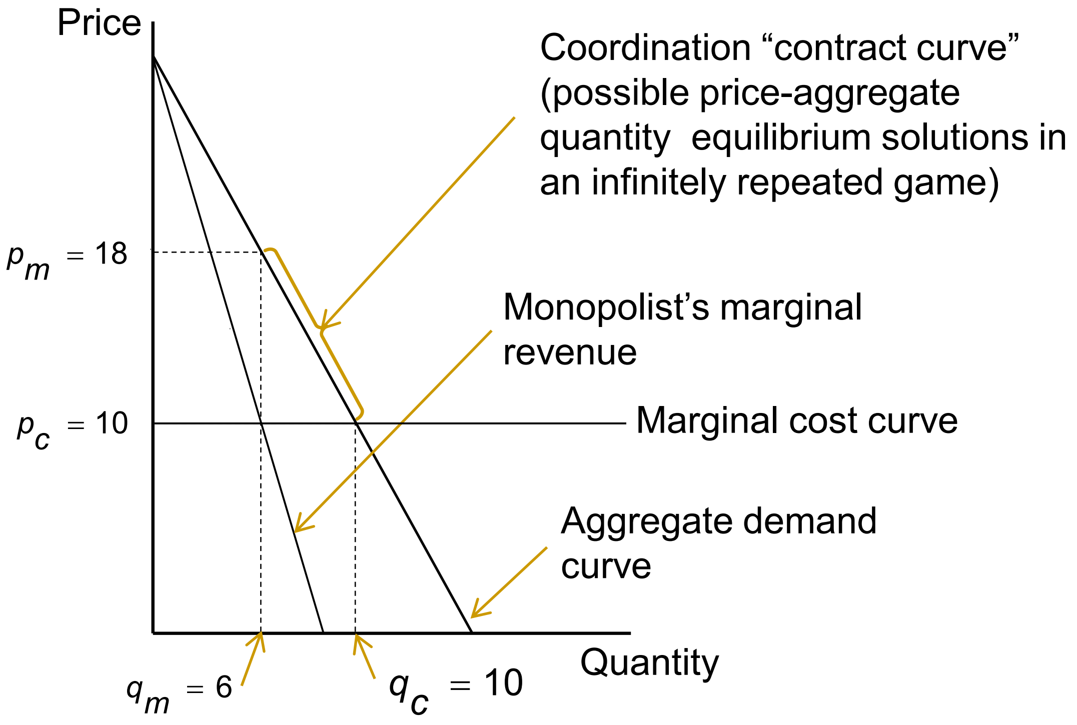
- 2010 Merger Guidelines
  - The “punishment” part of the Stigler conditions was difficult for agencies to explain
    - Courts were looking for some sort of punitive enforcement mechanism
    - But all that is required is the firms return to competition upon the detection of deviations, and so “punish” defectors by eliminating their future gains if other firms in the market continue to cooperate
  - *Solution*: Eliminate the Stigler conditions as a strict requirement, but still consider factors that make oligopolistic coordination more or less likely:
    1. The market must be susceptible to tacit coordination
    2. The merger must increase the probability of effective coordinated interaction/ accommodating conduct among some or all of the firms in the market, thereby facilitating the exercise of market power to the harm of consumers
       - Must find a causal relationship between the merger and the increased probability of coordination

Susceptibility

- Oligopolistic coordination is impeded by three problems:
  1. Selection problem
     - Will the firms be able to “agree’ to the price or other terms on which they will tacitly coordinate?
  2. Incentive compatibility problem
     - Will the (short-run) incentive to pursue a more competitively aggressive strategy, which all profit-maximizing firms have, undermine an any tacit coordination?
  3. External interference problem
     - Apart from the firms in the market, will other entities disrupt any tacit coordination?
       - Firms outside of the market that enter or threaten to enter the market
       - Buyers with the negotiating power to induce defections and disrupt the terms of coordination

Susceptibility: Selection problem

- The idea
  - There are an infinite number of possible price-quantity points on the demand curve on which the firms could tacitly "select" to achieve
  - Ineffectiveness or instability occurs if they cannot coordinate on the same point

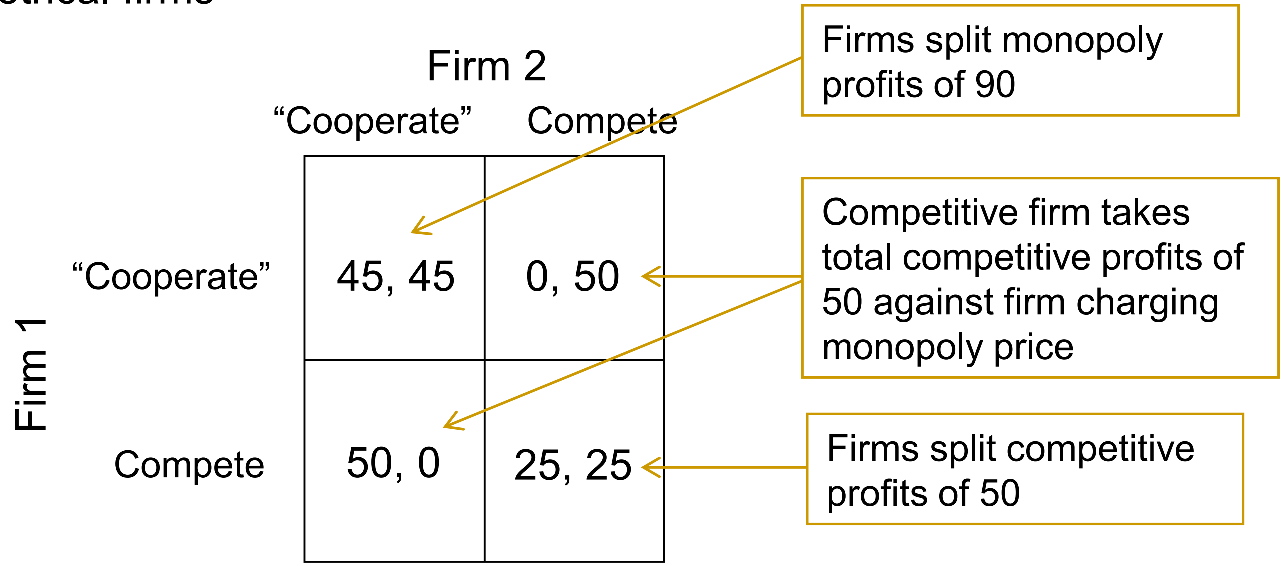

Price
$p_m = 18$
$p_c = 10$
Coordination "contract curve" (possible price-aggregate quantity equilibrium solutions in an infinitely repeated game)
Monopolist's marginal revenue
Marginal cost curve
Aggregate demand curve
Quantity
$q_m = 6$
$q_c = 10$

Susceptibility: Selection problem

- Factors to consider (not exhaustive)
  a. The ability of the firms to signal one another about their individually preferred outcomes
  b. The degree of firm and product heterogeneity
     - Significant heterogeneity may make reaching terms of coordination difficult due to different desired outcomes dictated by the individual conditions of each firm
     - Look for differences in product attributes, location, costs, or vertical integration
  c. Prior actual or attempted collusion or coordination/willingness to coordinate
     - Indicates that firms in the market believe that coordination is possible

Susceptibility: Incentive compatibility problem

- Internal instability
  - Inherent in oligopolistic coordination since each profit-maximizing firm has a incentive to compete more aggressively and steal market share rather than to cooperate
- *Illustration*: Duopoly “prisoner’s dilemma” in single period game
  - Two symmetrical firms



		Firm 2	
		“Cooperate”	Compete
Firm 1	“Cooperate”	45, 45	0, 50
	Compete	50, 0	25, 25

Firms split monopoly profits of 90

Competitive firm takes total competitive profits of 50 against firm charging monopoly price

Firms split competitive profits of 50

Key result: Charging the competitive price is the *dominant strategy* for each firms, regardless of what strategy the other firm chooses. But mutual monopoly strategies earn each firm higher profits.

Susceptibility: Incentive compatibility problem

- Two questions
  a. What is the probability that at least one firm in the market will defect?
  b. For any given firm, what factors influence its individual probability of defection?

Susceptibility: Incentive compatibility problem

a. Probability of at least one defection

- *Key factor*: The number of competitors
  - The more competitors, the more likely one or more firms will defect
- Heuristic illustration
  - Say (quite unrealistically) that the probability of defection is *p* for each firm and independent of what the others do. Then the probability of at least one defection—
    - Increases with *p*
    - Increases with the number of firms *n*
- More generally
  - The probability that at least *m* firms defect increases with—
    - Increases with *p*
    - Increases with the number of firms *n*

Probability of at Least One Defection

Number of firms *n*	Defection probability *p*		
	10.0%	20.0%	30.0%
2	19.0%	36.0%	51.0%
3	27.1%	48.8%	65.7%
4	34.4%	59.0%	76.0%
5	41.0%	67.2%	83.2%
6	46.9%	73.8%	88.2%
7	52.2%	79.0%	91.8%
8	57.0%	83.2%	94.2%
9	61.3%	86.6%	96.0%
10	65.1%	89.3%	97.2%

Susceptibility: Incentive compatibility problem

b. Factors affecting an individual firm’s incentive to defect (not exhaustive)

- The expected rewards of defection
  - The larger the expected reward relative to cooperation, the higher the probability of defection
  - The expected reward is a function of the size of the reward and the probability of obtaining it
- The size of the reward relative to the market (for a given probability of detection)
  - The larger the size of the reward relative to the size of the market, the larger the probability of defection
    - *Example*: As the number of contacts to be let become smaller, the probability of defection increases
    - *Example*: As individual sales become smaller relative to the market, the probability of defection decreases
  - Differences among firms in the market may affect the size of their expected reward
    - *Example*: Firms with large excess capacity can increase their production to service more demand at more competitive (defection) prices
    - *Example*: Firms operating at capacity have no incentive to defect
- The probability of detection (for a given size of reward)
  - The greater the probability of detection, the lower the probability of defection
    - That is, the defecting firm will not be able to make as many sales before other companies respond
  - Factors
    - The availability of key market information necessary to detect defections
    - Volatility of the market/predictability of demand
      - Volatility/unpredictability makes defections harder to detect

Susceptibility: External interference

c. Two three of “external” interference that may undermine coordinated interaction within a relevant market

   1. Producers outside of the market that enter the market
   2. Customers that switch to products outside of the market
   3. Customers with sufficient bargaining power to disrupt coordinated interaction

Merger increases effectiveness

- Rule
  - It is not enough that premerger the market is conducive to coordinated interaction—the merger *must reasonably increase the probability* that the market will be materially *more* conducive to coordinated interaction postmerger
- Implications
  - This means that the merger must materially improve the incentives or ability of a "sufficient group" of firms in the market to—
    - Solve the section problem
    - Solve the incentive incompatibility problem, or
    - Resist external interference
  - A "sufficient group" of firms means a subset of firms that, if coordinating, would create, enhance or facilitate the exercise of market power in the relevant market
    - The set of all firms in the market is a sufficient group (by the hypothetical monopolist test)
    - But a smaller subset may also be sufficient depending on the characteristics of the market
      - Think about a market that can be modeled as a "dominant firm" with a competitive fringe
      - But where the "dominant firm" is the tacitly coordinating sufficient group
    - Recognizes the potential for coordinated effects even if all firms in the market are not tacitly coordinating

Merger increases effectiveness

- Some factors to consider when thinking about merger effectiveness
  - ❑ Mitigating the selection problem
    - + The merger reduces firm or product heterogeneity in the market and better aligns the incentives of the various firms tacitly to achieve coordinated interaction
  - ❑ Mitigating the incentive incompatibility problem
    - + The merger reduces the number of independent competitors in a way that materially reduces the probability of defection, thereby increasing the probability of effective coordination
      - ❑ The magnitude of the HHI delta may be probative of significance here
    - – The merger results in significant efficiencies in the combined firm that increase the rewards of defection, thereby decreasing the probability of effective coordination
    - – The merger results in vertical integration that could improve the merged firm's ability to cheat without detection, thereby increasing the probability of defection
  - ❑ Mitigating the external interference problem
    - + The merger eliminates a likely potential entrant, thereby increasing the probability of effective coordination
    - + The merger increases the barriers to entry/expansion/repositioning

Key:
+ The merger increases the probability of effective coordinated interaction postmerger
– The merger decreases the probability of effective coordinated interaction postmerger

Coordinated effects in *H&R Block*

- Coordinated effects in H&R Block
  - Court:

    > Since the government has established its prima facie case, the burden is on the defendants to produce evidence of “structural market barriers to collusion” specific to this industry that would defeat the “ordinary presumption of collusion” that attaches to a merger in a highly concentrated market.[1]

    - This is consistent with a strict reading of *Baker Hughes*
    - BUT almost all modern courts in their opinions treat coordinated effects as part of the discussion of the plaintiffs’ prima facie case

[1] United States v. H & R Block, Inc., 833 F. Supp. 2d 36, 77 (D.D.C. 2011) (quoting FTC v. H.J. Heinz Co., 246 F.3d 708, 725 (D.C. Cir. 2001)).

Coordinated effects in *H&R Block*

- Merging parties' arguments
  - Intuit has no incentive to compete any less vigorously post-merger
  - In particular, Intuit has no incentive to reduce competitiveness of free product, since it is a principal driver of new customers
  - Therefore, HRB must compete vigorously postmerger or else lose customers to Intuit

Coordinated effects in *H&R Block*

- Evidence: Susceptibility
  1. Historical coordination
     - After TaxACT introduced its free offering, Intuit proposed that firms lobby the IRS to impose limits on their free offerings (HRB and others joined, but not TaxACT)
     - *Court*: "Highly persuasive historical act of cooperation"
     - *WDC*: Shows that evidence does not have to be of historical illegal coordination
  2. Other factors
     - Market is transparent (consumer offerings; available on Internet)
     - Can see price as well as attributes
     - Product differentiation not that relevant
     - Companies can observe and coordinate on attributes of "free" products
     - Transactions are small, numerous, and spread among a mass of consumers
     - Consumers have low bargaining power
     - Barriers to switching due to "stickiness" of DDIY products (learning curve)

Coordinated effects in *H&R Block*

- Evidence: Effect of merger
  1. Intuit engaged in “war games” designed to anticipate and defuse new competitive threats that might emerge from HRB postmerger
  2. BUT Intuit’s documents also indicated that it anticipated that the combined firm would likely “pull some of its punches” if Intuit is willing to go along and not compete aggressively against it
     - Anticipates that combined firm will “not escalate fee war”
     - NB: This could have been just a random observation by an Intuit employee and not Intuit’s considered strategy
  3. AND past cooperation as to lobbying the IRS for eligibility restrictions for free tax products probative of postmerger merger cooperation to further restriction eligibility
  4. AND merger would result in the elimination of a “particularly aggressive competitor” in a highly concentrated market

Coordinated effects in *H&R Block*

- Court
  - Acknowledges that Intuit and merged company will have strong incentives to compete for customers
  - BUT coordination does not have to be on all dimensions of competition
    - One aspect is enough (here, lower the quality of “free” products, causing marginal customers to switch to paid software → making them worse off)
    - Here, DOJ alleges “coordination would likely take the form of mutual recognition that neither firm has an interest in an overall “race to free” in which high-quality tax preparation software is provided for free or very low prices.” (p. 77)
    - That is, not eliminate free products (useful as marketing devices)
    - Rather, reduce their quality in order to drive more customers into paid products
  - Conclusion:
    - Defendants failed to rebut presumption that anticompetitive coordinated effects would result from the merger
    - To the contrary, the preponderance of the evidence indicates that coordinated effects likely would result

Coordinated effects

- Concluding comments
  - Coordinated effects is a more difficult story to tell than unilateral effects
    - Some of the precedent following the 1992 Guidelines is not helpful
  - Given the narrow market definitions usually found under the hypothetical monopolist test:
    - In problematic mergers, the merging firms tend to have high market shares and be close competitors with one another
    - Typically yields an easily understood unilateral effects theory
  - Result: Coordinated effects is rarely used in investigations or litigations as the primary theory of anticompetitive harm
    - Usually more of an add-on
    - Or when the agency is forced into it (*CCC/Mitchell*)

Anticompetitive Effects
Part 2B. Mavericks

Mavericks

- Plaintiff’s argument:
  - TaxACT is a “maverick” that has disruption tacit coordination that otherwise would have occurred in the DDIY market
    - Freemium business model
    - Bucked prevailing pricing norms by introducing free-for-all offer, which others matched
    - Remains the only competitor with significant market share that relies on free and low-cost high-quality products
    - TaxACT CEO appears dedicated to freemium strategy
      - NB: Note role of idiosyncratic management preferences
    - Had the effect in pushing industry toward lower pricing, even when the two major players were not anxious to follow
  - The merger will eliminate TaxACT as a disruptive force, which high result in a higher level of coordinated interaction in the relevant market postmerger

Mavericks

- General idea
  - A “maverick” is a competitor that disrupts coordinated interaction among the other, more accommodating competitors that would occur in the absence of the maverick
  - When an accommodating competitor acquires a maverick, the maverick’s disruptive conduct is suppressed and the market performs less competitively to the harm of consumers
  - As a result, the acquisition of a maverick by an accommodating competitor is a special case of coordination interaction
    - Typically used to challenge deals where the target has a sufficiently small market share that the transaction would not otherwise raise major concerns

Mavericks

- Why are “mavericks” mavericks, and should it matter in antitrust law?
  1. The most likely reason is idiosyncratic: The particular management of the firm simply believes in being disruptive
     - This may be the case when the management—
       - Refuses to pursue a more industry price-accommodating strategy[1]
       - Pursues a long-run strategy of disruptive new product development or new marketing innovations[2]
     - *Query*: Should a merger be prohibited simply because the current management—perhaps even just the current CEO—believes in being disruptive?

[1] *See, e.g.*, Complaint, United States v. Anheuser-Busch InBev SA/NV, No. 1:13-cv-00127 (D.D.C. filed Jan. 31, 2013) (settled by consent decree).

[2] *See, e.g.*, Complaint, United States v. AT&T Inc., No. 1:11-cv-1560 (D.D.C. filed Aug. 31, 2011) (challenging AT&T’s pending acquisition of T-Mobile; complaint voluntarily dismissed when transaction was terminated).

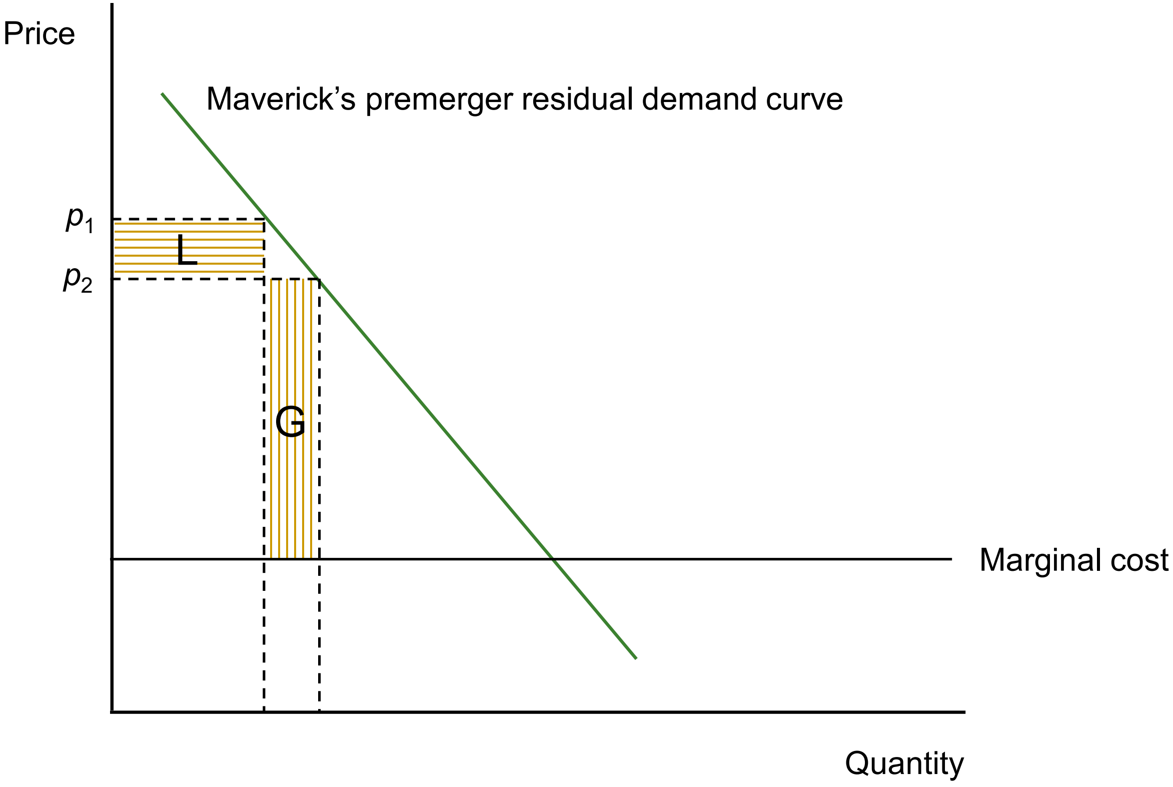
Mavericks

- Why are “mavericks” mavericks, and should it matter in antitrust law? (con’t)
  2. Another possible reason is that something inherent in the firm’s structure that makes it in the profit-maximizing interest of the firm to be disruptive regardless of the predilections of its management
     - This may be the case if the firm is a small but materially lower-cost producer than the larger, more established firms. In this case, the firm may wish to take advantage of its lower-cost structure to discount prices and gain market share.[1]
     - More generally, smaller firms may have more of an incentive to be a maverick than larger firms, since they have—
       - proportionally less incumbent business at stake in the event that a maverick strategy does not work, and
       - proportionally more to gain in market share in the event that the strategy works

[1] *See, e.g.*, United States v. H&R Block, Inc., 833 F. Supp. 2d 36 (D.D.C. 2011) (noting government argument that TaxACT was a “maverick” because, among other things, it was a low-cost competitor that pursued an aggressive pricing policy).

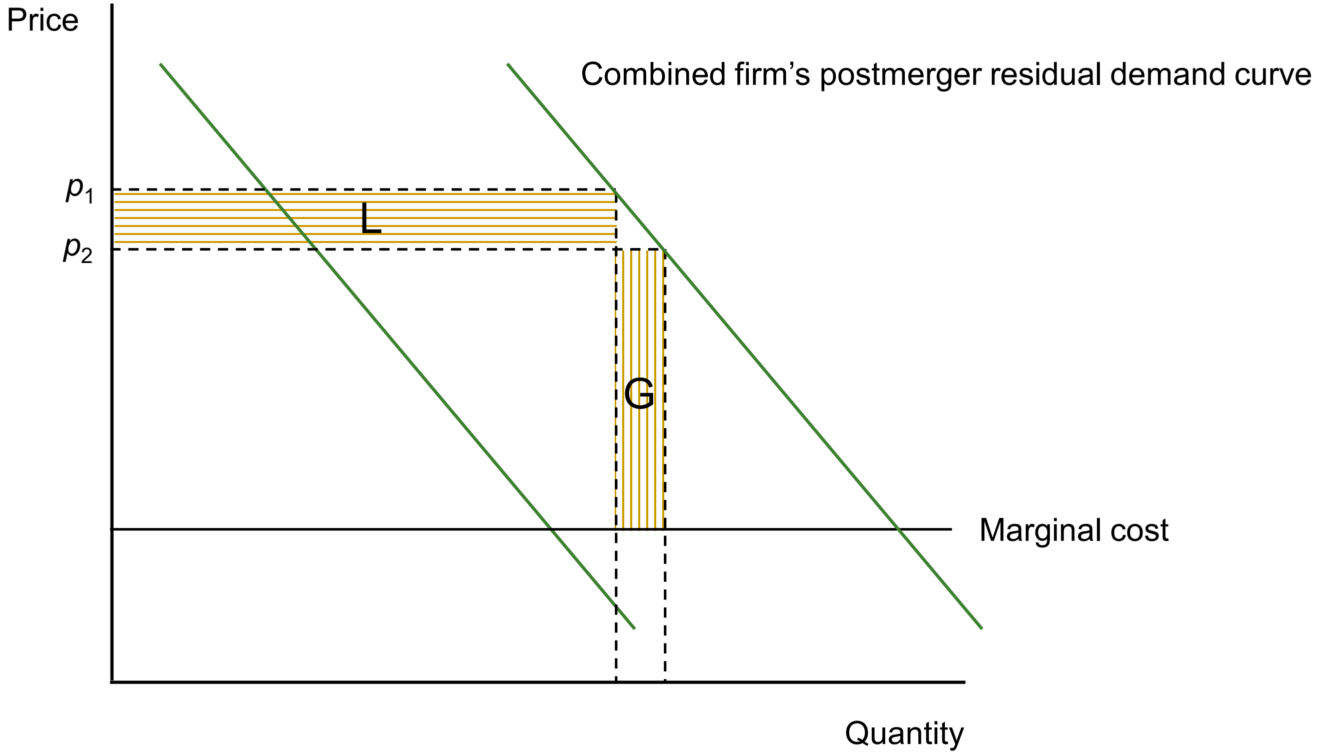
Mavericks

- Premerger incentives to act aggressively
  - As illustrated in the diagram below, the "maverick" standing alone has an increase to lower price because the profit gains outweigh the losses



Mavericks

- Postmerger disincentives to act aggressively
  - Postmerger, the combined firm has a greater sales volume and hence incurs greater losses than the maverick for a price decrease
  - As illustrated in the diagram below, the combined firm does not have an incentive to lower price


Price
Combined firm's postmerger residual demand curve
p_1
L
p_2
G
Marginal cost
Quantity

Mavericks

- Why are “mavericks” mavericks, and should it matter in antitrust law? (con’t)

  3. *Query*: While it makes sense to pay special attention to the acquisition of a “structural” maverick—that is, a firm that has been and is likely to continue to be disruptive of coordinated interaction in the absent of the acquisition—does it also make sense to give the same attention to an “idiosyncratic” maverick, whose behavior is likely to change with a change in management?

Mavericks

- Policy question
  - Mavericks have that Potter Stewart “I know it when I see it” quality[1]
  - In *H&R Block/TaxACT*, the district court observed:

> The government has not set out a clear standard, based on functional or economic considerations, to distinguish a maverick from any other aggressive competitor [2]

  - But maybe that is the point:
    - Perhaps a maverick is best defined as a firm that aggressive pursues a competitive strategy rather than an accommodating one and thereby disrupts coordination
    - Under this definition, the plaintiffs would have to show that—whatever the source of its maverickness—the firm would remain a maverick for some material period of time if the merger did not occur

[1] *See* Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (describe his threshold test for obscenity).
[2] United States v. H & R Block, Inc., 833 F. Supp. 2d 36, 79-80 (D.D.C. 2011).

Mavericks

- In any event—
  - As *H&R Block/TaxACT* suggests, the following requirements should be imposed on a theory of anticompetitive harm based on eliminating a maverick:
    1. The market is conducive to a materially higher degree of coordinated interaction than it exhibits premerger;
    2. The disruptive conduct of the merger target is a material contributor to the inability of the market to achieve this higher degree of coordinated interaction;
    3. The acquisition of the merger target is likely to result in the discontinuance of the disruptive conduct; and

       NB: Sometimes the target management will become the management of the combined company, which raises the question of whether the disruptive activity will be discontinued.
    4. The discontinuance of the merger target's disruptive activity is likely to result in a materially higher degree of coordinated interaction in the market to the harm of consumers
       - This requires that the target be unique or especially effective in its disruptive conduct

Mavericks in *H&R Block*

- Finds conditions satisfied here:

> The Court finds that TaxACT's competition does play a special role in this market that constrains prices. Not only did TaxACT buck prevailing pricing norms by introducing the free-for-all offer, which others later matched, it has remained the only competitor with significant market share to embrace a business strategy that relies primarily on offering high-quality, full-featured products for free with associated products at low prices.[1]

- Moreover, combined firm will have less to gain and more to lose from an aggressive, disruptive strategy:

> Moreover, as the plaintiff's expert, Dr. Warren-Boulton, explained, the pricing incentives of the merged firm will differ from those of TaxACT pre-merger because the merged firm's opportunity cost for offering free or very low-priced products will increase as compared to TaxACT now. In other words, the merged firm will have a greater incentive to migrate customers into its higher-priced offerings – for example, by limiting the breadth of features available in the free or low-priced offerings or only offering innovative new features in the higher-priced products.[2]

[1] United States v. H & R Block, Inc., 833 F. Supp. 2d 36, 80 (D.D.C. 2011).
[2] *Id*. (record citations omitted).

Anticompetitive Effects
Part 3. Unilateral Effects

Unilateral effects

- Definition
  - Unilateral effects is a theory of anticompetitive harm that goes to the elimination of significant "local" competition between the merging firms, so that the merged firm can raise prices independently of how other incumbent firms react

> A merger is likely to have unilateral anticompetitive effect if the acquiring firm will have the incentive to raise prices or reduce quality after the acquisition, independent of competitive responses from other firms.[1]

  - The idea is that can increase prices to an identifiable subset of customers in the market even *without* any accommodating conduct from the nonmerging firms in the market, and that this price increase is a cognizable anticompetitive effect under Section 7
    - The concept of unilateral effects as a theory of merger anticompetitive harm was introduced in the 1992 DOJ/FTC Horizontal Merger Guidelines
    - The theory has been accepted as valid under Section 7 by the courts

[1] United States v. H&R Block, Inc., 833 F. Supp. 2d 36, 81 (D.D.C. 2011).

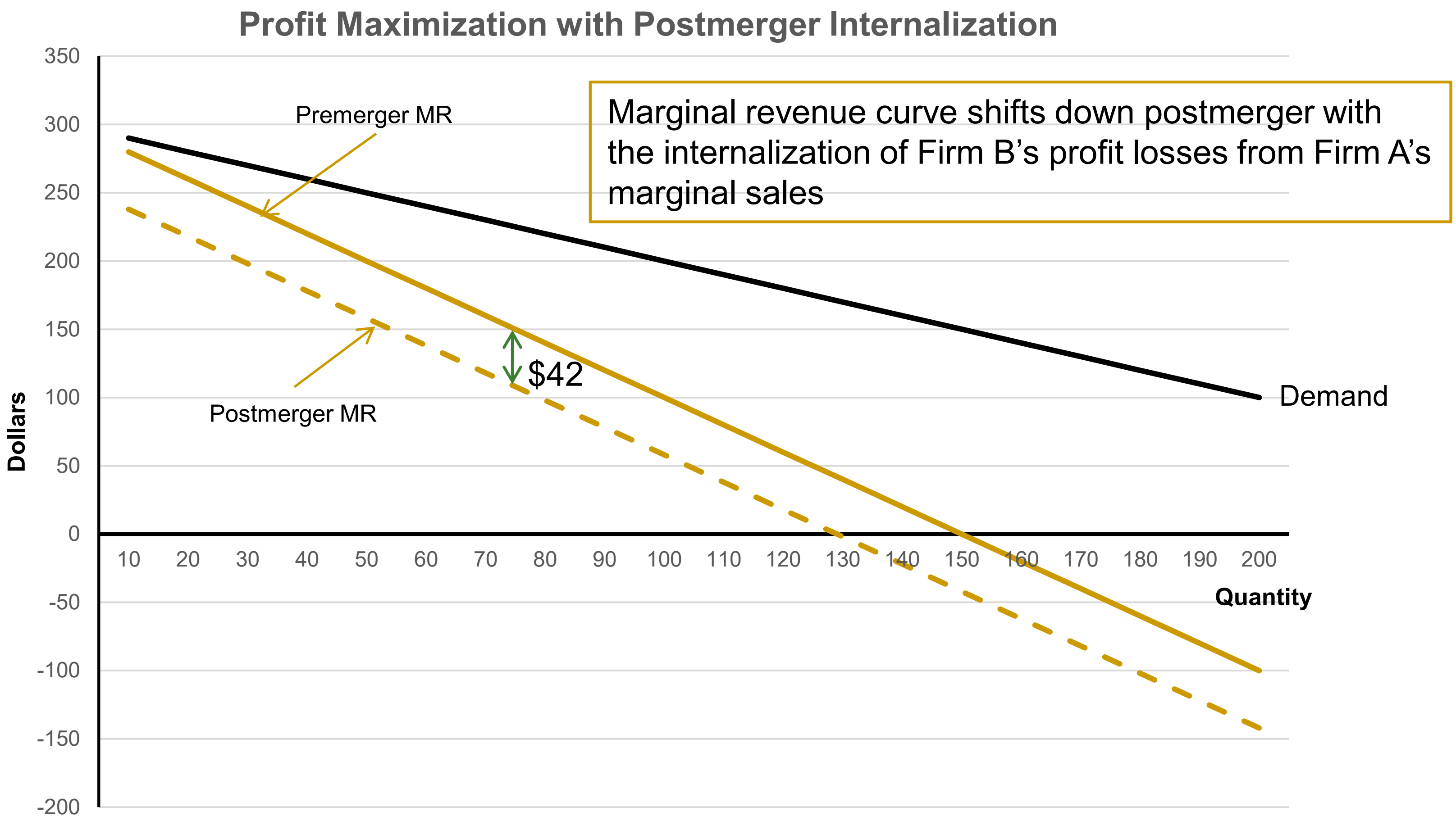
Unilateral effects

- A simple example
  - Say for Firm A:
    - Inverse demand: $p = 300 – q$
    - Fixed costs: $F = 0$
    - Marginal costs: $mc = 20$
    - Marginal revenue: $mr = 300 – 2q$
    - Setting $mr = mc$ and solving: $q^* = 140$
$p^* = 160$
  - Say when Firm A increases its production by 1 unit (and lowers its price by $1), 0.3 units that Firm B would have sold now divert to Firm A.
  - If Firm B's margin is also 140 at the initial price level, then Firm A's change in production causes Firm B to lose $42 (= (0.3)(140)).
    - That is, Firm A's conduct creates a *negative externality* for Firm B
  - When A and B are independent firms, Firm A does not care about Firm B's loss
  - But say Firm A acquires Firm B. Now Firm A must take into account Firm B's losses in Firm A's marginal revenue:

$$mr_{postmerger} = 300 – 2q - 42$$

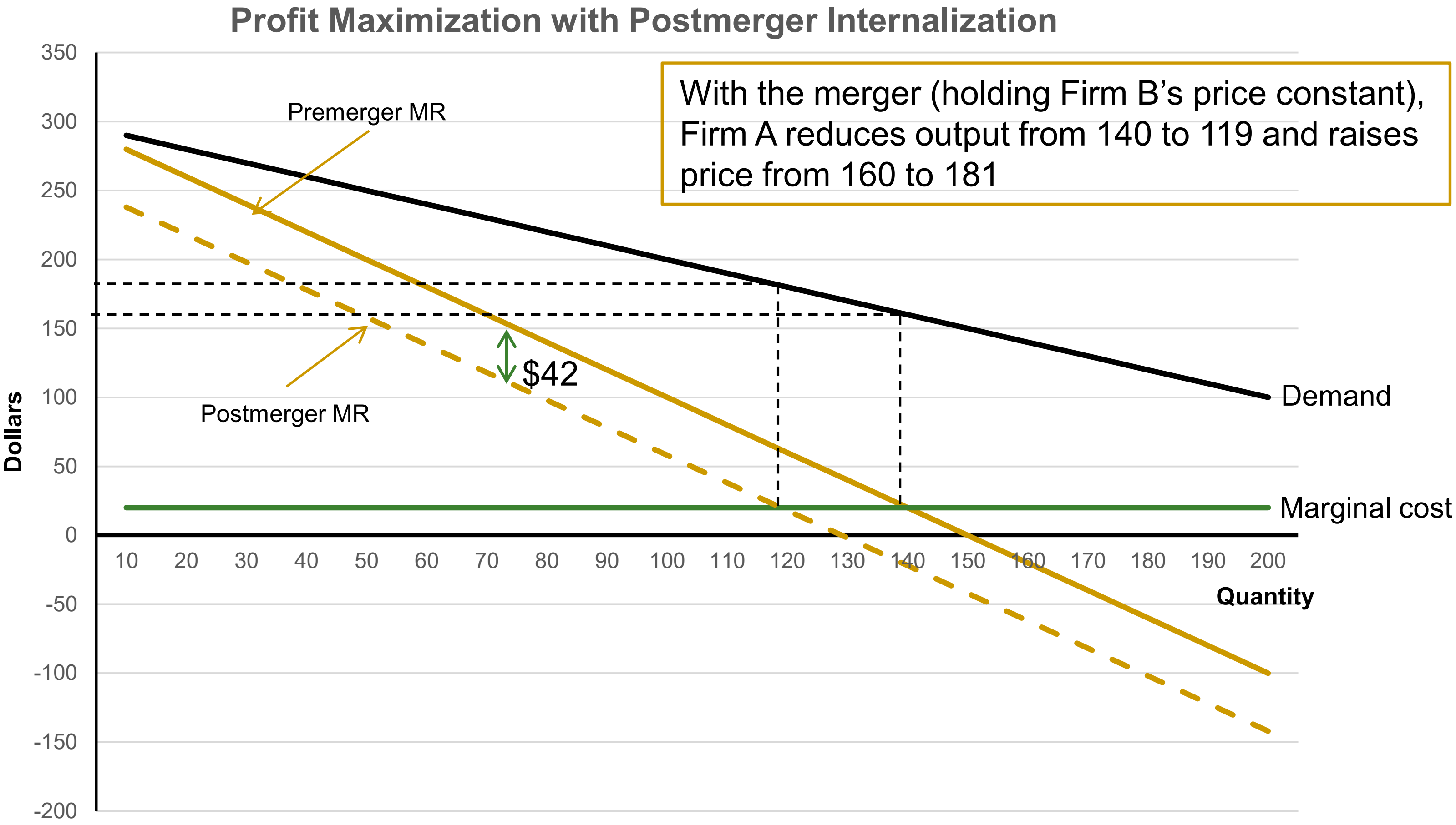
    - This shifts Firm A's marginal revenue curve down and makes Firm A's marginal revenue les than its marginal cost at premerger prices. *Firm A must decrease output and increase price to reequilibrate marginal revenue and marginal cost:* $q_{post} = 119$; $p_{post} = 181$

Unilateral effects



Marginal revenue curve shifts down postmerger with the internalization of Firm B's profit losses from Firm A's marginal sales

Unilateral effects



Profit Maximization with Postmerger Internalization

With the merger (holding Firm B's price constant), Firm A reduces output from 140 to 119 and raises price from 160 to 181