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The 2010 DOJ and FTC Horizontal Merger Guidelines: Increasing Realism While Reducing Predictability

On August 19, 2010, the DOJ and FTC released a comprehensive revision of the horizontal merger guidelines that had been issued almost two decades ago.[1] An overhaul was in order, since the agencies have not followed the prior guidelines for years. The revised Guidelines better reflect current agency thinking, including a greater range of potentially actionable transactions and greater roles for analytical flexibility and agency judgment in assessing transactions. The more aggressive and flexible tone of the revised Guidelines is likely intended to help the agencies in litigation, where some courts have criticized the agencies for departing from the more structured approach of the prior guidelines. However, since the agencies have been operating internally under the new models for some time, we expect no major change going forward in merger enforcement decision making.

The context

In principle, merger guidelines describe the approach the agencies use in analyzing mergers and acquisitions for the benefit of the agency staff, who must make enforcement recommendations to senior management, as well as the business community and the bar, who must consider how the antitrust agencies are likely to react to potential transactions. Guidelines also serve to educate the courts about the analytics the agencies use in evaluating transactions, presumably with the hope that the courts will defer to the agencies' expertise and gravitate to the same approach.

Beginning in the 1960s and continuing today, courts have held that a horizontal merger is presumptively unlawful if the transaction produces a combined firm with an "undue" market share in a sufficiently concentrated market. But the early standards for defining markets—which determine both market shares and market concentration—were nebulous at best. Without a meaningful standard, courts tended to defer to the government agencies, resulting in Justice Potter Stewart's famous observation "that the sole consistency that I can find [in antitrust merger litigation] is that the government always wins."

In 1982, the DOJ issued merger guidelines that, among other things, rejected limiting market concentration as the objective of merger antitrust law in favor of preventing mergers that create or facilitate the exercise of market power to the harm of

[1] The revised guidelines may be found at http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf.

consumers. Using this consumer welfare standard, the 1982 Guidelines provided a rigorous analytical approach to defining relevant antitrust markets and raised the thresholds of market share and concentration necessary to invoke a presumption of likely anticompetitive effect. The 1982 Guidelines, which many mark as a milestone of modern antitrust law, were intentionally rigid and formulaic, precisely because they were designed to eliminate fuzziness and unpredictability in merger antitrust analysis. The 1982 Guidelines also focused almost exclusively on the price effects of transactions, because the economic theory of price effects was reasonably well-developed and accepted, while the theory on nonprice effects—product quality, product choice, and innovation—was far behind in development, acceptance, and predictive value.

The 1992 DOJ/FTC revisions, which introduced the theories of "coordinated interaction" and "unilateral effects" and required that the anticompetitive mechanism of a putatively unlawful transaction strictly fit into one of these theories, retained the basic design, price focus, and programmatic approach of the 1982 Guidelines. Horizontal merger analysis was to follow a strict sequence: market definition, calculation of market shares and market concentration, application of the thresholds of presumptive illegality, fitting of the facts into one of the two theories of anticompetitive harm, and consideration of entry and efficiencies defenses.

The impetus for change

Two developments motivated the 2010 revisions. First, the agencies came to believe that the Guidelines were too inflexible in their approach and if strictly followed would allow some anticompetitive mergers to avoid challenge. Over time, the agencies internally adopted new approaches to merger analysis to the point where many elements of the 1992 Merger Guidelines—including market definition—were largely irrelevant to prosecutorial decision-making.

Second, despite some initial reluctance, courts increasingly accepted the Guidelines approach, especially as to market definition. But some courts rejected agency challenges when they concluded that the agency had departed from the Guidelines, either because the agencies failed to prove an element required by the Guidelines or because the court applied the Guidelines algorithms—especially on market definition—to the facts to reach different conclusions than the agencies.

The changes

The 2010 revisions are designed to conform the Guidelines to the actual practices of the agencies and, although not explicitly acknowledged by the agencies, to provide the agencies with more flexibility in challenging transactions in court without the prospect that the Guidelines will be cited or otherwise used against them. To this end, the 2010 revisions make four major thematic changes and a number of other less significant modifications.

New, flexible approach to analyzing competitive effect

Although the revised Guidelines continue to view the purpose of antitrust merger enforcement as preventing the creation, enhancement, or entrenchment of market power to the harm of consumers, they stress that the agencies need not and do not approach merger analysis in the linear fashion prescribed by the guidelines for the last 28 years. Rather, in addressing the central question of whether consumers will be harmed, the revised Guidelines—consistent with current practice over the last several years—hold that the agencies may use whatever tools and approaches the agencies thinks are appropriate. In other words, the agencies, "guided by their extensive experience," may employ any reliable means of analyzing the competitive effect of a transaction on customers.

The revised Guidelines are explicit that they only illustrate and not exhaust the range of tools and approaches the agencies may use in analyzing a transaction. And even for the approaches they illustrate, they are mostly qualitative rather than quantitative in their explication. For example, the 2010 Guidelines have eliminated several quantitative thresholds that were designed to prevent aggressive enforcement applications, notably the two-year period for evaluating ease of entry and the requirement in an unilateral effects challenge that the merging firms have a combined market share of at least 35 percent. Moreover, while the revised Guidelines offer a large number of helpful illustrative examples, the examples tend to be factually specific and the guidelines give little or no guidance of how much the facts can change before the conclusions also change.

The upshot is that the 2010 Guidelines will be less useful in predicting agency enforcement behavior. A literal reading of the 2010 Guidelines will yield far more actionable transactions than we believe the agencies will choose to challenge. We believe that this is an intentional feature of the revised Guidelines, designed to permit the agencies to exercise more judgment in evaluating the potential competitive effects of a merger without the risk that a party or a court will cite the Guidelines against them when they do bring a challenge. However, because the agencies have already been applying for some time the approaches described in the revisions, experienced practitioners should be able to predict agency decision-making in particular transactions reasonably well.

New emphasis on nonprice dimensions of anticompetitive harm

With a more flexible approach to analyzing anticompetitive effect, the revised Guidelines also place much greater emphasis on harm to customers arising from reduced product quality, reduced product variety, reduced service, or diminished innovation. This is a substantial change to the prior guidelines, which made only a passing reference to nonprice anticompetitive effects.

There is little experience, and almost no jurisprudence, on the relationship between mergers and these nonprice variables, although the agencies have obtained consent decrees, almost all in the pharmaceutical sector, on the basis that the merger will reduce incentives to continue with existing product development efforts. If the agencies elect to challenge mergers based on their predicted nonprice effects, they will be operating in largely uncharted waters. The existing economic theory and legal precedent on the relationship between mergers and nonprice welfare effects remains mostly ad hoc and sensitive to the assumptions of the model. In this context, reduced product variety could be especially problematic for the parties, since in many mergers the combined firm will seek to reduce costs by consolidating two differentiated premerger product offerings into a single postmerger offering.

Our view, however, is that the agencies will not aggressively pursue transactions solely on the basis of nonprice effects. Rather, they are likely to devote attention to potential welfare-reducing nonprice effects in cases that are otherwise actionable because of their price effects. However, when the direct evidence of a consumer welfare-reducing nonprice effect is sufficiently strong, we expect the agencies to challenge the transaction even in the absence of adverse price effect.

Deemphasis of market definition in favor of more direct evidence of competitive effect

For almost 50 years, courts consistently have used market definition, and the resulting market shares and market concentration in the defined market, as the sole means to assess the legality of horizontal transactions under the antitrust laws. Under this approach, horizontal combinations are unlawful when they create a firm with an “undue” market share in a sufficiently concentrated market.

Until now, the DOJ and FTC have accepted this approach and with rare exception tried their merger cases in the courts accordingly. In both their judicial challenges and their merger guidelines, the agencies focused on creating an algorithm to make market definition analytically sound and to specify market share and market concentration thresholds that were more consistent with the economic theory of the day.

The 2010 Guidelines move in a decidedly different direction. The revised Guidelines relegate market definition to just one of a number of tools the agencies may use in assessing competitive effect. In place of market definition, the revised Guidelines place much greater emphasis on more direct evidence of competitive effects. This direct evidence approach, which the agencies have used internally for several years, is consistent with many rule of reason cases under Section 1 of the Sherman Act. To date, however, the agencies have not pressed this approach on the courts, and given the language of the Clayton Act and the multiple Supreme Court precedents that expressly require the courts to locate the threatened anticompetitive effect in a "line of commerce" (product market) and a "section of the country" (geographic market), it is questionable whether the courts will be receptive to the direct evidence approach contained in the Guidelines in the absence of a traditional analysis of market definition, market shares and market concentration.

According to the revised Guidelines, direct evidence of anticompetitive effect may include, among other things, (1) documents or testimony from the merging parties indicating an intention to raise prices or otherwise harm consumers through means enabled by the merger; (2) the financial terms of the transaction, especially when they suggest that the combined firm will have to raise prices or otherwise act anticompetitively to make the transaction profitable to the buyer's owners; (3) information from customers about the extent to which they could protect themselves from an anticompetitive price increase or other harm by the merged firm; (4) "natural experiments" resulting from the historical impact of mergers, entry, expansion, or exit in same or a similar marketplace; (5) indications of substantial head-to-head competition that would be eliminated with the merger; and (6) indications of disruptive or "maverick" conduct of a merging party, which is likely to be eliminated by the merger.

For consummated transactions, the agencies will give "substantial weight" to any actual consumer harm attributable to the transaction. Indeed, the 2010 Guidelines suggest that, in a proper case, nothing more than a price increase may be necessary to support an agency decision to challenge the transaction. By contrast, consistent with the case law, the agency may give only limited weight to the absence of an actual anticompetitive effect in a consummated transaction, especially if there is reason to believe that the combined firm was moderating its conduct in light of the prospect of a postmerger review.

The revised Guidelines recognize that market shares and market concentration also can provide important, although not essential, evidence. When this evidence is used, markets must be defined using the traditional "hypothetical monopolist" test first introduced in the 1982 Guidelines to identify relevant markets in which market power can be exercised. But unlike the prior guidelines, which were designed to arrive at a unique market definition, the 2010 Guidelines appear to recognize essentially any market definition where a hypothetical monopolist could exercise market power. This approach could lead to multiple market definitions existing simultaneously, significantly increasing the agencies' flexibility to define markets and hence bring challenges.

The 2010 Guidelines also increase the market share and market concentration thresholds that trigger a presumption that a transaction may be anticompetitive.[2] We do not consider this change to be of much practical significance. It has been commonly accepted for many years that the thresholds in the prior guidelines were much too low compared to the agencies' actual enforcement decisions. Our view is that the 2010 thresholds will prove to continue to be too low and the agencies will rarely challenge transactions unless they are significantly above the new thresholds, at least in cases that depend on the standard presumption and not direct evidence of anticompetitive effect. Nonetheless, by continuing to set the thresholds at a relatively low level, the agencies will be able to argue in court that most challenged transactions far exceed their guidelines as well as reserve the ability to challenge lower concentration combinations without the Guidelines being cited against them.

[2] The Guidelines' thresholds are measured in terms of the postmerger Herfindahl-Hirschman Index (HHI), which is the sum of the squares of the market shares for all of the firms in the relevant market. Under the 2010 Guidelines, mergers that result in an unconcentrated market (HHI less than 1500, which would result from a market containing a little more than six equivalently-sized firms) or mergers that produce a change in the HHI of less than 100 are regarded as unlikely to have adverse competitive effects and ordinarily will require no further analysis. Mergers in moderately concentrated markets (HHI between 1500 and 2500, or between four and six equivalently-sized firms) that produce a change in the HHI of over 100 potentially raise significant competitive concerns. Mergers in highly concentrated markets (HHI over 2500) that produce a change in the HHI of between 100 and 200 potentially raise significant competitive concerns, while those that produce a change in the HHI of over 200 are presumed to be anticompetitive.

Increased emphasis on unilateral effects and on targeted customers

Merger antitrust law has historically been grounded in oligopoly theory, which holds combinations of significant competitors in concentrated markets are anticompetitive because they increase the prospect of collusion across the market. The 1992 Guidelines termed this theory "coordinated interaction" and distinguished it from "unilateral effects," which depends only on the elimination of significant competition between the merging firms and not on any marketwide coordination. Significantly, under the unilateral effects theory, a transaction can eliminate substantial premerger competition between the merging parties and result in an actionable competitive threat even in an unconcentrated market.

Unilateral effects theory quickly became the dominant method employed by the agencies for evaluating horizontal mergers, since it was relatively easy to apply in practice—especially as the agencies gravitated away from the quantitative requirements contained in the prior guidelines and hence did not require the agencies to define markets—and adverse unilateral effects were almost always present in every actionable coordinated effects case anyway. But for the most part the agencies did not seriously press a pure unilateral effects theory on the courts in what might appear otherwise to be relatively unconcentrated markets. Rather, the agencies attempted to define relevant markets narrowly around the products of the merging firms, so that the market shares and market concentration would be sufficiently high to trigger the standard judicial presumption of anticompetitiveness.

Not surprisingly, some courts rejected the prosecuting agency's narrow market definitions as artificial, finding the markets were much broader and concluding that competition in these broader markets was sufficient to ensure that the markets remained competitive postmerger. Other courts rejected the application of the theory of unilateral effects to the facts, finding that the agency had not satisfied some of the requirements in the existing Guidelines.

The 2010 Guidelines seek to elevate the theory of unilateral effects to a level at least on par with coordinated interaction and to make the application of the theory more robust. The reduced role of market definition is a major element in this effort. The 2010 Guidelines also eliminate certain requirements of the prior guidelines—specifically that the merged firm have a combined 35 percent share in the relevant market and that the products of the merging parties be each other's next best substitutes for a large fraction of customers—in order to give the theory more flexibility and reach in application.

The 2010 Guidelines also state that competition between the merging firms may exist for only certain customers and not be marketwide. In many situations, the nature of the product or service being offered will not permit arbitrage or resale in a secondary market, so that different groups of customers may be treated differently. In the extreme, as may occur when sales are individually negotiated, each customer may be treated differently and constitute its own group. The 2010 Guidelines hold that the unilateral effects theory can reach a transaction even if the threatened anticompetitive effect extends to only a targeted group of customers and not to customers in the market as a whole.

While the new qualitative nature of the theory, especially the broadened scope permitted by customer targeting, will give the agencies more flexibility and call for the exercise of more agency judgment, the agencies have been applying this approach for some time. Although a strict reading of the 2010 Guidelines is likely to substantially overpredict enforcement challenges, experienced practitioners should be able to assess with reasonable accuracy when the agencies will actually employ the theory to challenge a transaction in the future.

Raising the bar on entry and repositioning defenses

The case law recognizes several defenses to a presumption of anticompetitive effect in a properly defined market. One of the most important is entry. The idea is that when entry is easy, even if a merger creates a firm with a large combined share in a highly concentrated market, entry will ensure that the market continues to function competitively postmerger.

The agencies, and the prior merger guidelines, always have been demanding in the evidence required to make a valid entry defense. The 2010 Guidelines increase the demands on the parties: while the prior guidelines permitted entry to be evaluated over a period of two years, the revised Guidelines adopt the more ambiguous but presumably more restrictive requirement that entry be “rapid enough” to ensure that no meaningful anticompetitive effect will result from the merger. We believe that under this requirement the agencies will demand that the parties show that sufficient entry is likely to occur in a timeframe considerably shorter than two years in most cases.

Repositioning by nonmerging firms to take advantage of and thereby compete away any attempt by the merged firm to act anticompetitively can also be an important element of a merger defense. In some recent transactions, the agencies have exhibited significant skepticism as an analytical matter to repositioning as a means of ensuring competition. The 2010 Guidelines view repositioning as a supply-side response that should be evaluated much like entry, and we expect the agencies to apply the same demanding standards to repositioning as they are towards entry.

Other areas

The 2010 Guidelines make modifications in other areas, but these are not likely to be as significant to horizontal merger enforcement as the areas just discussed. For example, the revised Guidelines ease the requirements for applying a coordinated interaction theory, but even as reformulated coordinated effects almost surely will continue to take a back seat to unilateral effects as the primary theory motivating agency challenges. Likewise, the 2010 Guidelines make a number of changes to the treatment of efficiencies, including a greater acceptance of fixed cost efficiencies, but maintain the historical agency antipathy toward efficiency defenses. If anything, the revisions are even more demanding on the reliability and quantum of proof necessary to advance an efficiencies defense than the prior guidelines.

The revised Guidelines also cover a number of areas that have been a standard part of horizontal merger review that were not addressed in the prior guidelines. These include the competitive analysis of auction markets, the countervailing influence of powerful buyers, mergers of competing buyers (monopsony), and acquisitions of minority positions involving competing firms (partial acquisitions).

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