Unit 9. H&R Block/TaxACT

Part 3. Downward-Pricing Pressure Defenses

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Defenses generally

- Two types of defense
  1. Defenses that attack whether the plaintiff has made out its prima facie case
     - The plaintiff's evidence fails to make out a prima facie showing of relevant product market
     - The plaintiff's evidence fails to make out a prima facie showing of relevant geographic market
     - The plaintiff's evidence fails to make out a prima facie showing of anticompetitive effect
  2. Defenses that assume arguendo that the plaintiff has proved a prima facie case but show offsetting procompetitive forces that negate any likely anticompetitive effect from the merger:
     1. Power buyers
     2. Entry/expansion/repositioning
     3. Efficiencies
     4. Failing firm

     These are the standard *downward-pricing pressure defenses*

     The plaintiff does not have to anticipate these defenses in its complaint or proof of a prima face case (defendants, however, do have to plead them as "affirmative defenses" under FRCP 12(b))
- All merger antitrust defenses are *negative* defenses, not *affirmative* defenses

Defenses generally

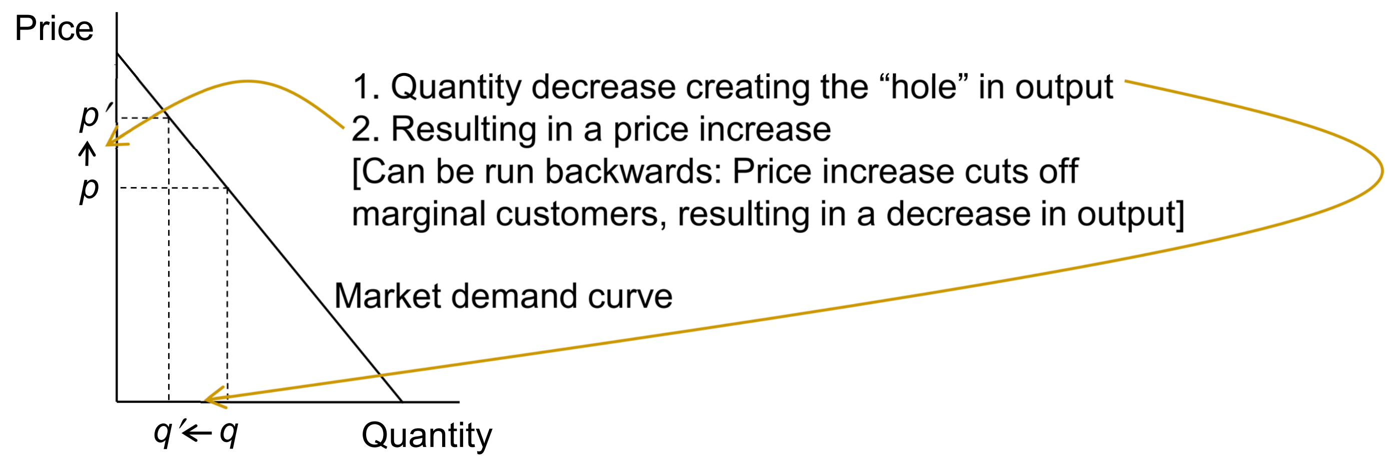
- *Baker Hughes* burden shifting
  - Formally, the plaintiff can make out its prima facie case on the *PNB* presumption without addressing any defense
  - The defendant has the burden of going forward with evidence predicating the defense (including challenging the *PNB* presumption)
  - If the defendant adduces sufficient evidence to permit the trier of fact to accept the defense, the burden of persuasion shifts to the defendant on the ultimate question of whether the merger, with all evidence taken as a whole, is anticompetitive

Entry/Expansion/Repositioning Defenses

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 9

Entry/Expansion/Repositioning

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



    - The defense depends on showing that the "hole" in the output will be filled by—
      1. New firms entering the market and adding new output
      2. Incumbent firms expanding their output over premerger levels, or
      3. Incumbent firms extending or repositioning their production in product or geographic space to replace output loses 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[1]
  - 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:
    1. Timely
    2. Likely
    3. Sufficient
  - Courts have adopted these requirements

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

Entry/Expansion/Repositioning

- The Merger Guidelines[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."
  - 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. "

[1] All quotations are from 2010 DOJ/FTC Horizontal Merger Guidelines § 9.

Entry/Expansion/Repositioning

- The Merger Guidelines[1]
  - 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."
      - *Note*: These are is a sufficient but not necessary conditions. All that is necessary is entry at a scale sufficient to fill the "hole."

[1] 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—The company has not considered entry and does not know what it would do
      - Can be a "go away staff" reaction—The company may appreciate that if it answers "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 company 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 entry. The problem is that entry can too easily precipitate a price war and destroy the pre-entry margin that made entry attractive in the first instance.

This is important!

  - 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

- When is the defense successful?
  - When the market is operating premerger close to competitively and a significant firm is already planning on entering
    - This is not technically an entry defense, since entry was not the proximate result of the merger (see the next slide)
    - Still, the agencies sometimes accept this “defense” as a matter of prosecutorial discretion
  - When there has been a significant history of entry in analogous markets, which have continued to operate competitively (“natural experiments”)
    - Think similar grocery store mergers in other parts of the country

Entry/Expansion/Repositioning

- A cautionary note
  - In some cases, the merging parties will argue that the pending entry of a new firm—that is, a firm that decided to enter the market independently of the merger—will be sufficient to prevent any anticompetitive effects from occurring
  - But is not a cognizable entry defense
    - 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[1]
    - 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?
      - Technically, for entry to be cognizable in an entry defense, the entry must be the proximate result of the merger
      - Under the Merger Guidelines, the new firm would be considered a market participant even though it was not in operation at the time of the sale, not a "new" entrant within the meaning of the entry defense

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

Efficiencies Defenses

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 10

Efficiencies

- Basic idea
  - “Efficiencies” are loosely defined to be public benefits that result from the deal
  - Contrast this with synergies, which are benefits to the merging parties resulting from the deal
    - Although sometimes the terms are used interchangeably
    - In this case, “cognizable efficiencies” is the term used to denote public benefits

Efficiencies

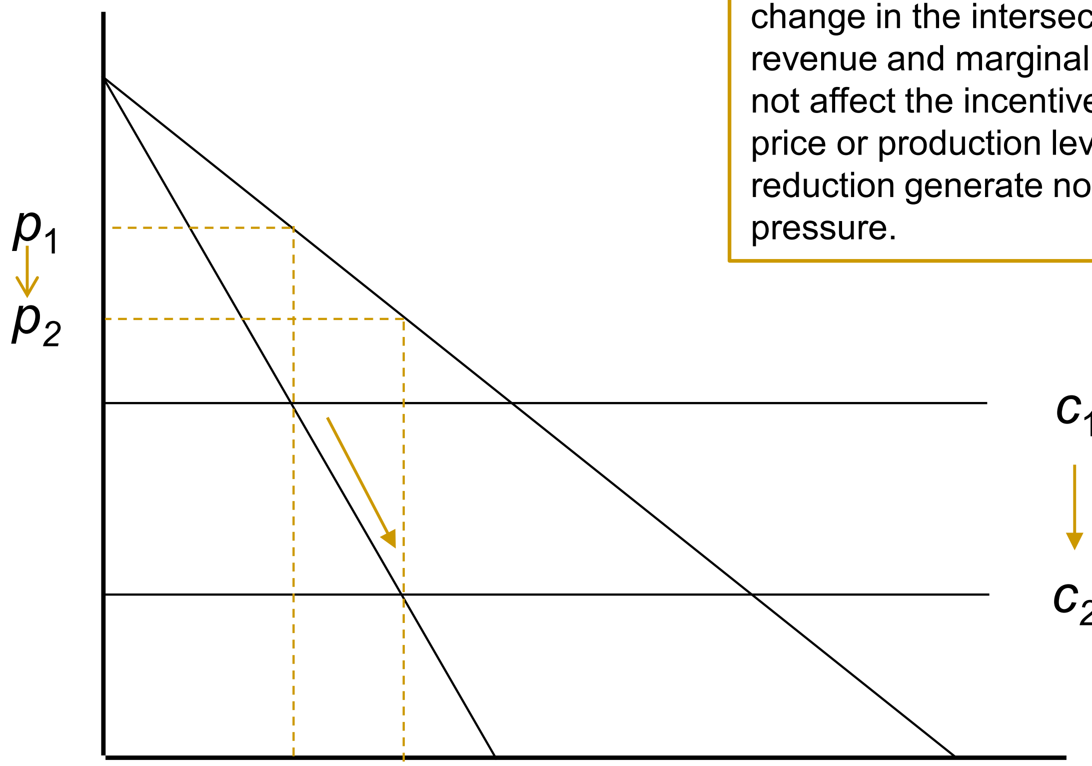
- Types of efficiencies
  - Cost efficiencies
    - Types of cost efficiencies
      - Reductions in fixed costs
        - *Fixed costs* are costs that do not change with the level of production—that is, they are expenses that have to be paid by a company, independent of any business activity
        - 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/marginal costs for a given level of production
        - *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).
  - Non-cost efficiencies
    - Increases in production
    - Improvements in product or service quality
    - Increase in the rate of R&D

Efficiencies and downward pricing pressure

- A reduction in marginal cost will even cause even a profit-maximizing monopolist to lower price

BUT NOTE: Reductions in fixed cost do *not* change in the intersection of the marginal revenue and marginal cost curves and hence do not affect the incentives of the firm to change its price or production level. Therefore, fixed cost reduction generate no downward pricing pressure.

Step 3. Increased output requires a reduction in the price to clear the market

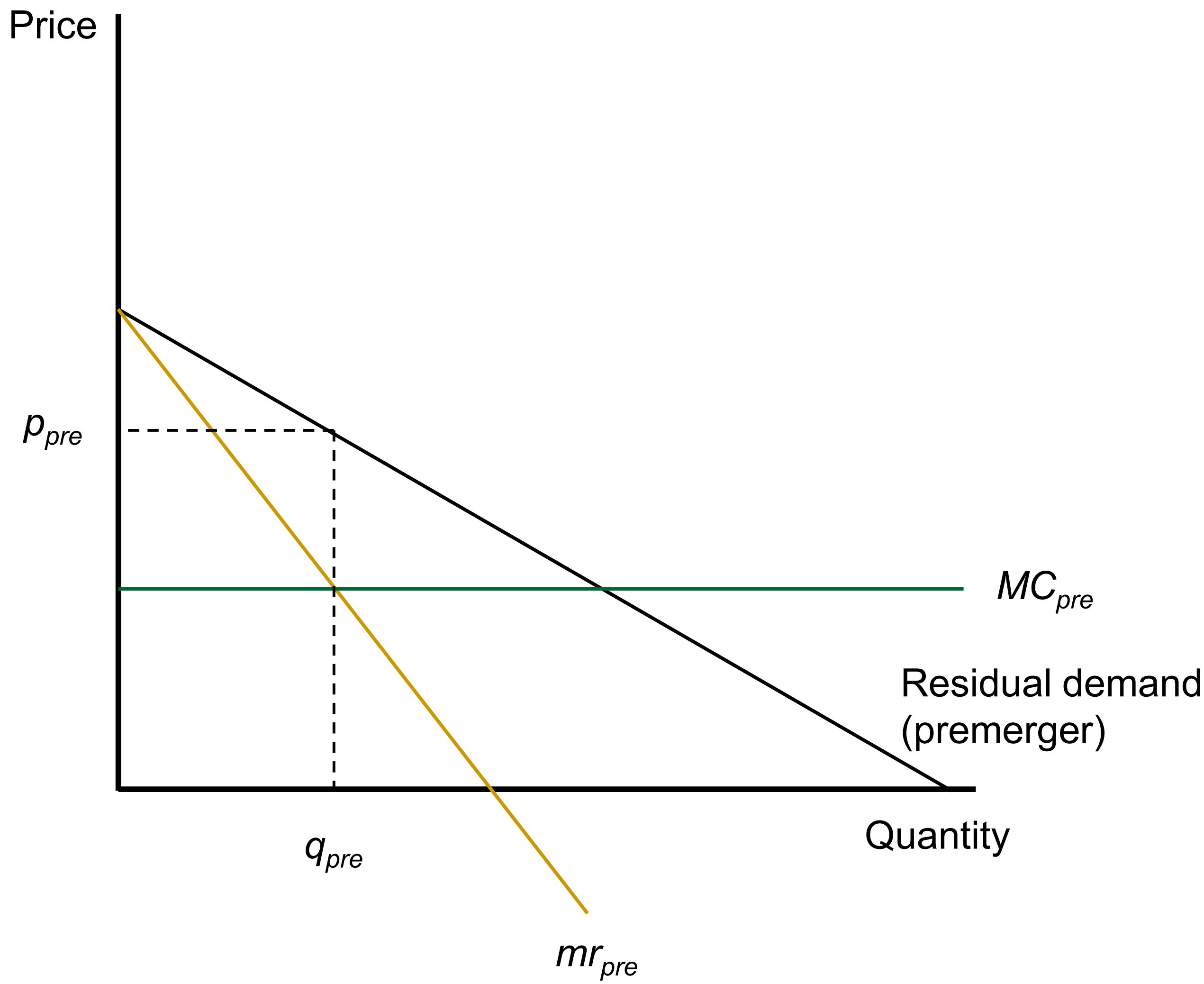


Step 1. Firm obtains a lower marginal cost due to a production efficiency

Step 2. Lower marginal cost causes the intersection with marginal revenue curve to move to the right, thus increasing output

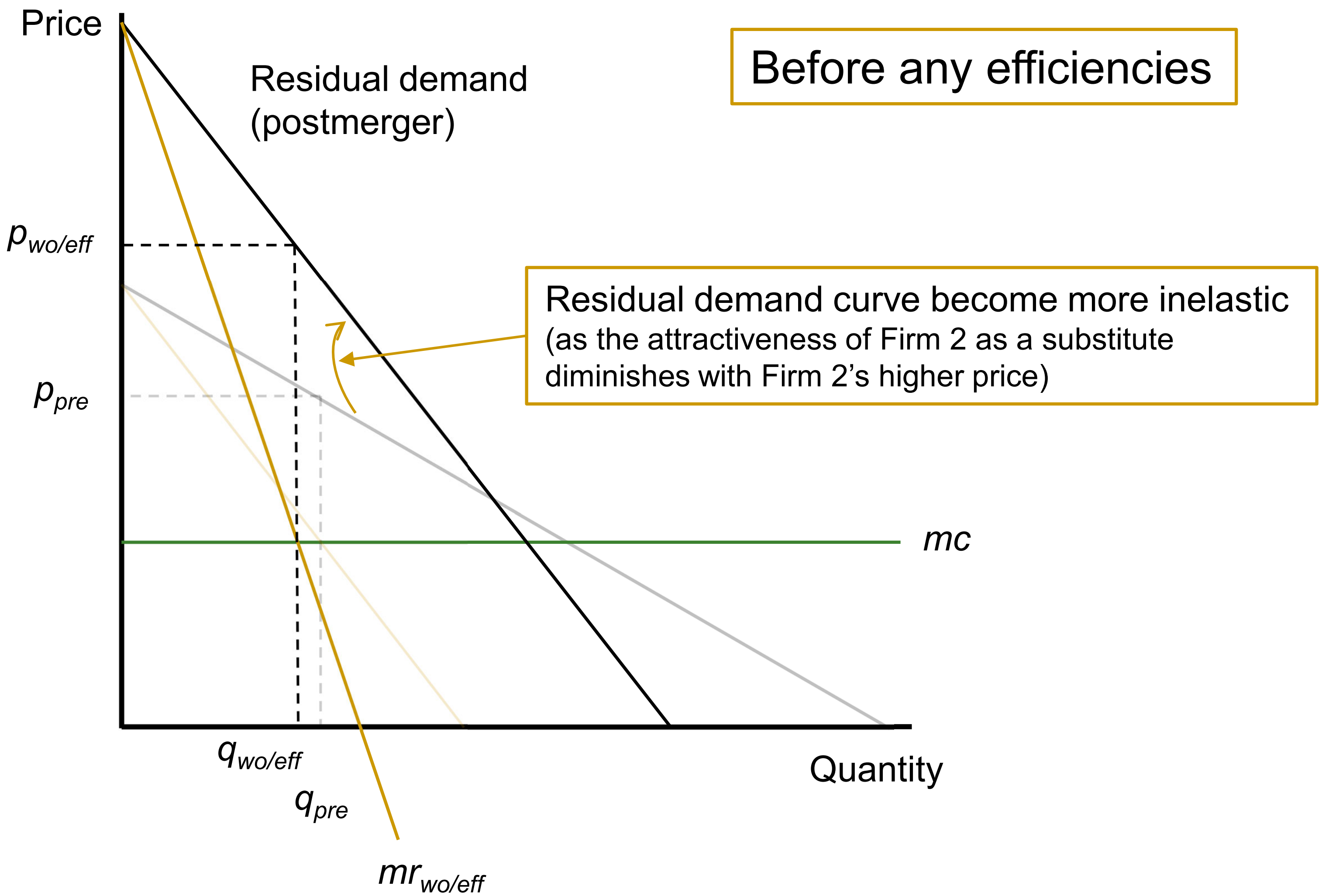
Efficiencies and downward pricing pressure

- The general idea with a reduction in marginal cost (diagram 1 of 3)
  1. Firm 1 premerger



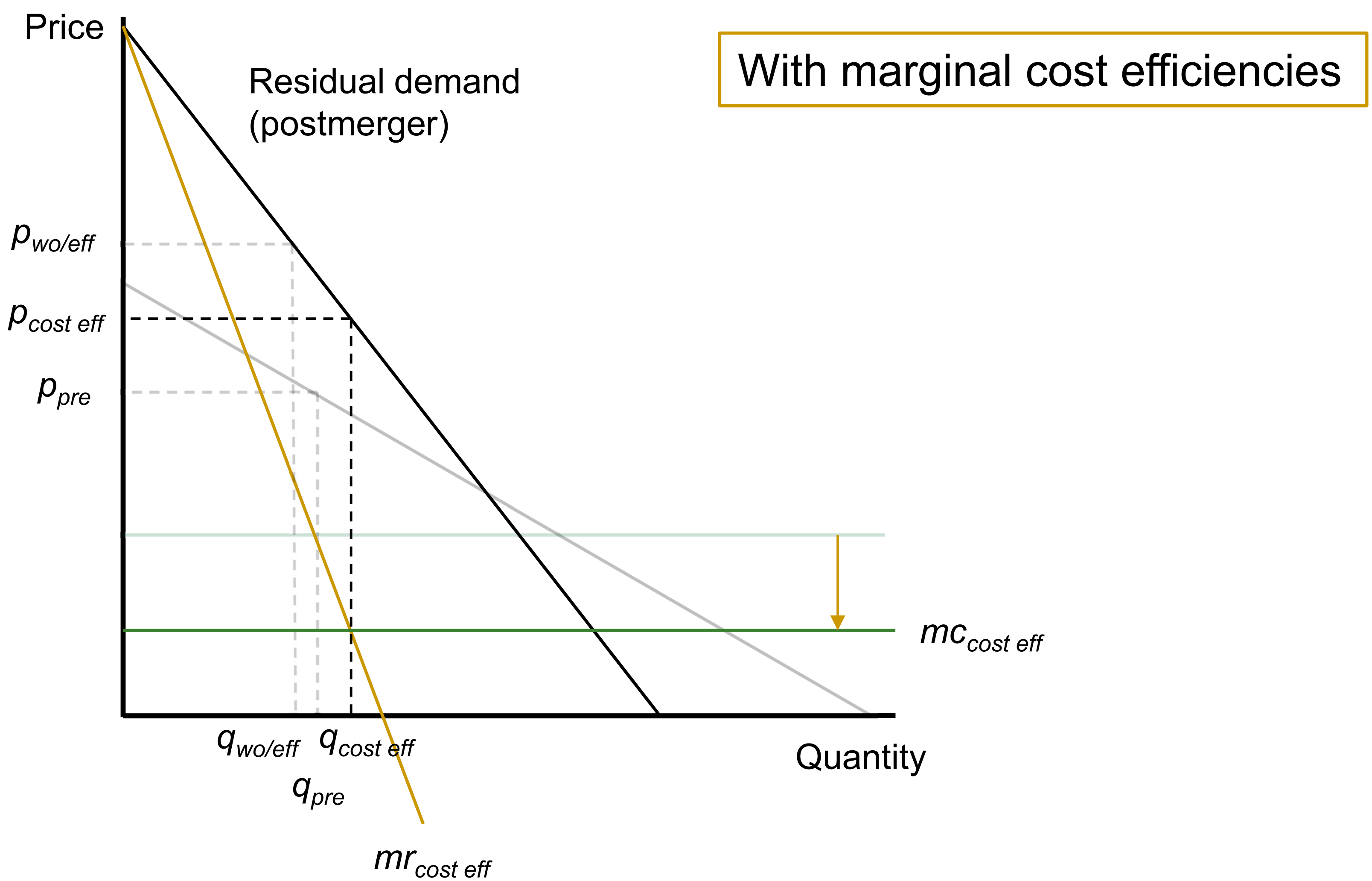
Efficiencies and downward pricing pressure

- The general idea with a reduction in marginal cost (diagram 2 of 3)
  2. Firm 1 postmerger (after the combined firm increases the price of Firm 2)



Efficiencies and downward pricing pressure

- The general idea with a reduction in marginal cost (diagram 3 of 3)
  3. Firm 1 postmerger (after the combined firm increases the price of Firm 2)



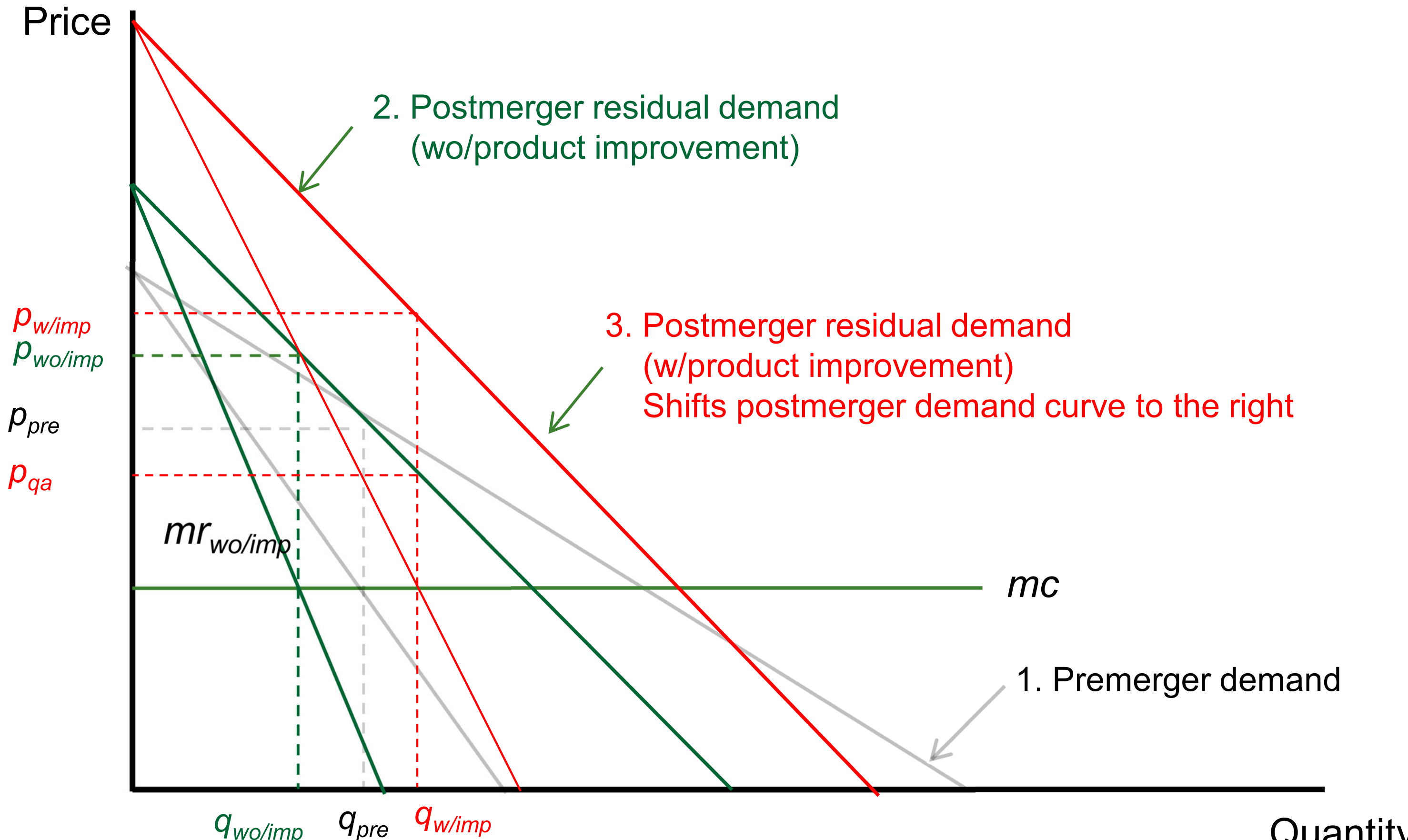
Efficiencies and downward pricing pressure

- The general idea with a product improvement
  - “Quality-adjusted price”
    - The “quality-adjusted price” is the market-clearing price for the quantity produced evaluated on the *original* demand curve
    - That is, fix the quantity produced at the postmerger market equilibrium after the product improvement. The quality-adjusted price is the price consumers would be willing to pay postmerger to clear the market at that level of production but without any product improvement
      - This means that the difference between what the market price with the product improvement and the product price without the improvement is the value consumers in the market place on the product improvement
  - Consumer welfare analysis
    - The conventional assumption is that the merger increases consumer welfare if the postmerger market equilibrium quantity with the product improvement (q_{qa}) is greater that the premerger production level (q_{pre}) even if the quality-adjusted price (p_{qa}) is above the premerger price (p_{pre})

Efficiencies and downward pricing pressure

- The general idea (diagrammatically)
  - Firm 1 postmerger (after the combined firm increases the price of Firm 2)
    - Quantity decreases in the absence of the product improvement from q_{pre} to $q_{wo/imp}$
    - Quantity increases with the product improvement to $q_{w/imp}$, which is greater than q_{wpre}
    - So in this case the merger is procompetitive

Value of the product improvement at the equilibrium production level: $p_{w/imp} - p_{qa}$



Efficiencies and downward pricing pressure

- Caution
  - It is an empirical question whether the downward pricing pressure resulting from an efficiency is sufficient to offset the upward pricing pressure resulting from the reduction in competition
    - This is reflected in the requirements of an efficiency defense in the Merger Guidelines

Efficiencies 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.[1]

- Examples of how efficiencies can offset the anticompetitive effects a merger would otherwise have:
  - Offset the unilateral anticompetitive effect by sufficiently reducing marginal costs
  - Create a new or better product that consumers prefer
  - Create a more effective competitor by combining complementary assets (e.g., IP rights)
  - Diminish incentives for coordinated interaction by creating a firm with the cost structure to engage in disruptive conduct

[1] 2010 DOJ/FTC Horizontal Merger Guidelines § 10.

Efficiencies under the Merger Guidelines

- Efficiencies are a *negative defense*
  - Efficiencies mitigate the anticompetitive effects a merger otherwise would have
    - That is, they result in *downward pricing pressure* that counters the upward pricing pressure of the merger's anticompetitive aspects
  - Standing alone, to be a sufficient defense, efficiencies must fully offset the upward pricing pressure of the transaction
- Downward pricing pressure
  - Efficiencies effect downward pricing pressing to the extent that they—
    - Reduce the marginal costs of production
    - Shift the demand curve to the right
  - These efficiencies change the postmerger intersection of the firm's marginal revenue and marginal cost curves, causing—
    - Production to increase
    - Price to decrease
  - Reductions in fixed costs do not change the intersection of the firm's marginal revenue and marginal cost curves and hence are not recognized as efficiencies under the Merger Guidelines

Efficiencies

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[1] 2010 DOJ/FTC Horizontal Merger Guidelines § 10.

Efficiencies

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

Merger specificity

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.[13] 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.
>
> ______________
>
> [13] 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.

Merger specificity

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 I 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 transferred to Firm 1. The transfer would be considered a cognizable efficiency under the “would” standard but not under the agencies’ “could” standard.

Verifiability

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 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

Timeliness/sufficiency

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 quickly enough time and with sufficient magnitude to offset the merger's anticompetitive effects 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[1]

Very important

[1] *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).

Do not arise from an anticompetitive effect

4. Do the efficiencies arise from an anticompetitive effect of the transaction?

> Cognizable efficiencies are merger-specific efficiencies that have been verified **and do not arise from anticompetitive reductions in output or service**.

- The idea here is that cost savings from a reduction in output or service are not cognizable efficiencies
  - This is uncontroversial
  - It is also probably superfluous since it is hard to see how downward pricing pressure would result from a reduction of output or service
  - Rarely analyzed by courts

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."[1]

    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.[2]

[1] Brown Shoe Co. v. United States, 370 U.S. 294, 344 (1962).
[2] United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 371 (1963).

Efficiencies in court

- Judicial skepticism (con't)
  - The Supreme Court has cast doubt on an efficiencies defense in three cases
    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."[1]

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

[1] FTC v. Procter & Gamble Co., 386 U.S. 568, 580 (1967) (citing Brown Shoe Co. v. United States, 370 U.S. 294, 344 (1962).
[2] *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 in court

- Modern practice
  - Notwithstanding the Supreme Court precedent, modern lower courts recognize that efficiencies resulting from the merger may be considered in rebutting the government's prima facie case
  - *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.[1]

[1] 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).

Efficiencies in court

- Modern practice
  - *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."[1]

> 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.[2]

[1] FTC v. Penn State Hershey Med. Ctr., 838 F.3d 327, 349 (3d Cir. 2016).
[2] *Id*.

Efficiencies in court

- Modern practice
  1. Interpretation
     - The most sensible way to read the modern approach is that efficiencies can be used as a *negative* defense to disprove the anticompetitive effect element of the prima facie case

> 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.[1]

     - But they cannot be used to as an *affirmative* defense to permit a merger that has the requisite anticompetitive effect in the relevant market

> 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.[2]

     - This distinction essentially reflects a consumer welfare standard over a total welfare standard

[1] *See, e.g.*, FTC v. Univ. Health, Inc., 938 F.2d 1206, 1222 (11th Cir. 1991).
[2] *See, e.g.*, Univ. Health, 938 F.3d at 1222 n.29.

Efficiencies in court

- Modern practice
  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?
     - Practical solution
       - Defendants must find customer-witnesses that would be harmed if the transaction was in fact anticompetitive who will 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

Efficiencies in court

- Modern practice
  - "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]the 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."[1]

  - 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

[1] 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 in court

- Modern practice
  4. 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
       - even if the cost savings in procurement is passed on to the downstream customers?
     - *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.[1]

       - The court of appeals also expressed skepticism but found it was unnecessary to answer the question given the facts in the case
       - Other courts have not opined on this

[1] 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[1]
      - "Projections of efficiencies may be viewed with skepticism, particularly if they are generated outside of the usual business planning process."[2]
      - "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."[3]
    - No court has yet found that the merging parties have successfully defended a merger through a showing of efficiencies

[1] *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).
[2] FTC v. ProMedica Health Sys., Inc., No. 3:11 CV 47, 2011 WL 1219281, at *40 (N.D. Ohio Mar. 29, 2011) .
[3] United States v. H & R Block, Inc., 833 F. Supp. 2d 36, 91 (D.D.C. 2011) .

Efficiencies

- Unilateral effects and marginal cost efficiencies
  - The model: Recall—
    - Recall that at profit-maximizing premerger output and price, Firm 1 sets marginal revenue equal to marginal cost: $mr_1 = mc_1$
    - When unilateral effects are present, postmerger Firm 1 must take into account the opportunity cost of the lost profits of Firm 2 that are diverted to Firm 1, so that Firm 1's marginal revenue now becomes $mr_1 + \Delta q_{B\to A}(p_2 - c_2)$.
    - Since opportunity costs are negative, when evaluated at Firm 1's premerger output and price:

$$mr_1 + \Delta q_{B\to A}\left(p_2 - c_2\right) < mc_1,$$

      which requires Firm 1 to contract output and raise price in order to reequilibrate marginal revenue and marginal cost postmerger. (This is the source of the *upward pricing pressure*)
    - Now say that the merger also reduced the marginal cost of Firm 1 by a percentage e (but did not change the marginal cost of Firm 2). Firm 1's postmerger marginal cost is then $(1\text{-}e)mr_{1.}$ The efficiency will offset the upward pricing pressure at firm 1's premerger output and price if:

$$mr_1 + \Delta q_{B\to A}\left(p_2 - c_2\right) \ge \left(1 - e\right)mc_1,$$

      or

$$\Delta q_{B\to A}\left(p_2 - c_2\right) \ge -e \times mc_1 \Rightarrow e \times mc_1 \ge -\Delta q_{B\to A}\left(p_2 - c_2\right).$$

    - This says that for efficiencies to offset the opportunity cost of Firm 2's lost profits, the savings in the marginal costs of production have to be at least as large as Firm 2's lost profits

Powerful Buyers Defenses

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 8

Power buyers defense[1]

- The idea
  - "Power buyers" have enough bargaining power to be able to protect themselves from an anticompetitive price increase
  - If the merged firm cannot raise prices in the face of power buyers, the merger cannot be anticompetitive
  - In other words, 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
- The Merger Guidelines recognize a power buyer defense

> The Agencies consider the possibility that powerful buyers may constrain the ability of the merging parties to raise prices.[1]

- Two requirements
  1. For each putative power buyer, the defendants must show the mechanism by which the putative powerful will be able to protect itself from the Merger's anticompetitive effects that would otherwise occur
  2. There are no other buyers in the market that will likely be harmed as a result of the merger

[1] *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 8 (rev. 2010).

Power buyers defense[1]

- *Requirement 1*: The protection mechanism
  - Generally
    - For each putative power buyer, the defendants must show the mechanism by which the putative powerful will be able to protect itself from the anticompetitive effects of the merger that would otherwise occur
    - The agencies will not assume that large and sophisticated buyers can ensure that suppliers will act competitively postmerger
  - *Mechanisms*: 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

[1] *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 8 (rev. 2010).

Power buyers defense[1]

- *Requirement 1*: The protection mechanism
  - Three important caveats:
    1. 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)
    2. 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)
         - 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 a premerger rates"
    3. 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

[1] *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 8 (rev. 2010).

Power buyers defense

- *Requirement 2*: All other buyers in the market must be able to protect themselves from an anticompetitive effect resulting from the merger
  - 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
  - Merger Guidelines example of a failure of Requirement 2:

> *Example 22*: Customer C has been able to negotiate lower pre-merger prices than other customers by threatening to shift its large volume of purchases from one merging firm to the other. No other suppliers are as well placed to meet Customer C's needs for volume and reliability. The merger is likely to harm Customer C. In this situation, the Agencies could identify a price discrimination market consisting of Customer C and similarly placed customers. The merger threatens to end previous price discrimination in their favor.[1]

- This is a second price auction scenario where—
  - The merging parties have the lowest and second-lowest costs of supplying the buyer
  - The third-lowest cost supplier has higher costs than the second-lowest supplier
- Here, the second price auction model would predict that the buyer's price would increase to just below the third-lowest cost supplier

[1] *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 8 (rev. 2010).

Defense 1: Blue Cross as a power buyer

- Power buyer defense: The practice
  - Requirement 1: Proof that a given buyer is able to protect itself
    - The mechanisms underlying a buyer power defense often a rigorous foundation
      - The foundation almost undoubtedly will be subject to intense cross-examination
      - The mere assertion that the buyer is large and therefore must be able to protect itself is not enough
    - A practically necessary (although not sufficient) condition is that the putative power buyer testify that it can protect itself
      - If the putative power buyer will not testify that it can protect itself, it is hard for the court to conclude that it can
    - Contrary evidence from "natural experiments" or buyer testimony can kill the defense (as was the case in *Sanford Health*)
  - Requirement 2: All buyers must be able to protect themselves
    - Almost impossible to prove—most markets contain small buyers that do not even arguably have sufficient buyer power to protest themselves from a price increase

Since the court of appeals found that Blue Cross was not a power buyer that could protect itself, there was no need to examine the second requirement

Power buyers defense

- Guidelines' example of an unsuccessful defense:

> *Example 22*: Customer C has been able to negotiate lower pre-merger prices than other customers by threatening to shift its large volume of purchases from one merging firm to the other. No other suppliers are as well placed to meet Customer C's needs for volume and reliability. The merger is likely to harm Customer C. In this situation, the Agencies could identify a price discrimination market consisting of Customer C and similarly placed customers. The merger threatens to end previous price discrimination in their favor.[1]

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[1] *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 8 (rev. 2010).

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 firms assets—and therefore productive capacity—to exit 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[1]
     - 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[2]

[1] 2010 DOJ/FTC Horizontal Merger Guidelines § 11.
[2] *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 Horizonal 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*[1]
    - Even if the firm is failing in the sense that it cannot meet its financial obligations, the 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 exiting 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

[1] International Shoe Co. v. FTC, 280 U.S. 291, 302 (1930).