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# Unit 8. Introduction to Formal Horizontal Merger Analysis

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# Topics

- The statutes
- Typical litigation paradigms
- Preliminary injunctions
  - Standards
  - Right of action
  - Appeals
  - Deal realities
- Elements of a Section 7 violation
- The allocation of the burdens of proof
- Relevant product markets
  - The *Brown Shoe* “outer boundaries” and “practical indicia” tests
  - The Merger Guidelines’ “hypothetical monopolist test”
- Relevant geographic markets

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# The Statutes

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# The beginning

- Mergers have always a central concern in federal antitrust enforcement
  - The acquisitive tendencies of the Great Trusts in the late 1800s provided a major impetus for the passage of the original antitrust statutes
  - Major concerns
    - Mergers to monopoly
    - Development of holding companies and the secret acquisition of competitors

# The Sherman Act

- Enacted in 1890
- Section 1 creates the offense of a “contract, combination . . . or conspiracy, in restraint of trade or commerce”

Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$100,000,000 if a corporation, or, if any other person, \$1,000,000, or by imprisonment not exceeding 10 years, or by both said punishments, in the discretion of the court.<sup>1</sup>

<sup>1</sup> 15 U.S.C. § 1.

# The Sherman Act

## ■ Use in merger antitrust enforcement

### □ *E.C. Knight* (1895)<sup>1</sup>

- First Supreme Court antitrust case
- Challenged the Sugar Trust's acquisition its four remaining major competitors
- Dismissed for lack of "in commerce" subject matter jurisdiction
  - Manufacturing is not "commerce" within the meaning of the Interstate Commerce Clause (later overruled)

### □ *Northern Securities* (1904)<sup>2</sup>

- Made Theodore Roosevelt's reputation as a "trust buster"
- Challenged J.P. Morgan's attempt to consolidate the only two railroad trunk lines serving the northern part of the United States
- Broadly condemned large mergers and other combinations as violations of Section 1
- Affirmed lower court injunction against the consolidation

NB: in the wake of *Northern Securities*, Roosevelt distinguished between "good" trusts and "bad" trusts and prosecuted only what he thought were "bad" trusts, although *Northern Securities* allowed him to reach all trusts

<sup>1</sup> United States v. E.C. Knight Co., 156 U.S. 1 (1895).

<sup>2</sup> Northern Securities Co. v. United States, 193 U.S. 197 (1904).

# The Sherman Act

- Use in merger antitrust enforcement
  - *Standard Oil* (1911)<sup>1</sup>
    - Perhaps the most important of all antitrust cases
    - Challenged, among other things, acquisitions by the Standard Oil Trust
    - Found Standard Oil to violate Section 1 and ordered it to be broken up
      - But held that Section 1 only prohibited only *unreasonable* restraints
      - Prior Supreme Court cases had held that *all* restraints of trade were prohibited by Section 1
    - Under *Standard Oil*, the reasonableness of a restraint (and therefore the legality of the combination effecting the restraint) was to be determined judicially by the judging employing the logic of *reason*
      - Many of the judges at the time adhered to “classical legal thought” (sometimes called formalism in the literature), a jurisprudential view that judges “discovered” the law and almost surely believed that the application of reason to a competition problem would reveal the correct outcome from basic legal principles
      - Others believed that the law should promote desirable social and economic ends (although they did not always hold common views of what these ends should be) and these reformers—who came to be called *progressives*—were becoming increasingly important politically
      - Overall, in the mind of the public—and, more importantly, in the mind of Congress—there was great uncertainty in what legal outcomes would result from Standard Oil’s rule of reason

<sup>1</sup> Standard Oil Co. of New Jersey v. United States, 221 U.S. 1 (1911).

# The Clayton Act

- Enacted in 1914 in reaction to *Standard Oil*
  - Section 7 was directed specifically at prohibiting mergers and acquisitions that were likely to be anticompetitive
    - *Concern*: Congress feared that the courts would not find anticompetitive mergers violated Section 1 of the Sherman Act under the new judicial “rule of reason”
- As originally enacted, Section 7 read in relevant part:

[N]o corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital of another corporation engaged also in commerce, where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition, or to restrain such commerce in any section or community, or tend to create a monopoly of any line of commerce.<sup>1</sup>

- Limitations
  - Limited to “corporations” that are “in commerce”
  - Limited to stock acquisitions
    - Limitation to corporate stock acquisitions was probably intentional: Congress' principal concern was with the activities of holding companies, and specifically with the practice whereby corporations secretly acquired control of their competitors by purchasing the stock of those companies.
  - Widely viewed as limited to horizontal acquisitions<sup>2</sup>

<sup>1</sup> Pub. L. No. 212, ch. 323, §7, 38 Stat. 730, 731-32 (1914) (current version at 15 U.S.C. § 18).

<sup>2</sup> This interpretation of the original act was ultimately but belatedly rejected by the Supreme Court in *United States v. E.I. duPont de Nemours & Co.*, 353 U.S. 586 (1957).



# FTC Act § 5

- Also enacted in 1914 in reaction to Standard Oil

**Unfair methods of competition** in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful.<sup>1</sup>

- Prohibits all conduct that—
  - Violations the Sherman or Clayton Acts, OR
  - If not a technical violation falls with the “spirit” of an antitrust violation
- Anticompetitive mergers are prohibited by Section 5
- Elements of a merger violation under Section 5
  - The Sherman Act and FTC Act, as applied to mergers, are either coextensive or less restrictive than Clayton Act § 7, so Section 7 provides the antitrust test for all mergers
  - Consequently, invocation of the Sherman Act or the FTC Act is usually superfluous and plaintiffs rarely allege violations of these statutes
- Enforcement
  - Enforced by the Federal Trade Commission
  - NB: Unlike other provisions, not included in the definition of “antitrust law” in Clayton Act § 1
    - Courts have interpreted this to mean that private parties have no right of action to enforce Section 5

<sup>1</sup> 15 U.S.C. § 45(a)(1).

# Celler-Kefauver Act<sup>1</sup>

- Enacted in 1950 to amend Section 7 of the Clayton Act
  - Amended Section 7 to—
    - Expand coverage to asset acquisitions
    - Change competitive effects language to current form (except for jurisdictional reach):

where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.
  - Supreme Court interpreted the “may be” and “tend to” language in the anticompetitive effects test to mean:
    - Only a *reasonable probability* that the proscribed anticompetitive effect will occur<sup>3</sup>
    - The plaintiff does not have to prove that an actual anticompetitive effect would occur
      - This is called the *incipiency standard*
  - Two significant restrictions remained after the 1950 amendments
    - Applied only to “corporations” that are “in commerce”
    - Anticompetitive effect arguably had to be “in commerce”

<sup>1</sup> Ch. 1184, 64 Stat. 1125 (1950) (amending Section 7 of the Clayton Act).

<sup>2</sup> See *Brown Shoe Co. v. United States*, 370 U.S. 294, 315-23 (1962).

<sup>3</sup> *United States v. E.I. duPont de Nemours & Co.*, 353 U.S. 586, 589 (1957); accord *Brown Shoe*, 370 U.S. at 323 n.39, 325.

# Celler-Kefauver Act

- Legislative history aggressively hostile to business combinations
  - This is actually the aspect of the 1950 legislation that most influenced the courts
- 1950 congressional concerns<sup>1</sup>
  - Fear of “the rising tide of economic concentration in the American economy”
  - Loss of opportunity for small business when competing with large enterprises
  - The spread of multistate enterprises and the loss of local control over industry
- Broadly shared macroeconomic concerns at the time
  - Suggested a very restrictive merger antitrust regime
  - Did not require deep microeconomic analysis to implement

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<sup>1</sup> See *Brown Shoe Co. v. United States*, 370 U.S. 294, 315-16 (1962) (in reading materials)

# Antitrust Procedural Improvements Act of 1980<sup>1</sup>

- Changes to Section 7
  - Eliminated limitation to corporations and made Section 7 applicable to acquisitions by and of any “person”
  - Eliminated requirement that the acquired and acquiring entities must be engaged “in commerce” and as amended reaches entities “engaged in commerce or in any activity affecting commerce”
  - Eliminated requirement that the effect be “in any line of commerce” and expanded it to “any line of commerce or in any activity affecting commerce”
- With the 1980 amendments, the reach of Section 7 is coextensive with the reach of the Commerce Clause
  - Just as with the Sherman Act

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<sup>1</sup> Pub. L. 96-349, § 6(a), 94 Stat. 1157 (1980).

# Summary of changes to the Clayton Act

	Application	Subject matter jurisdiction	Type of acquisition	Type of transaction
Clayton Act (1914)	Corporations	"In commerce"	Stock	Horizontal
Celler-Kefauver Act (1950)	↓	↓	Stock and assets	All types
APIA (1980)	Persons	"In commerce" or any activity affecting commerce	↓	↓

# Clayton Act § 7—Current version

- Provides the U.S. antitrust standard for mergers

No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, where in **any line of commerce** or in any activity affecting commerce **in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.** <sup>1</sup>

- Essential elements of a Section 7 violation

1. Acquisitions of stock or assets that,
2. “in any line of commerce” (product market)
3. “in any part of the country” (geographic market)
4. The effect of the acquisition “may substantially lessen competition or tend to create a monopoly”

Called the *relevant market*

Called the *anticompetitive effects test*

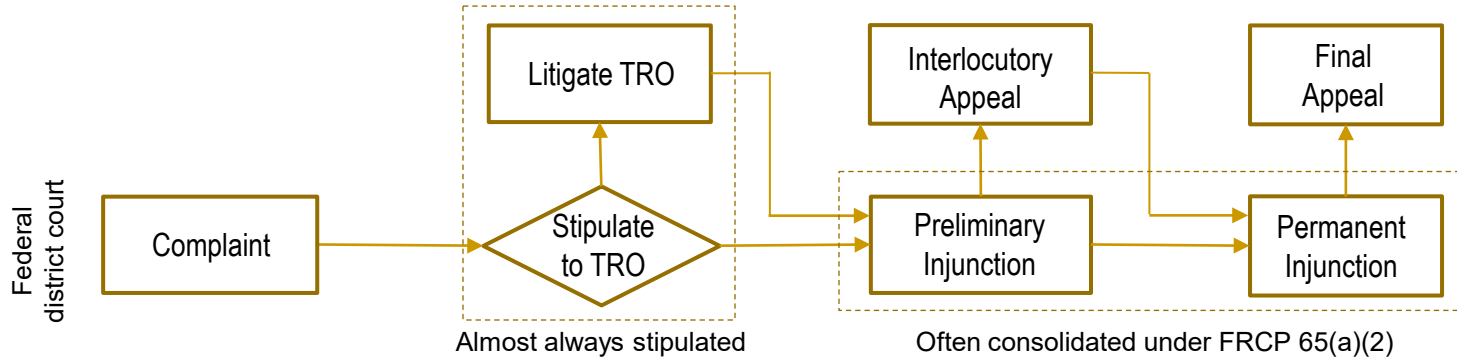
<sup>1</sup> 15 U.S.C. § 18 (emphasis added; remainder of section omitted).

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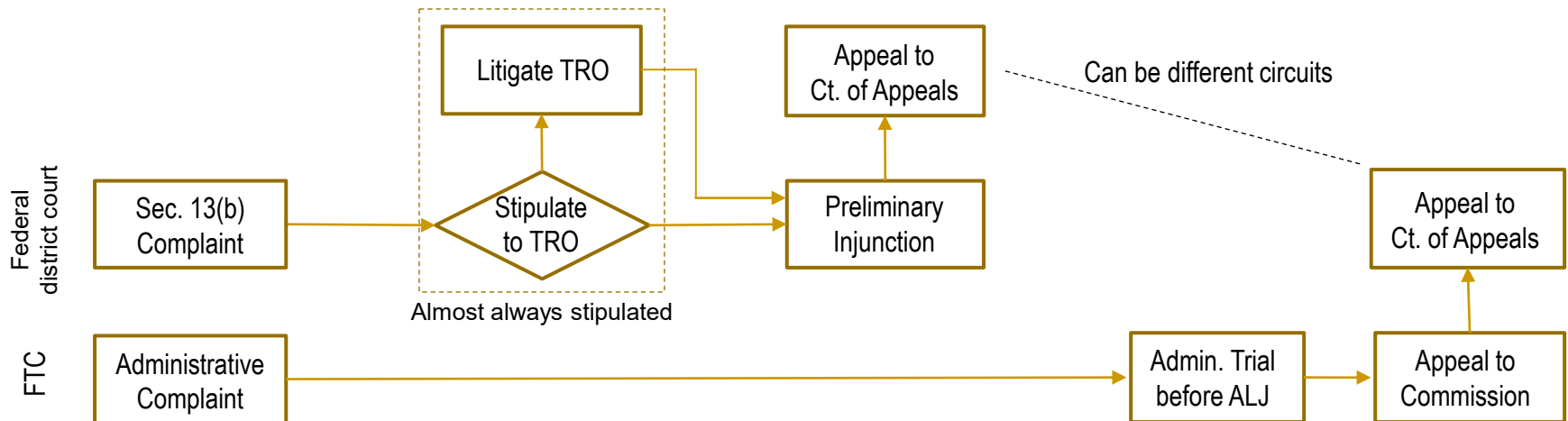
# Typical Litigation Paradigms

# Typical litigation paradigms

## DOJ preclosing challenge



## FTC preclosing challenge





# Typical litigation paradigms

## DOJ postclosing challenge



## FTC postclosing challenge



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# Preliminary Injunctions

# Preliminary injunctions

## ■ Purpose

- To maintain the status quo ex ante until a final decision on the merits
- In merger antitrust law, this usually means a blocking preliminary injunction if the transaction has not yet closed
  - Modern courts have held that “hold separate” injunctions, which allow the deal to close but require merged parties to be operated separately and not integrated, are usually regarded as inadequate relief

## ■ Deal realities

- A transaction is unlikely to survive as a business matter the time it would take for both a preliminary injunction and a subsequent trial on the merits
  - Most deals start to flounder if they have not closed within a year of signing
  - A HSR merger review is likely to take 6-8 months
  - Little time left practically for a trial and an appeal
- Federal judges in the District of Columbia recognize the time sensitivity of deals and usually give the parties the opportunity on a very expedited basis to present a complete case in the preliminary injunction proceeding
  - Usually includes 3-6 days of evidentiary hearings for live witnesses
  - *Trade-off*: Due to court schedules, the more trial days the parties want the more delayed the hearing

# Winter v. Natural Res. Def. Council, Inc.<sup>1</sup>

- Seminal Supreme Court case on preliminary injunctions
- “A preliminary injunction is an extraordinary remedy never awarded as of right.”<sup>2</sup>
- *Winter* test

A [private] plaintiff seeking a preliminary injunction must establish [1] that he is likely to succeed on the merits, [2] that he is likely to suffer irreparable harm in the absence of preliminary relief, [3] that the balance of equities tips in his favor, and [4] that an injunction is in the public interest.<sup>3</sup>

- Sliding scale
  - Prior to *Winter*, many courts held that the four factors could be balanced on a sliding scale, so that, for example, a weak showing of likelihood of success could be offset by a strong showing of irreparable harm
  - Post-*Winter*, some courts have rejected the sliding scale, holding that *Winter* requires a likelihood of success on the merits as an independent, free-standing requirement for a preliminary injunction

<sup>1</sup> 555 U.S. 7 (2008).

<sup>2</sup> *Id.* at 24.

<sup>3</sup> *Id.* at 20.

# Preliminary injunctions: Standards

## ■ DOJ

- *Clayton Act § 15*: Authorizes the district courts in antitrust cases brought by the Attorney General to “make such temporary restraining order or prohibition as shall be deemed just in the premises.”<sup>1</sup>
  - *Test: Modified Winter test*
    - Requires showing of—
      1. Likelihood of the plaintiff's success on the merits
      2. A public interest in the entry of an injunction
    - BUT irreparable injury requirement is modified—
      - Either eliminated the requirement altogether, OR
      - Requisite injury must be to the public (and not the government) and is conclusively presumed when there is the requisite a likelihood of a violation

NB: In either case, not a meaningful element on which the preliminary injunction decision will be based

  - Possibility of substantial harm to other interested parties from a grant of injunctive relief
    - But always outweighed by the public's interest in preventing an anticompetitive merger
- Likelihood of success is key
  - Usually requires a showing that there is a “reasonable probability of success at trial”
  - Courts give lip service to other factors, but rarely if ever important in DOJ cases

<sup>1</sup> 15 U.S.C. § 25.

# Preliminary injunctions: Standard

## ■ FTC

- *FTC Act § 13(b)*: Authorizes the district court to enjoin the consummation of a merger pending completion of an FTC administrative adjudication “[u]pon a proper showing that, weighing the equities and considering the Commission’s likelihood of ultimate success, such action would be in the public interest.”<sup>1</sup>
  - No requirement to show irreparable harm, although “equities” must be balanced
- *Test*: “Serious questions”

The issue is whether the Commission has demonstrated a likelihood of ultimate success. The Commission meets its burden if it “raise[s] questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals.”<sup>2</sup>

<sup>1</sup> 15 U.S.C. § 53(b).

<sup>2</sup> *FTC v. Warner Commc'ns*, 742 F.2d 1156, 1162 (9th Cir. 1984) (collecting citations); *accord* *FTC v. Whole Foods Mkt., Inc.*, 548 F.3d 1028, 1035 (D.C. Cir. 2008) (Brown, J.); *id.* at 1042 (Tatel, J.); *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 714-15 (D.C. Cir. 2001); *FTC v. Wilh. Wilhelmsen Holding ASA*, 341 F. Supp. 3d 27, 44 (D.D.C. 2018); *FTC v. Tronox Ltd.*, 332 F. Supp. 3d 187, 197 (D.D.C. 2018); *FTC v. Sanford Health*, No. 1:17-CV-133, 2017 WL 10810016, at \*24 (D.N.D. Dec. 15, 2017), *aff'd*, 926 F.3d 959 (8th Cir. 2019); *FTC v. Advocate Health Care*, No. 15 C 11473, 2016 WL 3387163, at \*2 (N.D. Ill. June 20, 2016), *rev'd and remanded*, 841 F.3d 460 (7th Cir. 2016); *FTC v. Staples, Inc.*, 190 F. Supp. 3d 100, 115 (D.D.C. 2016); *FTC v. Steris Corp.*, 133 F. Supp. 3d 962, 966 (N.D. Ohio 2015); *FTC v. Sysco Corp.*, 113 F. Supp. 3d 1, 22 (D.D.C. 2015); *FTC v. OSF Healthcare Sys.*, 852 F. Supp. 2d 1069, 1074 (N.D. Ill. 2012); *FTC v. ProMedica Health Sys., Inc.*, No. 3:11 CV 47, 2011 WL 1219281, at \*53 (N.D. Ohio Mar. 29, 2011); *FTC v. Lab. Corp. of Am.*, No. SACV 10-1873 AG MLGX, 2011 WL 3100372, at \*16 (C.D. Cal. Feb. 22, 2011); *FTC v. CCC Holdings, Inc.*, 605 F. Supp. 2d 26, 30 (D.D.C. 2009).

# Preliminary injunctions: Standard

- Private parties (includes states)
  - Clayton Act § 16
    - Provides private persons (including states) with a right of action to "sue for and have injunctive relief ... when and under the same conditions and principles as injunctive relief against threatened conduct that will cause loss or damage is granted by courts of equity."<sup>1</sup>
      - Interpreted to include TROs and preliminary injunctions as well as permanent injunctions
  - Test: Same as DOJ + immediate threat of irreparable harm
    - Irreparable harm is harm not remediable by damages
      - Courts typically find that harm is not irreparable → Damages are sufficient
      - But some cases hold that a harm resulting from a lessening of competition is a irreparable harm<sup>2</sup>
      - *Query*: Which is the proper reading in a private case?
    - Threat of irreparable harm must be immediate
      - Means that the plaintiff "is likely to suffer irreparable harm before a decision on the merits can be rendered."<sup>3</sup>
    - Also requires actual or threatened antitrust injury and prudential standing
    - The equities and the public interest count in the analysis (although still secondary to likelihood of success on the merits)

<sup>1</sup> 15 U.S.C. § 26.

<sup>2</sup> See, e.g., *Boardman v. Pacific Seafood Grp.*, 822 F.3d 1011, 1022 (9th Cir. 2016).

<sup>3</sup> *Winter*, 555 U.S. at 22.

# Preliminary injunctions: Right of action

## 1. FTC Act § 13(b)

(b) *Temporary restraining orders; preliminary injunctions.* Whenever the Commission has reason to believe—

- (1) that any person, partnership, or corporation is violating, or is about to violate, any provision of law enforced by the Federal Trade Commission, and
- (2) that the enjoining thereof pending the issuance of a complaint by the Commission and until such complaint is dismissed by the Commission or set aside by the court on review, or until the order of the Commission made thereon has become final, would be in the interest of the public—

the Commission by any of its attorneys designated by it for such purpose **may bring suit in a district court of the United States to enjoin** any such act or practice. Upon a proper showing that, **weighing the equities and considering the Commission's likelihood of ultimate success, such action would be in the public interest**, and after notice to the defendant, a temporary restraining order or a **preliminary injunction may be granted without bond**. . . .<sup>1</sup>

- Requires the preliminary injunction to be in the *public interest* after—
  - Considering the Commission's likelihood of success on the merits, and
  - Weighing the equities
- Note: Provides only the FTC with a cause of action

<sup>1</sup> 15 U.S.C. § 53(b).



# Preliminary injunctions: Right of action

- Clayton Act § 16

**Any person**, firm, corporation, or association shall be entitled to sue for and have injunctive relief, in any court of the United States having jurisdiction over the parties, against threatened loss or damage by a violation of the antitrust laws, including sections 13, 14, **18**, and 19 of this title, when and under the **same conditions and principles as injunctive relief against threatened conduct that will cause loss or damage is granted by courts of equity**, under the rules governing such proceedings, and upon the execution of proper bond against damages for an injunction improvidently granted and a showing that the danger of irreparable loss or damage is immediate, a preliminary injunction may issue. . . . <sup>1</sup>

- Observations

- Provides “any person” with a cause of action for injunctive relief under the usual judicial principles
  - A state is a “person” within the meaning of Section 16
  - “Loss or damage” to the state includes harm to its general economy or economic harm to its residents

<sup>1</sup> 15 U.S.C. § 26.

# Preliminary injunctions: Appeals

- Appeal: Appellate jurisdiction

- The grant or denial of a motion for a preliminary injunction is immediately appealable as a matter of right under 28 U.S.C. § 1292(a)(1):

[T]he courts of appeals shall have jurisdiction of appeals from: (1) Interlocutory orders of the district courts of the United States . . . or of the judges thereof, granting, continuing, modifying, refusing or dissolving injunctions, or refusing to dissolve or modify injunctions, except where a direct review may be had in the Supreme Court;

- *Query*: Is the review of a preliminary injunction decision in a Section 13(b) proceeding reviewed under Section 1292(a)1) or under Section 1291 as a final decision of the district court?
  - Does it matter?

# Preliminary injunctions: Appeals

- Appeal: Standard of review
  - The grant or denial of a preliminary injunction is reviewed for *abuse of discretion*
  - An abuse of discretion occurs when the court—
    - Adopts an incorrect legal rule
    - Relies upon a factor not legally cognizable under a proper legal rule
    - Omits consideration of a factor entitled to substantial weight under the proper legal rule
    - Makes a clear error in its factual findings or in the weighing of the evidence, or
    - Rests its conclusions on clearly erroneous factual determinations.

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# Elements of a Section 7 Violation

# Proving a Section 7 violation

- The prima facie case
  - The plaintiff must adduce evidence sufficient for the finder of fact to find each and every element of a Section 7 violation:
    1. The relevant product market
    2. The relevant geographic market
    3. The requisite anticompetitive effect in the relevant market
  - Note on market definition as an element of the offense
    - Some commentators argue that direct evidence of anticompetitive harm should obviate the need to prove the relevant market
      - For example, say the challenge is to a consummated merger and that the plaintiff can prove the merger resulted in a substantial price increase
    - Opponents of this view argue that by its terms Section 7 requires the showing of the product and geographic dimensions of a relevant market in which the anticompetitive effect would be located
    - Views of the DOJ and FTC
      - The DOJ and FTC agree that the determination of a relevant market is not necessary in order to prove the requisite anticompetitive effect in the vast majority of mergers
      - BUT they have not been willing to test whether they can dispense with the market definition elements in court
    - Courts
      - Have not had to decide a case on point

# Proving a Section 7 violation

- The prima facie case
  1. *Product market definition*: Courts broadly look at two types of indicia in evaluating evidence on the relevant product market—
    - a. The “Brown Shoe factors”
    - b. The “hypothetical monopolist test”
  2. *Geographic market definition*: Courts broadly look at two types of indicia in evaluating evidence on the relevant geographic market—
    - a. “The area of effective competition”
      - i. The area where customers of the merging firms can practically turn to alternative suppliers (when customers travel to suppliers—think retail stores)
      - ii. The area where alternative suppliers exist that can practically service the customers of the merging firm (when suppliers travel to customers—think plumbers)
    - b. The “hypothetical monopolist test”
  3. *Anticompetitive effect*: Courts broadly look at two types of indicia in evaluating evidence on the relevant geographic market
    - a. The *Philadelphia National Bank* presumption
    - b. Theories and supporting direct and circumstantial evidence of likely anticompetitive harm resulting from the merger

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# Allocation of the Burdens of Proof

# Allocation of the burdens of proof

- *Baker Hughes* three-step burden-shifting<sup>1</sup>
  1. The plaintiff bears burden of proof in market definition and in market shares and market concentration within the relevant market sufficient to trigger the *PNB* presumption and thereby prove a prima facie Section 7 violation
  2. If the plaintiff satisfies this burden, the burden of production shifts to defendants to adduce evidence sufficient to rebut *PNB* presumption
  3. The burden of persuasion then returns to plaintiff to prove in light of all of the evidence in the record that the merger is reasonably probable to have an anticompetitive effect in the relevant market
  
- Prevailing standard for the allocation of proof burdens in merger antitrust cases
  - D.C. Circuit opinion authored by Clarence Thomas and joined by Ruth Bader Ginsburg and David B. Sentelle
  - Expressly held that the *PNB* “clear showing” standard on the merging parties was implicitly abrogated by subsequent Supreme Court opinions
    - Especially *General Dynamics*<sup>2</sup>

<sup>1</sup> United States v. Baker Hughes Inc., 908 F.2d 981, 982-83 (D.C. Cir. 1990).

<sup>2</sup> United States v. General Dynamics Corp., 415 U.S. 486 (1974)



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# Relevant Product Markets

# Relevant product markets: Some background

- What is a relevant product market?
  - A relevant product market defines the product boundaries within which competition meaningfully exists<sup>1</sup>
  - Although discussed in terms of products, the product market concept equally applies to services or a mixed combination of a product with accompanying services
  
- Modern concept of relevant markets
  - Products in the relevant market should exert significant price pressure on one another
    - That is, an increase in price of one of the products in the market should cause customers to switch to other products in the market, and this loss of sales should result in the price increase being unprofitable.
  - Some definitions
    - *Inframarginal customers* continue to buy the product after the price increase
    - *Marginal customers* would buy the product at the original price but not at the increased price
  
- The showing of the relevant market(s) is an essential element of every Section 7 violation
  - The plaintiff must make a prima facie showing of a relevant market as part of its prima facie case and bears the ultimate burden of persuasion

<sup>1</sup> United States v. Continental Can Co., 378 U.S. 441, 449 (1964).

# Relevant product markets: Some background

- Two complementary tests under in judicial analysis
  1. The “outer boundaries” and “practical indicia” criteria of *Brown Shoe*<sup>1</sup>
  2. The hypothetical monopolist test of the Merger Guidelines<sup>2</sup>

<sup>1</sup> *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962).

<sup>2</sup> U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines § 4 (rev. Aug. 19, 2010).

# Brown Shoe “outer boundaries” test

## ■ *Brown Shoe*:

The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it.<sup>1</sup>

- This remains the prevailing definition of a relevant product market in the case law
- Key indicia—
  - Reasonable interchangeability of use
  - [High] cross-elasticity of demand

## ■ General idea

- The relevant product market should—
  1. *contain* all products that exhibit a reasonable interchangeability of use and a high cross-elasticity of demand with one another, *and*
  2. *exclude* all products that lack reasonable interchangeability of use and have a low cross-elasticity of demand with products in the relevant product market

## ■ Modern usage

- Reasonable interchangeability of use has largely come to mean high cross-elasticity of demand and is no longer a distinct “outer boundary” test

<sup>1</sup> *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962).

# *Brown Shoe* “practical indicia” test

- Submarkets and “practical indicia” of relevant markets

However, within this broad market [defined by reasonable interchangeability of use and high cross-elasticity of demand], well-defined **submarkets** may exist which, in themselves, constitute product markets for antitrust purposes. The boundaries of such a submarket may be determined by examining such **practical indicia** as

[1] industry or public recognition of the submarket as a separate economic entity,

[2] the product’s peculiar characteristics and uses,

[3] unique production facilities,

[4] distinct customers,

[5] distinct prices,

[6] sensitivity to price changes, and

[7] specialized vendors.<sup>1</sup>

<sup>1</sup> *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962).

# *Brown Shoe* “practical indicia” test

- Submarkets and “practical indicia” of relevant markets
  - This list of “practical indicia” was not intended to be exhaustive
  - Some additional factors that courts typically consider—
    1. Relative prices of products in the provisional market
      - A Timex and a Rolex both tell time, but they are unlikely to exhibit a high cross-elasticity of demand with on another
    2. Different functional attributes that might appeal to different classes of buyers
      - Consider the functional difference between a Ferrari 812 (0-60 mph: 2.8 sec.; top speed: 211 mph) and a Nissan Versa (0-60 mph: 10.2 sec.; top speed: 115 mph)
      - Differences in functionality are often accompanied by differences in price (Ferrari 812 base price: \$340,712; Nissan Versa base price: \$15,625)
    3. Differences in reputation
      - Even without functional differences
- Problems with the *Brown Shoe* “practical indicia” test
  - The list provides some factors to consider, but does not say what weight they should be given or give any other analytical technique to apply them to determine the boundaries of submarkets
  - This created an enormous amount of confusion, bad analysis, and bad decisions

<sup>1</sup> *Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962).

# Hypothetical monopolist test

- The original idea
  - The relevant market should be—
    1. the smallest group of products containing the products of interest (say, the products of the merging firms in a horizontal merger)
    2. in which a hypothetical monopolist of those products would raise prices profitably over the current level
    3. by at least “small but significant nontransitory” amount
  - Observations
    - Introduced in the 1982 DOJ Merger Guidelines
    - “SSNIP” = “Small but significant nontransitory increase in price”
    - Under the Merger Guidelines, a SSNIP is usually taken to be a price increase of 5% for at least one year

# Hypothetical monopolist test

## ■ The original idea

### □ The relevant market should be—

1. the smallest group of products containing the products of interest (say, the products of the merging firms in a horizontal merger)
2. in which a hypothetical monopolist of those products would raise prices profitably over the current level
3. by at least “small but significant nontransitory” amount

### □ Observations

- Introduced in the 1982 DOJ Merger Guidelines
- “SSNIP” = “Small but significant nontransitory increase in price”
- Under the Merger Guidelines, a SSNIP is usually taken to be a price increase of 5% for at least one year
- “Candidate market” = the market being tested to see if it is a relevant market



# Hypothetical monopolist test (1982)

## ■ Propositions:

1. If a hypothetical monopolist would not have market power with respect to a group of products to be able to profitably raise prices for those products, then a fortiori a merger of firms producing products within that group could not produce in an anticompetitive price increase
2. If a hypothetical monopolist would not raise prices by a SSNIP because it would be unprofitable, then products outside the candidate relevant market must be exerting competitive price pressure and the candidate market needs to be expanded to include the next closest substitutes (and the test run again)
3. Find the smallest group of products for which a hypothetical monopolist would have market power to raise prices and then assess whether a merger of two firms producing products within this group would likely result in an anticompetitive price increase

# Hypothetical monopolist test

## ■ Example:

- Say a hypothetical monopolist—
  - Faces an (inverse) demand:  $p = 10 - \frac{1}{2}q$
  - Has no fixed costs and constant marginal costs of 4 per unit of production
  - Starting point:  $p_1 = 5$
- Question: If the current market price is 5, would a SSNIP—taken to be 5 percent—be more profitable than the prevailing market price?

## Some definitions:

*Marginal sales* are sales that are lost when the price is increased

*Inframarginal sales* are sales that continued to be made at the higher price

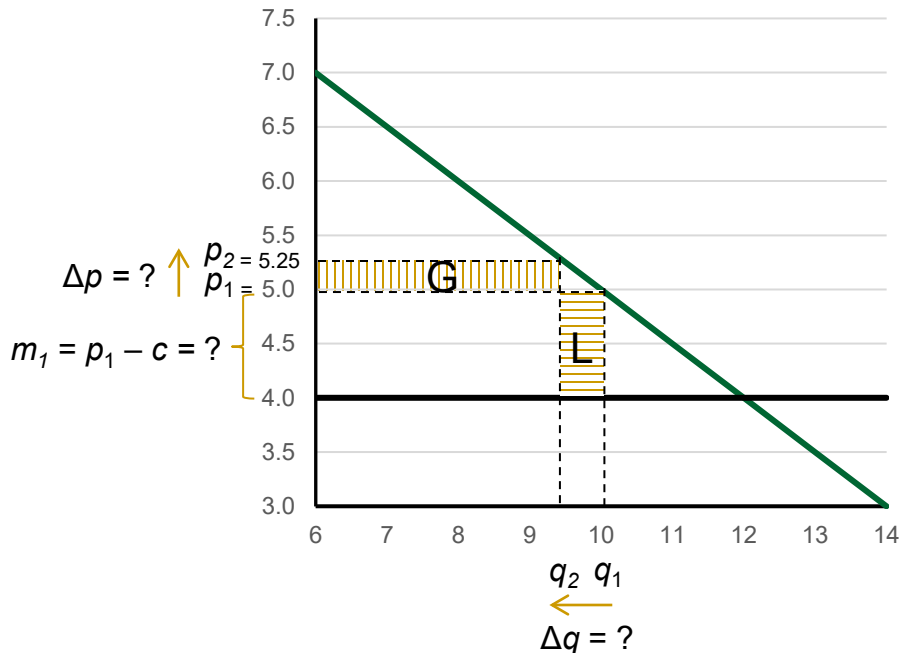
# Hypothetical monopolist test

- Step 1. Set up the problem with what you know:
  - (Inverse) demand:  $p = 10 - \frac{1}{2}q$
  - Prevailing (premerger) price:  $p_1 = 5$
  - SSNIP = 5%
  - Constant marginal cost  $c = 4$

# Hypothetical monopolist test

## Step 1. Set up the problem:

- (Inverse) demand:  $p = 10 - \frac{1}{2}q$
- Prevailing (premerger) price:  $p_1 = 5$
- SSNIP = 5%
- Constant marginal cost  $c = 4$



## Step 2: Figure out what you need:

1. Need the gross gain on inframarginal sales that will be retained (Area G):

$$\begin{aligned} \text{Area G} &= \text{price increase } (\Delta p) \\ &\quad \text{times inframarginal sales } (q_2) \\ &= \Delta p q_2 \end{aligned}$$

2. The gross loss on marginal sales that will be lost (Area L):

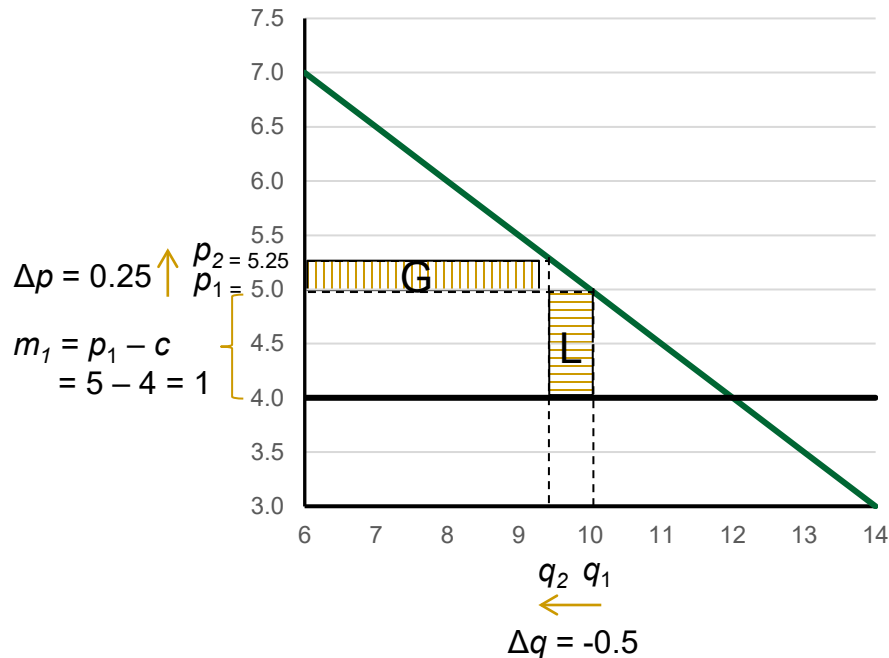
$$\begin{aligned} \text{Area L} &= \text{gross margin on marginal sales } (m_1) \\ &\quad \text{times (lost) marginal sales } (\Delta q) \\ &= m_1 \Delta q \end{aligned}$$

So need  $q_1$ ,  $q_2$ ,  $\Delta q$ ,  $\Delta p$ ,  $p_2$ , and  $m_1$

# Hypothetical monopolist test

## ■ Set up the problem:

- (Inverse) demand:  $p = 10 - \frac{1}{2}q$
- Prevailing (premerger) price :  $p_1 = 5$
- SSNIP = 5%
- Constant marginal cost  $c = 4$



Step 3. Solve for the variables you need using the parameters given in the problem and the demand curve:

$q = 20 - 2p$  (the demand curve derived by inverting the inverse demand curve)

$q_1 = 10$  (from the demand curve given  $p_1 = 5$ )

$\Delta p = 0.25$  (5% of  $p_1$ —the SSNIP)

$p_2 = 5.25$  ( $p_1 + \Delta p$ )

$q_2 = 9.5$  (plugging  $p_2$  into the demand curve)

$\Delta q = q_2 - q_1 = 9.5 - 10 = -0.5$

$m_1 = p_1 - c = 5 - 4 = 1$

# Hypothetical monopolist test

## ■ Set up the problem:

- (Inverse) demand:  $p = 10 - \frac{1}{2}q$
- Starting point:  $p_1 = 5$
- SSNIP = 5%
- Constant marginal cost  $c = 4$

$$q = 20 - 2p$$

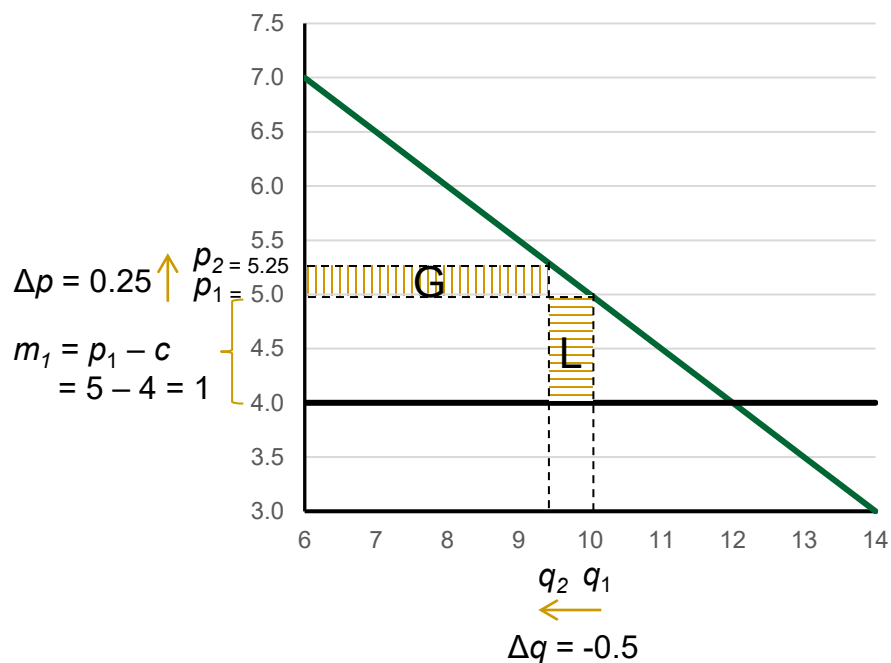
$$q_1 = 10$$

$$q_2 = 9.5$$

$$m_1 = p_1 - c = 5 - 4 = 1$$

$$\Delta q = q_2 - q_1 = 9.5 - 10 = -0.5$$

$$\Delta p = p_2 - p_1 = 5.25 - 5 = 0.25$$



## Step 4. Solve problem

$$\text{Area G} = q_2 \Delta p = (9.5)(0.25) = 2.375$$

$$\text{Area L} = m_1 \Delta q = (1)(-0.5) = -0.5$$

$$\begin{aligned} \text{Incremental profits} &= \text{Area G} - \text{Area L} \\ &= 2.375 - 0.5 = 1.875 \end{aligned}$$

*Therefore, a price increase of 5 percent above the current level is profitable and the HMT is satisfied*

# 2010 Merger Guidelines

- Adopts the 1992 Merger Guidelines market definition methodology with some very significant changes
  1. Relegates market definition to one of several tools useful in merger antitrust analysis
    - May not be necessary or even helpful in all cases
    - By contrast, market definition was the point of departure for all merger antitrust analysis under the 1982 and 1992 guidelines
  2. Abandons the “smallest market” principle and unique relevant markets
    - The 1982 and 1992 guidelines considered the relevant product market to be the smallest group of products that satisfied the hypothetical monopolist test
    - The 2010 guidelines accept as a relevant product market *any* group of products that satisfies the hypothetical monopolist test
      - This permits “cherry-picking” of products to include in the relevant product market
      - Also makes it difficult for defendants to argue in court that prosecuting agency misspecified the relevant product market

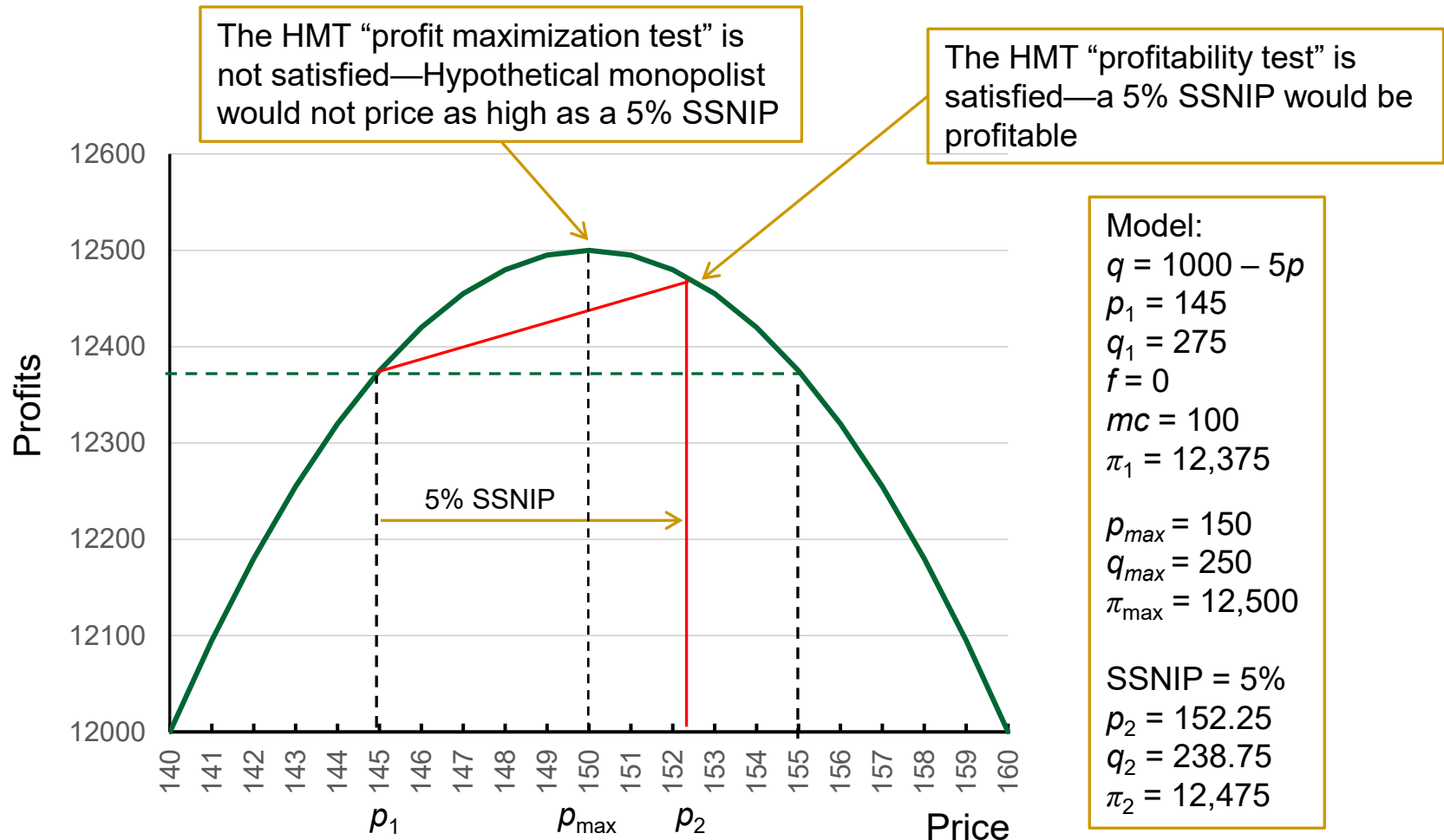
# 2010 Merger Guidelines

- Adopts the 1992 Merger Guidelines market definition methodology with some very significant changes
- 3. Asks whether a profit-maximizing hypothetical *would* raise price by a SSNIP, not whether it would be profitable to do so
  - *Profitability test*: The 1982 and 1992 Merger Guidelines asked whether the hypothetical monopolist would make more profits by raising the price by a SSNIP
    - That is, whether it would be profitable to do so, not whether it would be profit maximizing
  - *Profit-maximization test*: The 2010 Merger Guidelines ask whether it would be in the profit-maximizing interest of the hypothetical monopolist to raise price by at least a SSNIP
    - In other words, is the monopoly price higher by at least a SSNIP to the current price?
  - Adoption by the courts
    - As the courts were adopting the hypothetical monopolist test in the 1980s and 1990s, the 1982 and 1992 guidelines were in effect. As a result, the agencies urged the courts to adopt, and the courts did adopt, the profitability version of the hypothetical monopolist test
    - Given this precedent, the profitability test remains the judicial test in most courts notwithstanding the change in the 2010 Guidelines
  - Conventional wisdom
    - Since the current price would be close to the monopoly price only if the market is operating close to a perfect monopoly, in most cases the profitability test and the profit-maximization test will reach the same result with respect to a candidate market
  - *Query*: Were the 2010 Guidelines correct in adopting the profit-maximization test?
    - Won't it reject markets close to being monopolized and increase the probability of a *Cellophane* fallacy (see below)?



# 2010 Merger Guidelines

- Example: HMT profitability and profit maximization tests in a close-to-monopolized market



# 2010 Merger Guidelines

## ■ The *Cellophane* fallacy

- *Rule*: A monopolist will not price in the inelastic portion of the demand curve
  - Implication 1: A monopolist will increase its price until other goods become sufficiently substitutable to make a further price increase unprofitable
  - Implication 2: At the profit-maximizing price, a monopolist will not be able to profitably increase its price, much less increase its price by a SSNIP
  - Implication 3 (the *Cellophane* fallacy): Using prevailing prices, the hypothetical monopolist test will reject a perfectly or close to perfectly monopolized market as a relevant market
- The *Cellophane* case<sup>1</sup>
  - In 1947, the DOJ sued DuPont for monopolizing cellophane, a flexible wrapping material duPont had developed, through anticompetitively restrictive patent practices
  - The Court evaluated the relevant market using duPont's prevailing prices for cellophane
  - At these prices, other wrapping materials—including aluminum foil and Saran wrap—exhibited significant cross-elasticity with cellophane
  - *Court's conclusion*: In the proper relevant market of all flexible wrapping paper, cellophane's relatively small market share negated the DOJ's monopolization claim
- Implications for the hypothetical monopolist test
  - The profit-maximization version of the hypothetical monopolist test is more susceptible to the *Cellophane* fallacy than the profitability version, since it is more likely to reject close-to-monopolized markets

<sup>1</sup> United States v. E.I. du Pont de Nemours & Co., 351 U.S. 377 (1956) ("Cellophane").

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# Relevant Geographic Markets

# Relevant geographic markets

## ■ Definition

- For each relevant product market, there is one or more associated relevant geographic markets
- A single firm may operate in a number of different geographic markets
  - For example, a dialysis firm operating in a retail dialysis product market can operate in multiple distinct geographic markets
- Relation to the sales area of the merging parties
  - The relevant geographic market is not necessarily, and indeed frequently is not, congruent with the sales area of one or both of the merging parties
  - The boundaries of the relevant geographic market turn not on where customers in fact have gone to purchase the relevant product, but rather where they practically could go to protect themselves in the event the merger or acquisition was in fact anticompetitive

# Relevant geographic markets

- Judicial tests: *Philadelphia National Bank*
  - Defined the relevant geographic market to be “the area of effective competition . . . in which the seller operates, and to which the purchaser can practically turn for supplies.”<sup>1</sup>
  - The Court also observed that an element of “fuzziness would seem inherent in any attempt to delineate the relevant geographic market” and that the market need not be defined by “metes and bounds as a surveyor would lay off a plot of ground.”<sup>2</sup>
  - Can be applied separately from the test for relevant product market definition
- Merger Guidelines test
  - Hypothetical monopolist test
    - Applied to simultaneously to the candidate product market and the associated candidate geographic market

<sup>1</sup> United States v. Philadelphia Nat’l Bank, 374 U.S. 321, 359 (1963) (emphasis removed) (quoting Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320, 327 (1961) (Sherman Act § 2).

<sup>2</sup> *Id.* at 360 n.37; see United States v. Connecticut Nat’l Bank, 418 U.S. 656, 669 (1974) (geographic markets “need not—indeed cannot—be defined with scientific precision”).

# Relevant geographic markets

- Geographic markets are often stipulated by the parties
  - In many mergers, there is no serious dispute over geographic market definition
    - Example 1: National markets
      - Where manufacturers produce products at a single location, but ship and sell nationally at no competitive disadvantage, the relevant geographic market is usually found to be national
    - Example 2: Regional or local markets
      - Where a firm and its rivals sell their product only in a limited geographic area and their customers have no ready access to an outside source of supply, the general rule is to define the geographic market as that particular area and to include only sales made within the market
  - Notable exceptions where geographic market definition can be highly contentious:
    - Products sold in retail stores and purchased by end-user consumers
      - So that consumers have to travel to the retail stores
      - Broadly defined to include, for example, grocery stores, department stores, banks, hospitals, dialysis clinics
    - Intermediate products with high transportation costs relative to their prices
      - So that it is costly to ship products to customers (e.g., glass beer bottles shipped to breweries)

<sup>1</sup> 1992 Horizontal Merger Guidelines § 1.21.

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# The *PNB* Presumption

# United States v. Philadelphia National Bank

## ■ Background

- Decided in 1963, during the “restrictive” post-war period of antitrust law between 1946-1973
- Perhaps the single most important case in merger antitrust law

## ■ Market environment

- Merger of two banks in the four-country Philadelphia metropolitan area
  - PNB (#1 w/21% total assets) to acquire Girard Corn Exchange Bank (#3 w/16% total assets) → Combined bank (#1 w/36% total assets)
- Area experienced a trend toward concentration: Since 1950—
  - 7-FCR: 61% → 90%
  - PNB made 9 acquisitions representing 59% of its growth
  - Girard made 6 acquisitions, representing 85% of its growth
- Acquisition would significantly increase concentration
  - 2-FCR: 44% → 59% (assets)
  - 4-FCR: \_\_\_% → 78% (assets)<sup>1</sup>

The “*n*-FCR” is the *n*-firm concentration ratio, that is, the sum of the market share of the largest *n* firms in the market.

<sup>1</sup> The opinions do not contain sufficient information to determine the premerger 4-FCR.



# United States v. Philadelphia National Bank

## ■ District court

- E.D. Pa.: Dismissed complaint on merits
  - Section 7 was inapplicable to the transaction
    - Section 7 applies to asset acquisitions only by “corporations subject to the jurisdiction of the Federal Trade Commission”
    - Banks are excluded from FTC jurisdiction under FTC Act § 5
    - The district court deemed the merger to be an asset acquisition for Section 7 purposes
  - But even assuming Section 7 applied, the transaction was not likely to substantially lessen competition because PNB and Girard actively compete in commercial banking with other banks throughout the northeastern United States
- United States appealed directly to the Supreme Court under the Expediting Act

# United States v. Philadelphia National Bank

- Supreme Court: Reversed with instructions to enter an injunction
  - Majority: Brennan for a 6-member majority
    - Created in 1963 as the Court was becoming increasingly restrictive on business
      - Next merger antitrust case after *Brown Shoe*
      - Written by Richard Posner, law clerk to Justice Brennan (who did not like to draft opinions)
    - Section 7 applies to mergers
      - Within the statutory scheme (especially after the 1950 Celler-Kefauver Amendments), mergers are better viewed as stock acquisitions
      - Section 7 reaches any stock acquisition by a corporation (whether or not within the jurisdiction of the FTC)
    - Product market: Commercial banking
    - Geographic market: Four-county Philadelphia metropolitan region

# The *PNB* presumption

“This intense congressional concern with the trend toward concentration warrants dispensing, in certain cases, with elaborate proof of market structure, market behavior, or probable anticompetitive effects. Specifically, we think that a merger which **produces a firm controlling an undue percentage share of the relevant market**, and **results in a significant increase in the concentration of firms** in that market is so inherently likely to lessen competition substantially that it must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anticompetitive effects.”<sup>1</sup>

## □ Requires—

- The combined firm to pass some (undefined) threshold of market share, *and*
- The increase in market concentration caused by the transaction

NB: The opinion is careful to note that it is not setting a lower bound and that commentators have suggested 20% as a threshold of “undue” market share

## □ Supposed to reflect the latest in economic thinking in the then prevailing structure-conduct-performance paradigm

- “[T] the test is fully consonant with economic theory.”<sup>2</sup>
- “[C]ompetition is greatest when there are many sellers, none of which has any significant share.”<sup>3</sup>

<sup>1</sup> United States v. Philadelphia National Bank, 374 U.S. 321, 363 (1963).

<sup>2</sup> *Id.* (citing extensively to structure-conduct-performance literature).

<sup>3</sup> *Id.*

# The *PNB* presumption

- Application in *Philadelphia National Bank*
  - Combined firm had at least a 30% share in the relevant market
    - Enough for an “undue market share”
  - Share of the two largest banks in the relevant market should increase from 44% to 59%:
    - Enough for a “significant increase” in market concentration
  - *Court’s conclusion: PNB* presumption satisfied
  - Nothing in record to rebut presumption
    - District court’s reliance on testimony by competitors that competition was vigorous and would continue to be vigorous post-merger misplaced
      - Problem was too complex
      - Witnesses failed to give “concrete reasons” for conclusions
    - Summarily rejects testimony as sufficient to establish that dissatisfied customers can turn to one of 40 other banks in four-county region
      - Outside of outright monopoly, customer always has alternatives
      - Purpose of statute is to arrest tendency to monopoly in incipency; purpose ill-served if law could not act until customer choice has largely disappeared
        - *Query: At what point do you worry?*
      - Testimony provided by small bank competitors must treat skeptically
      - Barriers to entry (primarily in government regulation)
      - Government regulation insufficient to ensure competition

# Problems with the *PNB* presumption

- Presumption depends critical on boundaries of the relevant market, but there was no economically sound test for market definition to use when applying the *PNB* presumption
- The “Potter Stewart rule”
  - In the absence of a test, courts generally defer to the government’s alleged market definition
  - So if the government gets to define the market, it essentially can ensure that the market shares will trigger the *PNB* presumption of anticompetitive effect

The sole consistency that I can find is that in litigation under § 7, the Government always wins.<sup>1</sup>

- Although originally created as a rebuttable presumption, soon treated by lower courts as a conclusive presumption—essentially admitted no defenses

<sup>1</sup> United States v. Von’s Grocery Store, 384 U.S. 270, 301 (1966) (Stewart, J., dissenting).

# Some early Supreme Court precedents

- The Court in the 1960s was very aggressive on the market share thresholds of the *PNB* presumption
  - Brown Shoe/Kinney (1962)
    - Combined share of as little as 5% in an unconcentrated market
  - Von's Grocery/Shopping Bag Food Stores (1966)
    - 4.7% (#3) + 4.2% (#6) → 8.9% (#2) in an unconcentrated market
  - Pabst Brewing/Blatz Brewing (1966)
    - 3.02% (#10) + 1.47% (#18) → 4.49% (#5) in an unconcentrated market

*Bottom line:* Through the 1960s and into the 1970s, antitrust law prevented most significant horizontal mergers and acquisitions

<sup>1</sup> Brown Shoe Co. v. United States, 370 U.S. 294 (1962).

<sup>2</sup> United States v. Von's Grocery Co., 384 U.S. 270 (1966).

<sup>3</sup> United States v. Pabst Brewing Co., 384 U.S. 546 (1966).

# United States v. General Dynamics Corp.

- In the 1970s, the economy took a downturn
  - Significant inflation as a result of the debt financing of the Vietnam war and the Mideast oil shocks
  - Substantial concern about U.S. competitiveness in the world market
- General Dynamics (1974)<sup>1</sup>
  - DOJ action—Filed September 22, 1967
    - DOJ relied on PNB presumption
      - 1959: 15.1% (#1) + 8.1% (#5) → 23.2% (#1) (in Illinois market)
      - 1967: 12.9% (#2) + 8.9% (#6) → 21.8% (#2) (in Illinois market)
      - Increasing concentration
    - Supreme Court—No violation
      - Agreed that DOJ's evidence triggered *PNB* presumption
      - BUT defendants rebutted presumption ←
        - Since competition was manifested more in rivalry for new long-term contracts, and since the ability to compete for long-term contracts depended on available coal reserves, share of uncommitted reserves a better measure of future competitive significance
        - United Electric's uncommitted reserves very weak → DOJ's prima facie case rebutted
  - There has been no significant merger antitrust case on the merits in the Supreme Court since *General Dynamics* in 1974

*Key: General Dynamics reestablished the PNB presumption as rebuttable by showing that the merger would not increase the exercise of market power*

<sup>1</sup> United States v. General Dynamics Corp., 415 U.S. 486 (1974).

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# Defenses



# Defenses to anticompetitive effect

- Common defenses
  - Entry/expansion/repositioning
  - Power buyers
  - Efficiencies
  - Failing firm
- Defenses are negative defenses, not affirmative defenses
  - A negative defense says that the merger is not anticompetitive in the first instance
  - An affirmative defense says that even if the merger is anticompetitive, it is nonetheless not unlawful
- *Baker Hughes* burden shifting
  - Formally, the plaintiff can make out its prima facie case on the *PNB* presumption without addressing any defense
  - The defendant has the burden of going forward with evidence predicating the defense (including challenging the *PNB* presumption)
  - If the defendant adduces sufficient evidence to permit the trier of fact to find for the defendant on the defense, then the plaintiff has the burden of persuasion shifts on the ultimate question of whether the merger, with all evidence taken as a whole, is anticompetitive

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# Entry/Expansion/Repositioning Defenses

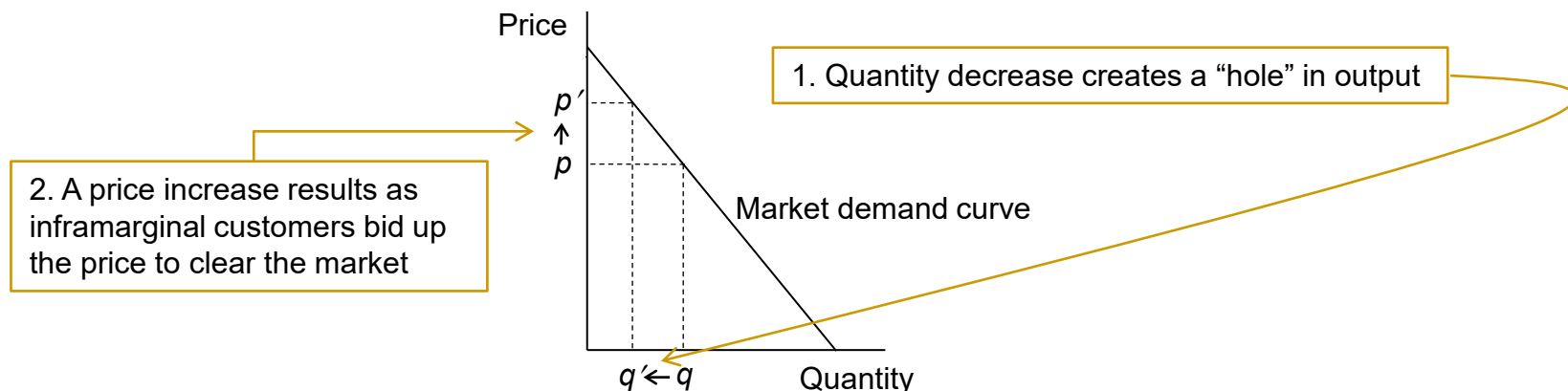
REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 9

# Entry/Expansion/Repositioning

## ■ The story

### □ General idea

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



- 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 product lines in product or geographic space to replace output losses resulting from unilateral effects
- Proof of 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

# Entry/Expansion/Repositioning

- The Merger Guidelines<sup>1</sup>
  - The formalities
    - 1982 and 1992: Depended largely on actual entry having a significant impact within two years of the merger
      - This allows 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
  - Guidelines requirements—Entry must be:
    - Timely
    - Likely
    - Sufficient
  - Courts have adopted these requirements

<sup>1</sup> References to entry in this section also include expansion and repositioning.

# Entry/Expansion/Repositioning

## ■ The Merger Guidelines<sup>1</sup>

### 1. Timely

- “In order to deter the competitive effects of concern, entry must be rapid enough to make unprofitable overall the actions causing those effects . . . .”
- “Even if the prospect of entry does not deter the competitive effects of concern, post-merger entry may counteract them. This requires that the impact of entrants in the relevant market be rapid enough that customers are not significantly harmed by the merger, despite any anticompetitive harm that occurs prior to the entry.”
- “The Agencies will not presume that an entrant can have a significant impact on prices before that entrant is ready to provide the relevant product to customers unless there is reliable evidence that anticipated future entry would have such an effect on prices.”

### 2. 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.”
- “Profitability depends upon (a) the output level the entrant is likely to obtain, accounting for the obstacles facing new entrants; (b) the price the entrant would likely obtain in the post-merger market, accounting for the impact of that entry itself on prices; and (c) the cost per unit the entrant would likely incur, which may depend upon the scale at which the entrant would operate. “

<sup>1</sup> All quotations are from 2010 DOJ/FTC Horizontal Merger Guidelines § 9.

# Entry/Expansion/Repositioning

## ■ The Merger Guidelines<sup>1</sup>

### 3. Sufficient

- Even where timely and likely, entry must be sufficient to deter or counteract the competitive effects of concern
  - “For example, in a differentiated product industry, entry may be insufficient because the products offered by entrants are not close enough substitutes to the products offered by the merged firm to render a price increase by the merged firm unprofitable.”
  - “Entry may also be insufficient due to constraints that limit entrants’ competitive effectiveness, such as limitations on the capabilities of the firms best placed to enter or reputational barriers to rapid expansion by new entrants.”
- Sufficient condition for sufficiency
  - “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.”

<sup>1</sup> All quotations are from 2010 DOJ/FTC Horizontal Merger Guidelines § 9.

# Entry/Expansion/Repositioning

## ■ Likelihood of a successful defense

- Almost impossible to make out 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—Firm has not considered entry and does not know what it would do
    - Can be a “go away staff” reaction—Firm may appreciate that if it answer “yes” the staff will begin a much more detailed investigation to determine whether the firm is in fact likely to enter. This will not be pleasant for the firm.
    - Can be an informed “no”: If the firm has not already entered or is not actively considering entry, the likelihood is that a relatively small increase in margin will not cause it to enter, especially since its entry is likely to increase postmerger competition and decrease postmerger margins below the SSNIP
      - *Note:* 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 enter. 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.
- Barriers to entry: Some examples

Capital requirements

Patents/other IP

Skilled employees

Development time

Reputation

Skilled sales reps

Regulatory barriers

Skilled management

# Entry/Expansion/Repositioning

- Burden of proof/likelihood of a successful defense
  - When has the defense been successful?
    - When there has been a significant history of entry and the market has continued to operate competitively even with variations in concentration levels
    - When the market is operating premerger close to competitively and a significant firm is already planning on entering
      - NB: Technically, this should not work. If the new entrant was already planning on entering absent the challenged merger, then on a going-forward basis the new entrant would be a committed entrant and should already be considered a market participant in the competitive analysis and not a new entrant. Only when the merger precipitates the entry should the entry defense be applied.
      - But if the market was operating premerger close to competitively, then the presence of an additional firm in the postmerger market may be enough to negate any anticompetitive effect of the merger. So there is a defense; it is just not an entry defense.
      - The key here is the market must be close to operating competitively premerger. But in highly concentrated markets this may not make sense
      - Suppose that there are two incumbent firms, which are merging, and a third firm in the process of entering with the prospect of gaining significant market share. The merging parties are likely to argue that, in light of the pending entry, the transaction is a 2-to-2 merger and therefore should not be challenged<sup>1</sup>
      - But if the third firm had already entered some time ago and actually gained significant share, then the transaction would be a 3-to-2 merger, which would likely be challenged. Why then should the pending entry of a new firm serve as a defense to a 2-to-1 merger?

<sup>1</sup> FTC v. Staples, Inc., No. CV 15-2115 (EGS), 2016 WL 2899222, at 22 (D.D.C. May 17, 2016) (making entry defense, which the court considered but rejected for lack of sufficient evidence that Amazon Business would restore lost competition).



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# Powerful Buyers Defenses

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 8

# Power buyers defense<sup>1</sup>

- The idea
  - The upward pricing pressure that otherwise would be created by a merger is negated by the ability of buyers to “force” the combined company to charge premerger prices in the postmerger period

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<sup>1</sup> See U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines § 8 (rev. 2010).

# Power buyers defense

- *Key question #1: What is the mechanism by which this “forcing” takes place?*
  - The agencies will not assume that a buyers can ensure that its suppliers will act competitively postmerger simply because the buyer is large and sophisticated
  - There are three (and perhaps only three) situations when a buyer may be able to protect itself from an anticompetitive merger:
    1. *Share shifting*: Where the purchases of the product by the buyer from the merged firm are sufficiently large that a shift of some or all of these purchases to alternative suppliers would make the price increase to that buyer unprofitable
      - This requires that sufficient alternative suppliers be available to the power buyer
      - The buyer does not have to shift all of its purchases from the merged firm. It only needs to be able to shift enough to make the price increase unprofitable to the merged firm.
    2. *Inducing entry*: Where the purchases of the product by the buyer are sufficiently large that the buyer could sponsor the entry of a minimum efficient scale firm to supply the buyer
    3. *Vertical integration*: A special case of sponsored entry where the buyer itself vertically integrates into production of the input
  - Even when there is an arguable mechanism for a given buyer, the defense is likely to fail for lack of sufficient evidence if—
    1. the putative power buyer does not support the defense, OR
    2. there is evidence of historical episodes where the putative power buyer (or a similarly situated firm) has not been able to prevent a merged firm from raising prices to it

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# Power buyers defense

- *Key question #2: Are all of the purchasers in the market able to protect themselves*
  - Even if some buyers could protect themselves from a price increase in the wake of an otherwise anticompetitive merger, other buyers may not be able to do so and the merger will be anticompetitive with respect to these other (targeted) buyers

# Power buyers defense

- *Key question #3*: Is the only anticompetitive effect threatened by the merger an anticompetitive price increase or output reduction?
  - Power buyer defenses work best, if they work at all, against postmerger price increases or output reductions
  - Other types of anticompetitive effects, especially a reduction in the rate of innovation or product improvement, are much more difficult to negate
    - The buyer may not perceive a reduction postmerger
    - Even if the buyer does perceive a reduction postmerger, it may not be able to trace the reduction to an anticompetitive effect from the merger (as opposed to other, nonreaddressable causes)
    - *Example*: While it is easy (in principle) to direct a seller to maintain premerger prices and other terms postmerger, it is much more difficult to direct the merged firm “to continue to innovative at premerger rates”

# Power buyers defense

## ■ Other observations

- The parties bear the burden of production of evidence of a mechanism that would be sufficient to negate the upward pricing pressure that the merger otherwise would have
  - Under *Baker-Hughes*, the ultimate burden of persuasion should be on the plaintiffs in Step 3<sup>1</sup>
- The standard bargaining models used by the agencies predict that buyers, no matter how large or sophisticated they are, will not be able to negate the entirety of a postmerger price increase if the merger increases the combined firm's market power (Nash bargaining models)

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<sup>1</sup> See *FTC v. Sanford Heath*, 926 F.3d 959, 965 (8th Cir. 2019).

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# Efficiencies Defenses

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 10

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# Efficiencies

- Basic idea

- “Efficiencies” are loosely defined to be benefits that result from the deal
  - These are also called “synergies” or “strategic benefits”



# Efficiencies

## ■ Types of efficiencies

### □ Cost efficiencies

- These are reductions in the fixed or variable costs of operation and production that result from the deal

### ■ Types of cost efficiencies

#### □ Reductions in fixed costs

- *Fixed costs* are costs that do not change with the level of production—that is, they are expenses that have to be paid by a company, independent of any business activity
- Some fixed costs may be incurred only once, such as the building cost for a new facility
- Other fixed costs may be recurring, such as the compensation for the CEO, the annual maintenance costs for the headquarters building, the annual interest on the company's debt, insurance costs, and property taxes
- Fixed cost efficiencies usually result from the elimination of duplicative costs: the combined company does not need two CEOs, two headquarters buildings, or two back office accounting systems

#### □ Reductions in variable costs

- *Variable costs* are costs that depend on the level of output
- Economies of scale or scope (one factory or one sales force may be able to handle the production and sales of both companies)
- The combination of complementary technical assets and skills (the combined company may be able to produce products with lower costs or better products faster).

#### □ Reductions in marginal cost

### □ Others (e.g., R&D)

# Efficiencies

## ■ Types

- Cost efficiencies (fixed and marginal cost)
- Others (e.g., R&D)

## ■ Cost efficiencies

- Most common in merger defenses
- Consider the firm's profit maximization problem:

$$\pi = p(q)q - (f + cq)$$

where  $f$  is fixed cost and  $c$  is constant marginal cost.

The first order condition for a profit maximum is:

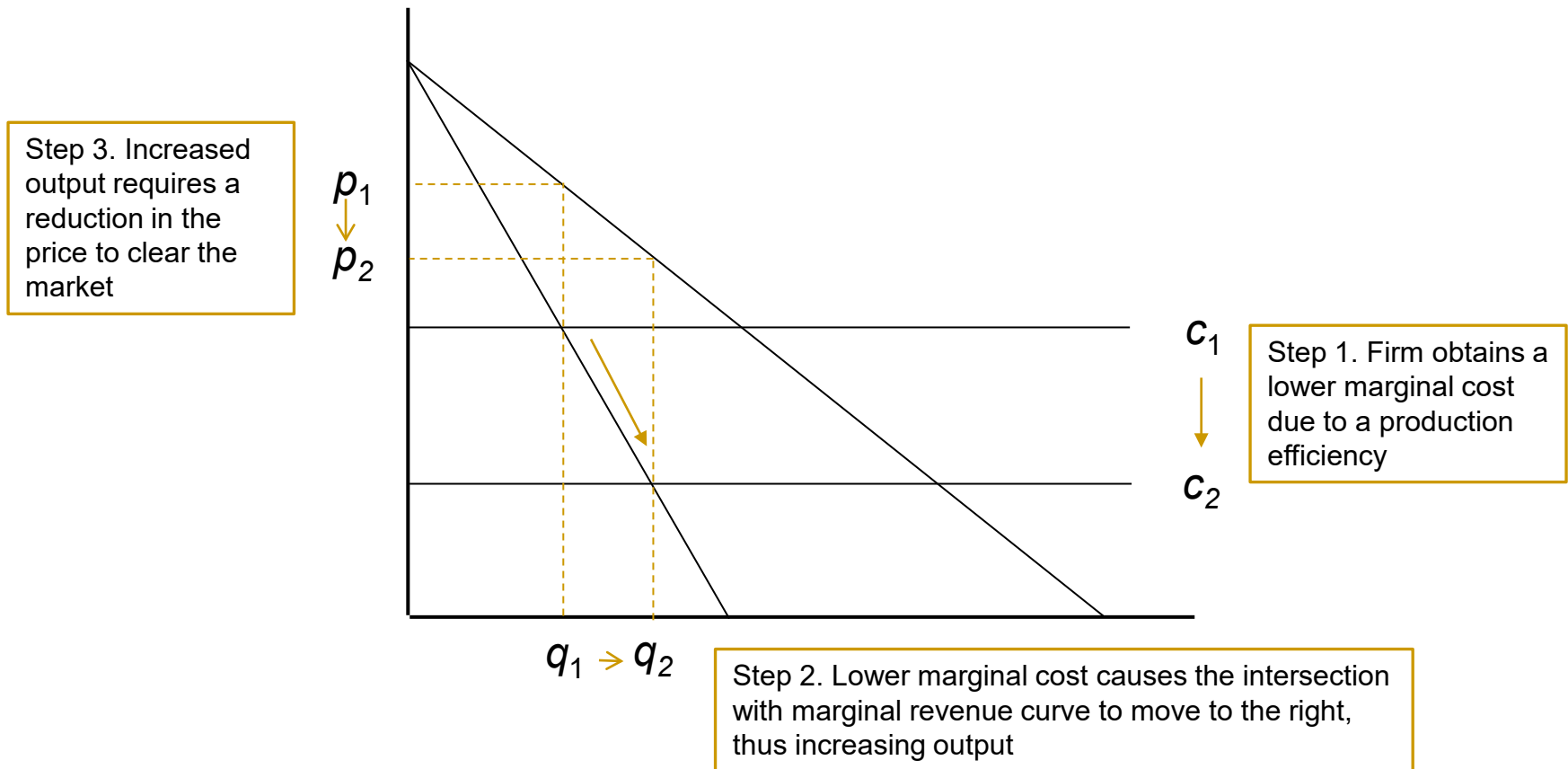
$$\frac{d\pi}{dq} = p + q \frac{dp}{dq} - c = 0,$$

that is, marginal revenue equals marginal cost

- Note that in this model changes in fixed costs  $f$  have no effect on the first order condition and therefore no effect on postmerger prices
  - As a result, changes in fixed costs are usually disregarded by the agencies in the HSR review. *Query*: Are they also disregarded by courts?

# Efficiencies

- But a change in  $c$  can affect prices
  - *Rule:* A reduction in marginal cost will even cause a profit-maximizing monopolist to lower price



# Efficiencies

## ■ Efficiencies as a merger defense under the Merger Guidelines

### □ Basic idea

[A] primary benefit of mergers to the economy is their potential to generate significant efficiencies and thus enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products. For example, merger-generated efficiencies may enhance competition by permitting two ineffective competitors to form a more effective competitor, e.g., by combining complementary assets. In a unilateral effects context, incremental cost reductions may reduce or reverse any increases in the merged firm's incentive to elevate price. Efficiencies also may lead to new or improved products, even if they do not immediately and directly affect price. In a coordinated effects context, incremental cost reductions may make coordination less likely or effective by enhancing the incentive of a maverick to lower price or by creating a new maverick firm. Even when efficiencies generated through a merger enhance a firm's ability to compete, however, a merger may have other effects that may lessen competition and make the merger anticompetitive.<sup>1</sup>

### □ Examples of how efficiencies can offset the anticompetitive effects a merger would otherwise have:

- Create a more effective competitor by combining complementary assets (e.g., IP rights)
- Offset the unilateral anticompetitive effect by sufficiently reducing marginal costs
- Diminish incentives for coordinated interaction by creating a firm with the cost structure to engage in disruptive conduct

<sup>1</sup> 2010 DOJ/FTC Horizontal Merger Guidelines § 10.

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# Efficiencies

- Efficiencies as a merger defense under the Merger Guidelines
  - Four requirements
    1. Merger specificity
    2. Verifiability
    3. Sufficiency
    4. Not anticompetitive

# Efficiencies

- Efficiencies as a merger defense under the Merger Guidelines
  1. Are the alleged efficiencies *merger specific*?

The Agencies credit only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies.<sup>13</sup> Only alternatives that are practical in the business situation faced by the merging firms are considered in making this determination. The Agencies do not insist upon a less restrictive alternative that is merely theoretical.

<sup>13</sup> The Agencies will not deem efficiencies to be merger-specific if they could be attained by practical alternatives that mitigate competitive concerns, such as divestiture or licensing. If a merger affects not whether but only when an efficiency would be achieved, only the timing advantage is a merger-specific efficiency.

# Efficiencies

## ■ Efficiencies as a merger defense under the Merger Guidelines

### 1. Are the alleged efficiencies *merger specific*?

#### ■ The “would”/”could” debate

- *Could* the efficiencies be achieved in the absence of the transaction? Or is the right question “*Would* they be achieved in the absence of the transaction”?
- Although the Merger Guidelines ask the second question, in practice the agencies (and to an extent the courts) ask only the first question
  - WDC: Even apart from the language of the Guidelines, this is analytically a mistake. The antitrust laws are concerned with competition as it occurs in the marketplace. If a firm “could” theoretically achieve the efficiency in question absent the merger but has indicated no interest or intent to do so, but the efficiency would occur if the merger takes place, why regard this efficiency as not cognizable? If the efficiencies were large enough to offset the gross anticompetitive effect, then rejecting the defense under the “could” standard only deprives consumers of the benefits of efficiencies that they would otherwise receive if the defense was permitted and the merger was allowed to take place.
  - *Example*: Firm 1 may be able to develop a better formula for baby food if it makes a large investment, but it would rather use the funds for another investment. Firm 2 has a better formula that could easily be transfer to Firm 1. The transfer would be consider a cognizable efficiency under the “would” standard but not under the agencies’ “could” standard.

# Efficiencies

## ■ Efficiencies as a merger defense under the Merger Guidelines

### 2. Are the alleged efficiencies *verifiable*?

[I]t is incumbent upon the merging firms to substantiate efficiency claims so that the Agencies can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific.

- Have the efficiencies been rigorously demonstrated by the parties?
- Can they be objectively ascertained by a third party?
  - The agencies usually regard this “third party” as an accountant or an economist, who typically lack experience and expertise in the industry in question
    - The agencies' use of “experts” who lack knowledge or judgment about the business operations in question can often lead them to reject of a legitimate efficiency simply because the agency's expert does not understand it
  - Courts are trending this way as well
  - The merging parties may be able to mitigate this problem somewhat by retaining an outside industry expert to present to the investigating agency or court



# Efficiencies

## ■ Efficiencies as a merger defense under the Merger Guidelines

### 3. Are the alleged efficiencies *timely and sufficient*?

[I]t is incumbent upon the merging firms to substantiate efficiency claims so that the Agencies can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific.

- Will the claimed efficiency occur in time and with sufficient magnitude to offset the anticompetitive effects of the merger that would be likely to occur in the absence of the efficiencies?
- NB: Inherent in sufficiency is the requirement that to be cognizable the efficiencies must be passed to consumers and not retained by the merged firm<sup>1</sup>

Very important

<sup>1</sup> See, e.g., *FTC v. Univ. Health, Inc.*, 938 F.2d 1206, 1223 (11th Cir. 1991); *New York v. Deutsche Telekom AG*, No. 19 CIV. 5434 (VM), 2020 WL 635499, at \*96 (S.D.N.Y. Feb. 11, 2020); *United States v. Aetna Inc.*, 240 F. Supp. 3d 1, 9 (D.D.C. 2017); *United States v. H & R Block, Inc.*, 833 F. Supp. 2d 36, 87 (D.D.C. 2011); *FTC v. Swedish Match*, 131 F. Supp. 2d 151, 172 (D.D.C. 2000); *FTC v. Cardinal Health, Inc.*, 12 F. Supp. 2d 34, 62 (D.D.C. 1998); *United States v. Long Island Jewish Med. Ctr.*, 983 F. Supp. 121, 149 (E.D.N.Y. 1997).

# Efficiencies

## ■ Efficiencies in court

- Judicial skepticism: The Supreme Court has cast doubt on an efficiencies defense in three cases

1. In *Brown Shoe*, the Supreme Court, though acknowledging that mergers may sometimes produce benefits that flow to consumers, stated:

“Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization.”<sup>1</sup>

2. In *Philadelphia National Bank*, the Court observed:

a merger the effect of which “may be substantially to lessen competition” is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial.... Congress determined to preserve our traditionally competitive economy. It therefore proscribed anticompetitive mergers, the benign and the malignant alike, fully aware, we must assume, that some price might have to be paid.<sup>2</sup>

<sup>1</sup> *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962).

<sup>2</sup> *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 371 (1963).

# Efficiencies

## ■ Efficiencies in court (con't)

### □ Judicial skepticism (con't)

3. In *Procter & Gamble*, the Supreme Court enjoined a merger without any consideration of evidence that the combined company could purchase advertising at a lower rate:

“Possible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition.”<sup>1</sup>

- Significantly, in these older cases an accepted goal of antitrust law was the protection of small business
- In light of these Supreme Court statements, even modern lower courts have expressed skepticism that an efficiencies defense exists<sup>2</sup>

<sup>1</sup> *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 580 (1967) (citing *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962)).

<sup>2</sup> See *United States v. Anthem, Inc.*, 855 F.3d 345, 353-54 (D.C. Cir. 2017) (expressing doubts about an efficiency defense in light of *Procter & Gamble*, which has never been overruled); *FTC v. Penn State Hershey Med. Ctr.*, 838 F.3d 327, 348-49 (3d Cir. 2016).

# Efficiencies

## ■ Efficiencies in court (con't)

- That said, other modern lower courts recognize that efficiencies resulting from the merger may be considered in rebutting the government's *prima facie* case

- Here are two typical statements:

- *Advocate Health Care*:

Although the defense has never been sanctioned by the Supreme Court, the Horizontal Merger Guidelines and some lower courts recognize that defendants in a horizontal merger case may rebut the government's *prima facie* case by presenting evidence of efficiencies offsetting the anticompetitive effects.<sup>1</sup>

- *Penn State Hershey Medical Center*:

Remaining cognizant that the “language of the Clayton Act must be the linchpin of any efficiencies defense,” and that the Clayton Act speaks in terms of “competition,” we must emphasize that “a successful efficiencies defense requires proof that a merger is not, despite the existence of a *prima facie* case, anticompetitive.”<sup>2</sup>

The efficiencies defense, on the other hand, is a means to show that any anticompetitive effects of the merger will be offset by efficiencies that will ultimately benefit consumers.<sup>3</sup>

<sup>1</sup> FTC v. Advocate Health Care, No. 15 C 11473, 2017 WL 1022015, at \*12 (N.D. Ill. Mar. 16, 2017) (entering preliminary injunction on remand).

<sup>2</sup> FTC v. Penn State Hershey Med. Ctr., 838 F.3d 327, 349 (3d Cir. 2016).

<sup>3</sup> *Id.*

# Efficiencies

## ■ Efficiencies in court (con't)

- That said, some modern lower courts recognize that efficiencies resulting from the merger may be considered in rebutting the government's prima facie case

### 1. Interpretation

- The most sensible way to read this statement is that efficiencies can be used as a *negative* defense to disprove the anticompetitive effect element of the prima facie case<sup>1</sup>
- But they cannot be used to as an *affirmative* defense to permit a merger that has the requisite anticompetitive effect in the relevant market<sup>2</sup>
- This distinction essentially reflects a consumer welfare standard over a total welfare standard

<sup>1</sup> See, e.g., *FTC v. Univ. Health, Inc.*, 938 F.2d 1206, 1222 (11th Cir. 1991) (“It is clear that whether an acquisition would yield significant efficiencies in the relevant market is an important consideration in predicting whether the acquisition would substantially lessen competition.”).

<sup>2</sup> See, e.g., *Univ. Health*, 938 F.3d at 1222 n.29 (“Of course, once it is determined that a merger would substantially lessen competition, expected economies, however great, will not insulate the merger from a section 7 challenge.”).

# Efficiencies

## ■ Efficiencies in court (con't)

- That said, some modern lower courts recognize that efficiencies resulting from the merger may be considered in rebutting the government's prima facie case

### 2. Difficulty in application

- Plaintiffs establish their prima facie case through the *PNB* presumption and additional supporting evidence of unilateral and/or coordinated effects, which collectively gives a qualitative result that the merger is presumptively likely to substantially lessen competition and harm consumers
- But how is the qualitative result to be negated by a showing of efficiencies, even if the efficiencies are in some way quantified?
- Example: *Penn State Hershey Medical Center*:

Irrespective of whatever benefits the merger may bestow upon the Hospitals in increasing their ability to engage in risk-based contracting, the Hospitals must demonstrate that such a benefit would ultimately be passed on to consumers. It is not clear from the record how this would be so beyond the mere assertion that it would save the Hospitals money and such savings would be passed on to consumers.<sup>1</sup>

- Practical solution
  - Defendants must find customer-witnesses that would be harmed if the transaction was in fact anticompetitive who would testify that they believe that the balance of the merger's harmful and beneficial effects will be procompetitive (i.e., beneficial to customers), or, more precisely, not anticompetitive
  - Since the defendants must at least make a prima facie case that the efficiencies will offset any of the merger's anticompetitive tendencies, the defendants' failure to adduce such evidence is likely to result in a rejection of their efficiencies defense

<sup>1</sup> FTC v. Penn State Hershey Med. Ctr., 838 F.3d 327, 349 (3d Cir. 2016).

# Efficiencies

## ■ Efficiencies in court (con't)

### □ “Pass on”

- In any event, claimed efficiencies can offset an anticompetitive effect on consumers only to the extent that the efficiencies are “passed on” by the merged company to the consumers that otherwise would be competitively harmed.
- *Anthem* court:

[T]he claimed medical cost savings only improve consumer welfare to the extent that they are actually passed through to consumers, rather than simply bolstering Anthem’s profit margin. After all, the merger potentially harms consumers by creating upward pricing pressure due to the loss of a competitor, and so only efficiencies that create an equivalent downward pricing pressure can be viewed as “sufficient to reverse the merger’s potential to harm consumers . . . , e.g., by preventing price increases.”<sup>1</sup>

- In *Anthem*, the court appears to have rejected the idea that an aggregate dollar savings greater than the aggregate dollar value of an anticompetitive price increase would make out an efficiencies defense
  - That is, it is not sufficient that the gross consumer surplus from efficiencies outweigh the gross wealth transfer resulting from an anticompetitive price increase
- Rather, the court appeared to require that the downward pressure on prices from efficiencies at least offset the upward pressure on prices from the anticompetitive effect, so that there would be no net price increase to customers

<sup>1</sup> United States v. Anthem, Inc., 855 F.3d 345, 362 (D.C. Cir. 2017) (internal citations omitted); see FTC v. Penn State Hershey Med. Ctr., 838 F.3d 327, 348 (3d Cir. 2016) (“In order to be cognizable, the efficiencies must, first, offset the anticompetitive concerns in highly concentrated markets.”).

# Efficiencies

## ■ Efficiencies in court (con't)

### □ Rent shifting

- *Query*: Is a lowering of input prices due to greater bargaining power gained by the merger a cognizable efficiency when the lower prices do not reflect any production efficiency?
- *Anthem* court:

The district court also expressed doubt as to whether the type of efficiencies claimed by Anthem, which merely redistribute wealth from providers to Anthem and its customers rather than creating new value, are even cognizable under Section 7.<sup>1</sup>

- The court of appeals also expressed skepticism, but found it was unnecessary to answer the question given the facts in the case

<sup>1</sup> United States v. Anthem, Inc., 855 F.3d 345, 352 (D.C. Cir. 2017) (internal citations omitted).



# Efficiencies

## ■ Efficiencies in court (con't)

### □ Judicial practice

- Courts essentially have adopted the requirements of the Merger Guidelines<sup>1</sup>
  - “Projections of efficiencies may be viewed with skepticism, particularly if they are generated outside of the usual business planning process.”<sup>2</sup>
  - “The difficulty in substantiating efficiency claims in a verifiable way is one reason why courts generally have found inadequate proof of efficiencies to sustain a rebuttal of the government’s case.”<sup>3</sup>
- No court has yet found that the merging parties have successfully defended a merger through a showing of efficiencies

<sup>1</sup> See, e.g., *FTC v. Penn State Hershey Med. Ctr.*, 838 F.3d 327 (3d Cir. 2016) (reversing question of whether an efficiencies defense exists, but assuming it does applying the Merger Guidelines standard and finding that claimed efficiencies cannot offset the merger’s likely anticompetitive effects).

<sup>2</sup> *FTC v. ProMedica Health Sys., Inc.*, No. 3:11 CV 47, 2011 WL 1219281, at \*40 (N.D. Ohio Mar. 29, 2011) .

<sup>3</sup> *United States v. H & R Block, Inc.*, 833 F. Supp. 2d 36, 91 (D.D.C. 2011) .

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# Failing Firm Defenses

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 11

# Failing firm defense

## ■ Theory

- A “failing firm” is a firm that will exit the market *with its assets* in the absence of an acquisition
- The original idea behind a failing firm defense is that it is better to permit an “anticompetitive” acquisition than to allow the failing firm’s assets—and therefore productive capacity—to exist in the market
  - While this may sound like an affirmative defense, it is actually a negative defense.
  - If the firm’s productive capacity would exit the market in the acquisition, then it has no competitive significance going forward and its acquisition by a competitor cannot reduce competition
  - The key here is whether the firm’s productive assets would in fact exit the market in the absence of the challenged acquisition—if, in the “but for” world, the failing firm’s assets would be acquired by another firm in a transaction that would make consumers better off than with the challenged acquisition, then the challenged acquisition is anticompetitive

# Failing firm defense

- Requirements: The allegedly failing firm—
  1. would be unable to meet its financial obligations in the near future,
  2. would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act, AND
  3. has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger<sup>1</sup>
    - NB: The alternative buyer need not match the purchase price of the original buyer—as long as the alternative buyer is willing to pay a price above liquidation value the alternative buyer qualifies<sup>2</sup>

<sup>1</sup> 2010 DOJ/FTC Horizontal Merger Guidelines § 11.

<sup>2</sup> *Id.* at § 11 n. 6 (stating that a reasonable alternative offer is “[a]ny offer to purchase the assets of the failing firm for a price above the liquidation value of those assets”); see *United States v. Energy Sols., Inc.*, 265 F. Supp. 3d 415, 446 (D. Del. 2017) (quoting Horizontal Merger Guidelines).

# Failing firm defense

## ■ Observations

- The failing firm defense works in principle for a failing division or subsidiary
- The failing firm defense has had essentially no success since the Supreme Court recognized it in 1930 by the Supreme Court in *International Shoe*<sup>1</sup>
  - Even if the firm is failing in the sense that it cannot meet its financial obligations, there defense is likely to fail before the agencies and the courts because either—
    - The firm can be reorganized in bankruptcy and continue to operate without its assets existing the market, OR
    - The firm has failed to conduct the requisite search to the satisfaction of the agencies or the court for an alternative, less anticompetitive buyer

<sup>1</sup> *International Shoe Co. v. FTC*, 280 U.S. 291, 302 (1930).