

MERGER ANTITRUST LAW

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Georgetown University Law Center
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Tuesdays and Thursdays, 11:10 am – 1:10 pm
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CLASS 15 WRITTEN ASSIGNMENT—INSTRUCTOR’S ANSWER

Instructions

Submit by email by 11:10 am on Thursday, October 19

Send to wdc30@georgetown.edu

Subject line: Merger Antitrust Law: Assignment for Class 15

Assignment: Calls for a memorandum to a partner (which may be sent to a client)

Dianne Lockhart has read your memorandum on coordinated effects. She would now like you to expand the memo to include a description of the unilateral effects theory of anticompetitive harm. As before, she also would like you to address what factors the agencies consider in deciding whether a merger is anticompetitive under the unilateral effects theory.

If you have any questions, send me an email. See you in class.

ABLE & BAKER LLP

INSTRUCTOR'S ANSWER

TO: Dianne Lockhart
FROM: Dale Collins

Unilateral Effects

You have asked me to prepare a brief memorandum explaining the unilateral effects theory of anticompetitive harm under the 2010 Horizontal Merger Guidelines. You also have asked that the memorandum address what factors the agencies and the courts consider in deciding whether a merger is anticompetitive under the unilateral effects theory.

The theory of unilateral effects addresses the elimination of significant “local” competition between the merging firms selling differentiated products so that the merged firm can raise prices to one or both of the products of the merging firms independently of how other incumbent firms react. Unilateral effects has been the primary explicit theory of anticompetitive harm employed by the agencies in their horizontal merger investigations since 1992.

The agencies and the courts recognize two variations of unilateral effects: (1) recapture unilateral effects and (2) auction unilateral effects.

Recapture unilateral effects. This original variation of unilateral effects was introduced in the 1992 DOJ/FTC Horizontal Merger Guidelines and, with some changes, continued in the 2010 Horizontal Merger Guidelines:

A merger between firms selling differentiated products may diminish competition by enabling the merged firm to profit by unilaterally raising the price of one or both products above the premerger level. Some of the sales lost due to the price rise will merely be diverted to the product of the merger partner and, depending on relative margins, capturing such sales loss through merger may make the price increase profitable even though it would not have been profitable prior to the merger.¹

2010 DOJ/FTC Horizontal Merger Guidelines § 6.1. Under the 1992 Merger Guidelines, the unilateral effects theory applied whenever: (1) the two merging firms were each other’s closest competitors, and (2) their combined market share was greater than 35%. The 2010 Merger Guidelines relaxed these requirements so that the firms only need to be close competitors to each other (although not necessarily the closest) and eliminated the 35% combined share requirement.

When courts originally recognized recapture unilateral effects as a cognizable theory of anticompetitive harm in Section 7 cases,² they essentially adopted the tests of the Merger

¹ U.S. Dep’t of Justice & Fed Trade. Comm’n, Horizontal Merger Guidelines § 6.1 (Aug. 19, 2010).

² See, e.g., ProMedica Health Sys., Inc. v. FTC, 749 F.3d 559, 568-70 (6th Cir. 2014); FTC v. H.J. Heinz Co., 246 F.3d 708, 717-19 (D.C. Cir. 2001) (holding that elimination of competition between second- and third-largest jarred baby food manufacturers would weaken competition); New York v. Deutsche Telekom AG, 439 F. Supp. 3d 179, 237 (S.D.N.Y. 2020); FTC v. RAG-Stiftung, 436 F. Supp. 3d 278, 318-21 (D.D.C. 2020); FTC v. Wilh. Wilhelmsen Holding ASA, 341 F. Supp. 3d 27, 59 (D.D.C. 2018); United States v. Anthem, Inc., 236 F. Supp. 3d 171, 216 (D.D.C.), *aff’d*, 855 F.3d 345 (D.C. Cir. 2017); FTC v. Staples, Inc., 190 F. Supp. 3d 100,

Guidelines. While cases after the 1992 Merger Guidelines but before 2010 included the requirements that the two merging firms be each other's closest competitors and have a combined market share of at least 35 percent,³ following the 2010 Merger Guidelines courts have dropped both requirements.

To understand the economics of recapture unilateral effects, consider firm A premerger. Suppose if A increases its price and loses some unit sales (its "marginal sales"), a significant proportion of those lost unit sales will divert to firm B because of B's close substitutability. In effect, A's price increase creates a positive externality for firm B, namely, the increased profits B earns from the sales it captures from A in the wake of A's price increase. Premerger, when A maximizes its profits, it ignores this externality: what happens to B's profits is irrelevant to A. Assuming A was maximizing its profits premerger, then the price increase would decrease A's profitability: the gain of incremental profits on the sales A keeps at the higher price (its "inframarginal sales") will be outweighed by the incremental loss of profits on its foregone marginal sales, for a net profit loss.

However, when firms A and B merge, the combined firm seeks to maximize their joint profits. In the right circumstances, the combined firm can profitably increase the price of firm A's product above its premerger level to some degree, even if all other competitors maintain their prices at their premerger levels. A price increase in A's product is profitable when B's incremental profits on the recaptured sales outweigh A's net profit loss. The ability of the combined firm to increase the price of at least one of the merging firm's products above the premerger level because of the diversion of lost sales to the other merging firm while all other firms hold at their premerger prices is the anticompetitive effect of the recapture unilateral effects theory of anticompetitive harm.

As applied by the courts, a few important observations are in order:

131 (D.D.C. 2016) (*Staples II*); *FTC v. v. Sysco Corp.*, 113 F. Supp. 3d 1, 61 (D.D.C. 2015) ("Courts have recognized that a merger that eliminates head-to-head competition between close competitors can result in a substantial lessening of competition."); *United States v. Bazaarvoice, Inc.*, No. 13-CV-00133-WHO, 2014 WL 203966, at *54 (N.D. Cal. Jan. 8, 2014); *United States v. H&R Block, Inc.*, 833 F. Supp. 2d 36, 81 (D.D.C. 2011) ("A merger is likely to have unilateral anticompetitive effect if the acquiring firm will have the incentive to raise prices or reduce quality after the acquisition, independent of competitive responses from other firms."); *FTC v. Swedish Match*, 131 F. Supp. 2d 151, 169 (D.D.C. 2000) (finding a likelihood of unilateral price increase where merger would eliminate one of Swedish Match's "primary direct competitors"); *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1083 (D.D.C. 1997) (*Staples I*) (finding anticompetitive effects where the "merger would eliminate significant head-to-head competition

³ See *FTC v. CCC Holdings Inc.*, 605 F. Supp. 2d 26, 71 (D.D.C. 2009); *FTC v. Foster*, No. CIV 07-352 JBACT, 2007 WL 1793441, at *27-*31 (D.N.M. May 29, 2007); *New York v. Kraft Gen. Foods, Inc.*, 926 F. Supp. 321, 365 (S.D.N.Y. 1995) (adopting 1992 Merger Guidelines test *argundo* and rejecting its application on the facts); *but see United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1123 (N.D. Cal. 2004) ("A presumption of anticompetitive effects from a combined share of 35% in a differentiated products market is unwarranted. Indeed, the opposite is likely true. To prevail on a differentiated products unilateral effects claim, a plaintiff must prove a relevant market in which the merging parties would have essentially a monopoly or dominant position.").

- First, the profit-maximizing price for product A from the merged firm—when the prices of B and all competitive products are held constant—will typically not be the same as the merged firm's profit-maximizing price if it also has the option to increase the price of B. When A and B are close substitutes, the optimal profit-maximizing strategy usually involves a smaller price increase for A accompanied by an increase in B's price. Nonetheless, the incremental profits derived from only raising A's price will be a lower bound for the merged firm's profit-maximizing potential when both A's and B's prices can be increased.
- Second, as noted above, it is not necessary for the merging firms' products to be each other's closest substitutes, provided there is significant diversion from Firm A to Firm B. This typically implies that there are few, if any, other close substitutes for the product whose price is being increased.
- Third, there must be differentiation in the products. Usually, the differentiation exists before and after the merger, but at a minimum there must be differentiation either before or after the merger for diversion to occur.
- Fourth, in assessing the substitutability of products, the critical factor is the *proportion* of unit sales lost by Firm A that are captured by Firm B, rather than the total volume of Firm A's lost unit sales due to a price increase. Sales that are retained by Firm A despite the price hike (the “inframarginal sales”) will yield additional profits at the new, higher price. Firm A will only incur profit losses on the sales it no longer makes (the “marginal sales”).
- Fifth, while price is the most common dimension for anticompetitive unilateral effects, the theory can also extend to other dimensions of competition. For example, in *H&R Block*, H&R Block produced a free, low-functionality software product restricted to customers with an adjusted gross income below a threshold level alongside a paid, higher-functionality software product. By contrast, TaxACT produced an unrestricted free low-functionality product and a higher-functionality paid product.⁴ The court determined that, postmerger, the merged firm could profit by limiting the availability of TaxACT's free product, inducing some former TaxACT customers to purchase one of the paid products instead. The recapture unilateral effect arises because the merged firm, in effect, would raise the price to the customers who were no longer eligible to purchase TaxACT's free product and recapture some of the lost sales with the paid products.

Auction unilateral effects. This theory applies when in “winner-take-all” bidding situations where (1) the merger involves the lowest and second-lowest cost suppliers to one or more customers; (2) the third-lowest cost supplier has costs to supply the customer that are (materially) higher than the second lowest cost-supplier; (3) suppliers can engage in price discrimination among customers without risk of arbitrage;; and (4) there are barriers to entry/expansion/repositioning that will impede another supplier postmerger from achieving the cost structure of the second-lowest cost supplier in supplying the customer.

⁴ Both firms utilized a “freemium” business model, where a free product induced customers to try the firm's product. When the customer desired a higher-functionality product, they would “migrate” to a product extension of the free product offered by the same firm.

The idea behind the theory is straightforward. Premerger, the customer “plays off” competing suppliers to obtain the lowest price. When the customer gets a bid, it then informs the other suppliers of the bid price they must now beat. When another supplier offers a lower price, the customer again informs the other suppliers of the now lower bid price they must beat. As this process continues iteratively, suppliers drop out of the bidding as the required bid price drops below their costs until only two bidders remain: the lowest cost supplier and the second-lowest cost supplier. The customer continues to “play off” the two suppliers against each other until the second-lowest price supplier drops out. The lowest cost supplier then wins the bid at a price just below the cost of the second-lowest cost supplier.

When the lowest and second-lowest cost suppliers merge, the auction process proceeds similarly. Postmerger, however, the merged firms do not compete against each other, leaving the lowest and the third-lowest cost suppliers as the final competitors. Again, the lowest-cost firm wins, but this time at a price just below the cost of the third-lowest cost supplier. The auction unilateral effect is the higher cost that the supplier pays, which is the difference between the costs of the second-lowest and third-lowest suppliers.

Anticompetitive auction unilateral effects are often observed in situations where suppliers travel to their customers and incur significant transportation costs in delivering their goods or services. Where suppliers have similar input costs, they are differentiated mainly by their location relative to customers, which in turn determines their relative costs of transporting goods or services to the customer. If the two most cost-effective suppliers to a specific customer—the lowest and the second-lowest cost suppliers—merge, that customer is likely to face higher prices since the price-constraining force on the merged firm will be the third-lowest cost supplier to that customer.⁵

If you have any questions or would like to discuss these theories further, please let me know.

⁵ See, e.g., *FTC v. Sysco Corp.*, 113 F. Supp. 3d 1 (D.D.C. 2015) (Sysco/U.S. Foods merger).