Unit 5B: H&R Block/TaxACT

Part 2. Anticompetitive Effect and Defenses

Professor Dale Collins
Merger Antitrust Law
Georgetown University Law Center

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H&R
BLOCK®


TaxAct®

Typical structure of a formal merger analysis

- Step 1: The prima facie case
  - A. Relevant market
    - *Brown Shoe* "outer boundaries" and "practical indicia" tests for product markets
    - "Commercial realities" test for geographic market
    - Hypothetical monopolist test [and other 2023 Guidelines tests to the extent adopted]
  - B. *PNB* presumption
    - Market participants and market shares
    - Application of the *PNB* presumption ← Judicial precedent; Guidelines thresholds [t the extent adopted]
  - C. Other evidence of anticompetitive effect
    - Unilateral effects
    - Coordinated effects
    - Elimination of a maverick

    → *H&R Block*
- Step 2: Defendants' rebuttal
  - A. Challenges to the prima facie case (failure of proof on upward pricing pressure)[1]
  - B. Traditional defenses (offsetting downward pricing pressure)
    - Entry/expansion/repositioning
    - Efficiencies
    - Countervailing buyer power ("power buyers")
    - Failing company/division
- Step 3: Court resolves factual issues and determines net effect on competition

[1] Often addressed in Step 1.

Defendants' rebuttal arguments

- Four arguments
  1. The likelihood of expansion by existing DDIY firms besides Intuit, HRB, and TaxACT will offset any anticompetitive effects
  2. The relevant market is not susceptible to coordination and the merger will not increase the probability of effective coordinated interaction
  3. The merger will not result in anticompetitive unilateral effects
  4. The efficiencies resulting from the merger will offset any anticompetitive effects

Explicit Theories of Anticompetitive Harm: Coordinated Effects

Introduction

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

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

Think price fixing without an agreement

  - *Terminology*: May use "accommodate" rather than "coordinate" or "cooperate"
  - *Scope*: Firms can coordinate across any or all dimensions of competition, including price, product features, customers, geography of operation, innovation, wages, or benefits[2]

[1] FTC v. CCC Holdings Inc., 605 F. Supp. 2d 26, 60 (D.D.C. 2009); *accord* United States v. H&R Block, Inc., 833 F. Supp. 2d 36, 77 (D.D.C. 2011).
[2] *See* 2023 Merger Guidelines § 2.3.

Introduction

- Relation to Sherman Act § 1
  - Section 1 provides explicit coordination by agreement on competitive variables that that can be manipulated to harm consumers and increase producer profits
  - Section 7 addresses tacit coordination, that is, coordination that occurs in the absence of agreement (and hence cannot violate Section 1)

Rule*: Since Section 7 prohibits mergers with a reasonable probability of lessening competition, a merger is anticompetitive if it* increases the likelihood, effectiveness, or stability *of coordinated interaction.*

A Section 7 violation does not *require proof that firms in the market would engage in such coordination as a result of the merger.*

Introduction

- What can firms do if the merged firm seeks to increase price?
  1. *Do nothing*: Just continue doing what they were doing
  2. *Compete more aggressively*: Expand production/maybe even lower price to gain market share from the firms that are increasing their prices
  3. *"Accommodate" the price increase*: "Pull their competitive punches"
     - Need not match it the price increase
  - Key question:

    Will the merger increase the probability of effective coordinated interaction/ accommodating conduct among some or all the firms in the market, thereby facilitating the exercise of market power to the harm of consumers?

  - Key requirements:
    - Must find a causal relationship between the merger and the increased probability, effectiveness, or stability of tacit coordination

Merger Guidelines history

1. 1982 Guidelines
   - Accepted an unspecified theory of oligopoly as the underpinning of the *PNB* presumption
   - Did not require more for a prima facie case

Merger Guidelines history

2. 1992 Guidelines
   - *Problem*: There exist highly competitive markets with only a few firms
     - E.g., Coke and Pepsi
   - *Solution*: Require proof that the "Stigler conditions" for (tacit) coordination were satisfied in the relevant market:

Stigler conditions

1. *Tacit agreement*: Market conditions must be conducive to firms (tacitly) reaching terms of coordination that are individually profitable to the firms involved
2. *Detection*: Market conditions must be conducive to firms detecting deviations from the tacit terms of coordination
3. *Punishment*: Market conditions must be conducive to firms punishing deviations from the tacit terms of coordination

   - *In practice*:
     - The courts—and, indeed, many within the agencies—did not understand the punishment requirement
     - Many thought that it required participating firms to tacitly reach an agreement on a particular punishment and then tacitly coordinate to implement it
     - Prosecutors had a difficult time convincing courts to accept proof that market conditions were conducive to punishing deviations and the theory grew out of favor

Merger Guidelines history

3. 2010 Merger Guidelines
   - The 2010 Merger Guidelines sought to revitalize the coordinated effects theory
   - *Solution*: Eliminate the language of the Stigler conditions and focus more generally and less prescriptively on—
     1. The premerger *susceptibility* of coordinated interaction, and
     2. The *effectiveness* of the merger in increasing the likelihood, effectiveness, or stability of coordinated interaction among some or all the firms in the market
        - Requires a causal relationship between the merger and the increased probability of effectiveness of coordination

   2010 MG requirements

   - Relation to the Stigler conditions
     - The 2010 susceptibility requirement subsumed the structural market, information, and incentive compatibility considerations inherent in the first two Stigler conditions
     - The Stigler punishment element disappeared altogether as a factor in the analysis and was replaced by the effectiveness condition
     - Effectiveness only requires a showing of an increased likelihood of successful coordination interaction, not proof that coordination interaction would in fact occur postmerger

Merger Guidelines history

3. 2010 Merger Guidelines (con't)
   - Adoption of the 2010 Merger Guidelines test by the courts has been mixed
     - Some courts have adopted the 2010 Merger Guidelines two-element test[1]
     - Other courts continue to use the *H&R Block* approach of:
       - Presuming coordinating effects when postmerger concentration is sufficiently high to trigger the *PNB* presumption, *and*
       - Shifting the burden (presumably of production) to the merging parties to rebut the presumption[2]
         - If the burden is one of persuasion, the shift violates *Baker Hughes*

[1] *See* New York v. Deutsche Telekom AG, 439 F. Supp. 3d 179, 234 (S.D.N.Y. 2020); FTC v. RAG-Stiftung, 436 F. Supp. 3d 278, 317 (D.D.C. 2020).

[2] *See* United States v. Bertelsmann SE & Co. KGaA, 646 F. Supp. 3d 1, 44-45 (D.D.C. 2022) ("[W]hen the government has shown that a merger will substantially increase concentration in an already concentrated market, . . . 'the burden is on the defendants to produce evidence of "structural market barriers to collusion" specific to this industry that would defeat the "ordinary presumption of collusion" that attaches to a merger in a highly concentrated market.'") (quoting *H&R Block*, 833 F. Supp. 2d at 77); FTC v. OSF Healthcare Sys., 852 F. Supp. 2d 1069, 1087 (N.D. Ill. 2012).

Merger Guidelines history

4. The 2023 Guidelines refinements
    1. *Consistent terminology*: While the 2010 Merger Guidelines used "coordinated interaction," "coordinated conduct," and "coordinated effects" interchangeably, the 2023 Merger Guidelines uses the term "coordinated interaction" consistently
    2. *Extension to nonprice dimensions*: Adopted the approach of the 2023 Guidelines but explicitly recognized that coordinated interaction can occur across multiple dimensions of competition in addition to price, including product features, customer segmentation, output, innovation, and (on the input side) labor market conditions such as wages and benefits[1]
        - *WDC*: Expect the major focus in cases to be on price unless the evidence in a particular case is materially probative of likely coordination on other dimensions
        - In this connection, a history of past attempts of coordination on a specific dimension is likely to be regarded by the agencies as highly probative
    3. *Simplify the proof*
        - The 2023 Guidelines collapse the two-element 2010 test into one requirement: does the merger increase the “the likelihood, stability, or effectiveness of coordination” in the relevant market?
        - Simplifies the proof by listing three “primary factors” presumptive and six “secondary factors” probative in showing a merger

See the class notes for more detail on each of these factors

[1] 2023 Merger Guidelines §§ 2.3.

Coordinated effects in *H&R Block*

- Coordinated effects in *H&R Block*
  - Court:

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

    - This is consistent with a strict reading of *Baker Hughes* only if the plaintiffs have established a prima facie case of coordinated effects
      - BUT *H&R Block* in effect rebuttably presumes a prima facie case of coordinated effects when the *PNB* presumption is triggered
      - Courts taking the *H&R Block* approach typically cite to *Heinz*, a D.C. Circuit case decided in 2001[2]
        - This illustrates that precedent can trump the Merger Guidelines
      - The *H&R Block* approach is contrary to the approach of the 2010 Horizontal Merger Guidelines
    - Other courts follow the 2010 Merger Guidelines and require the plaintiff to prove a prima facie case of coordinated effects through a showing that—
      - The relevant market is susceptible to coordinated effects, *and*
      - The merger will increase the likelihood or effectiveness of coordinated effects

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

Coordinated effects in *H&R Block*

- Merging parties' arguments
  1. Intuit has no incentive to compete any less vigorously postmerger
  2. In particular, Intuit has no incentive to reduce competitiveness of its free product, since free products are a principal driver of paid new customers to Intuit
  3. Therefore, HRB must compete vigorously postmerger or else lose customers to Intuit

Coordinated effects in *H&R Block*

- Evidence: Premerger susceptibility
  1. Three firms could form the "collusive group"
     - Fringe firms too insignificant to be able to disrupt coordination among the "Big Three"
  2. Historical coordination
     - After TaxACT introduced its free offering, Intuit proposed that firms lobby the IRS to impose limits on their free offerings (HRB and others joined, but not TaxACT)
     - *Court*: "Highly persuasive historical act of cooperation"
     - *WDC*: Shows that evidence does not have to be of historical illegal coordination
  3. Other factors
     - Market is transparent (consumer offerings—prices and features available on the Internet)
     - Product differentiation not that relevant
     - Companies can observe and coordinate on attributes of "free" products
     - Transactions are small, numerous, and spread among a mass of consumers
     - Consumers have low bargaining power
     - Significant barriers to switching due to "stickiness" of DDIY products (learning curve)

Coordinated effects in *H&R Block*

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

Coordinated effects in *H&R Block*

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

The practice today

- Last choice as a theory
  - Even after the 2010 revisions to the Merger Guidelines, coordinated effects is the last choice as an independent theory of competitive harm in horizontal merger investigations
    - *Exception*: Where the merger eliminates a "maverick"
  - Given the narrow market definitions usually found under the hypothetical monopolist test:
    - In problematic mergers, the merging firms tend to have high market shares and be close competitors with one another
    - Typically yields an easily understood unilateral effects theory
  - *Result*: Coordinated effects is rarely used in investigations or litigations as the primary theory of anticompetitive harm
    - Usually more of an add-on theory in the complaint
    - Or when the agency is forced into it (*CCC/Mitchell*)

A final note

- A largely unrecognized asymmetry—The "price ratchet"
  - It is relatively hard for firms to tacitly coordinate to *increase* prices
    - *Problem*: Some firm has to lead the price increase, and if other firms do not follow, the putative price leader will suffer a profit loss → A risky gamble for the putative price leader
    - Some exceptions
      - An established price leader already exists
      - Where price increases can be announced in advance and retracted if insufficient firms follow
  - It is much easier for firms to tacitly coordinate *not to decrease* prices
    - Say there is a common cost increase to suppliers in the market (e.g., fuel prices increase)
    - All firms increase their prices to cover this increased cost
    - Then there is a common cost decrease (e.g., fuel prices decrease)
    - WHAT DO THE FIRMS DO?
      - If one decreases price, other firms will decrease their prices → Market shares stay the same, but profits decline given the price decrease
      - So the usual strategy is for each firm to maintain price and wait for another firm to trigger a price decrease
      - But if all firms follow this strategy, market prices will not decrease in the wake of a common cost decrease

WDC: The antitrust risk of coordinated interaction comes primarily from firms tacitly coordinating to maintain prices when common costs decrease rather than coordinating to increase prices from prevailing levels

Explicit Theories of Anticompetitive Harm: Mavericks

Mavericks

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

Mavericks in *H&R Block*

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

Mavericks in *H&R Block*

- Court:
  - DOJ failed to provide clear standards for identifying a maverick
  - But key question remains:

    "Does TaxACT consistently play a role within the competitive structure of this market that constrains prices?"

  - *Conclusion 1*: TaxACT play a special role in keeping the market competitive

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

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

Mavericks in *H&R Block*

- Court
  - *Conclusion 2*: The incentives of the merged firm to be disruptive will differ from those of TaxACT premerger

> [T]he pricing incentives of the merged firm will differ from those of TaxACT pre-merger because the merged firm's opportunity cost for offering free or very low-priced products will increase as compared to TaxACT now. In other words, the merged firm will have a greater incentive to migrate customers into its higher-priced offerings—for example, by limiting the breadth of features available in the free or low-priced offerings or only offering innovative new features in the higher-priced products.[1]

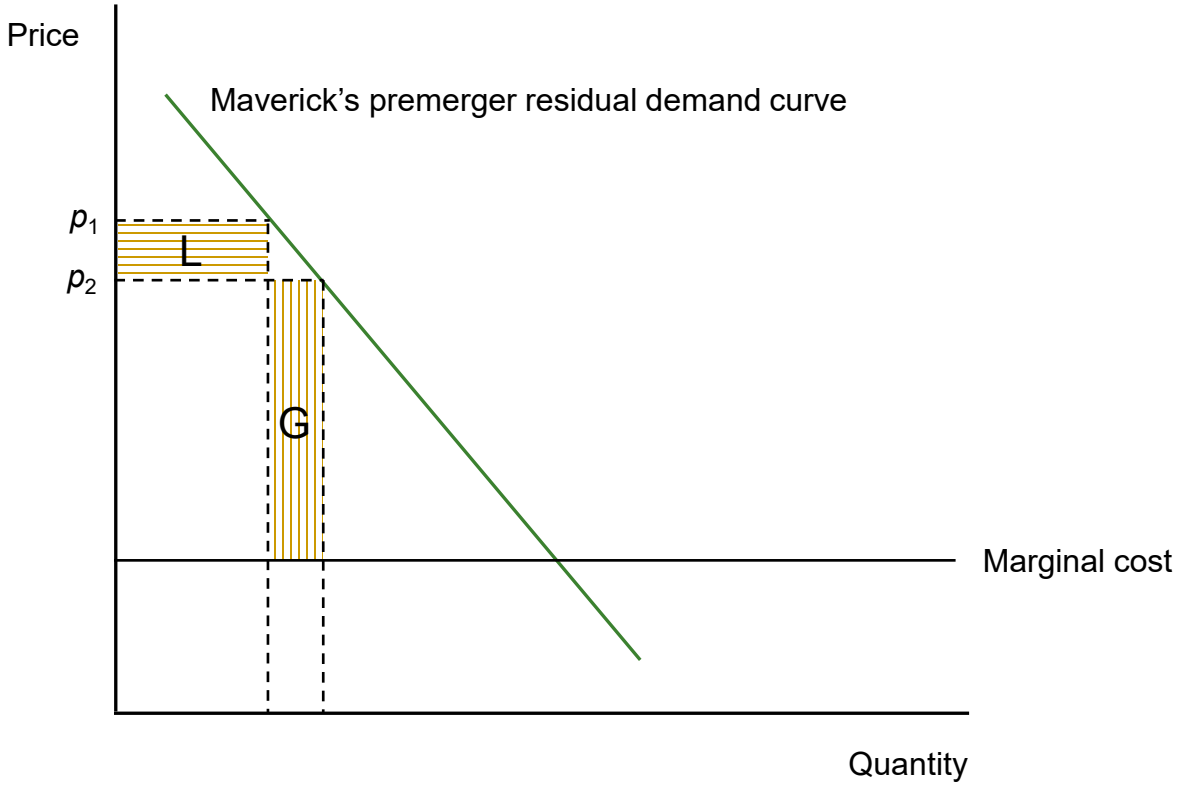
- Generally, a firm is less likely to be aggressive in pricing to increase its market share when as inframarginal sales become larger relative to marginal sales
  - In a single-price market, a price cut to increase sales requires the firm to reduce prices on all inframarginal sales
- So a merger between an established firm with a large share and a smaller "maverick" with a low market share is likely to decrease the incentive for the combined firm to be a maverick, even if the maverick's management runs the combined firm

This change in incentives is illustrated on the next two slides

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

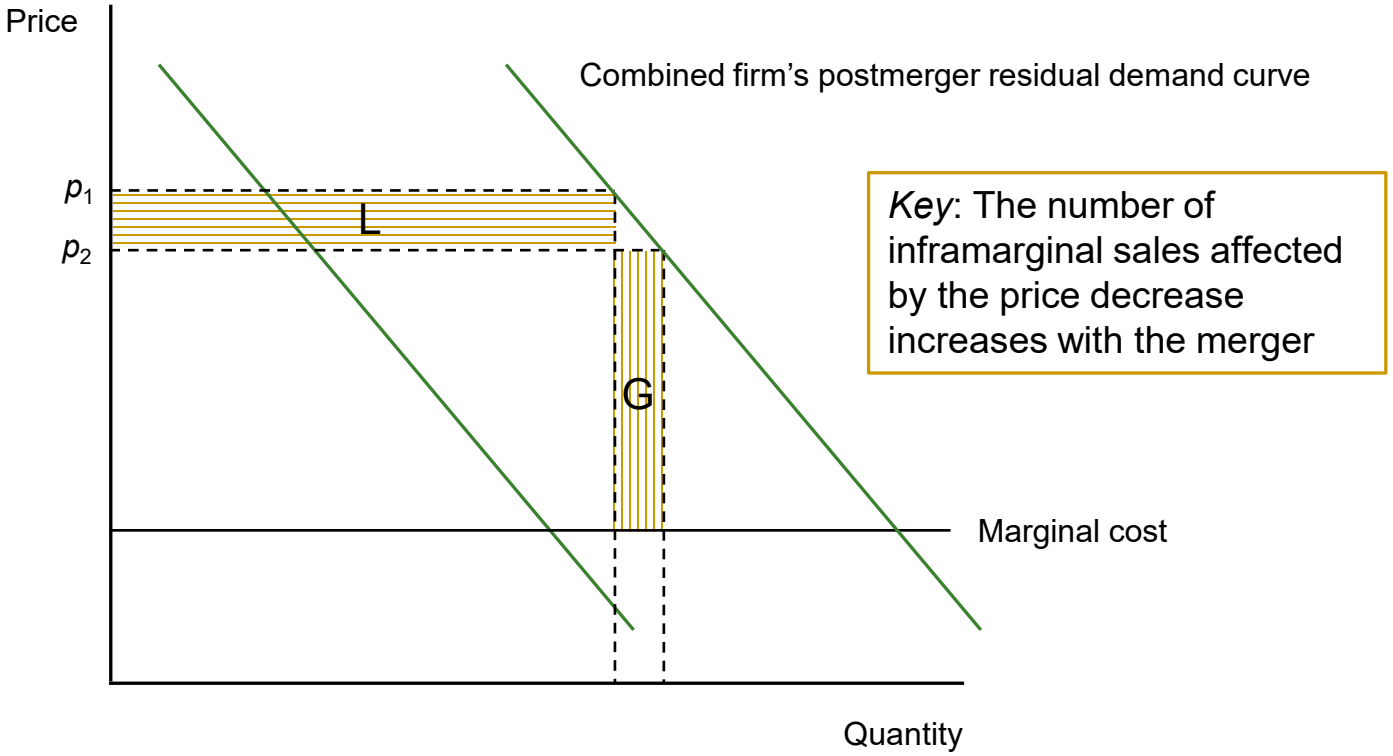
Mavericks–Postmerger incentives

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



Mavericks–Postmerger incentives

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



Mavericks—Essential elements

- Bottom line: Requirements of a "maverick" theory
  - As *H&R Block/TaxACT* suggests, the following requirements should be imposed on a theory of anticompetitive harm based on eliminating a maverick:
    1. The market is conducive to a materially higher degree of coordinated interaction than it exhibits premerger;
    2. The disruptive conduct of the merger target is a material contributor to the inability of the market to achieve this higher degree of coordinated interaction;
    3. The acquisition of the merger target is likely to result in the discontinuance of the disruptive conduct; *and*
    4. The discontinuance of the merger target's disruptive activity is likely to result in a materially higher degree of coordinated interaction in the market to the harm of consumers
       - This requires that the target be unique or especially effective in its disruptive conduct

Mavericks

- One final note: The acquiring firm as the maverick
  - Although in most applications of the theory the target is the maverick, in some cases the acquiring firm may be the maverick
    - Conversely, even when the buyer is a maverick, sometimes the target management will become the management of the combined company, which raises the question of whether the disruptive activity will be discontinued
  - The incentives argument is harder for the plaintiff in these situations since the disruptive management will run the combined company
  - But the combined firm still faces an incentive to be less of a maverick because of the effect on a larger number of inframarginal sales

Explicit Theories of Anticompetitive Harm: Unilateral Effects

Unilateral effects in *H&R Block*

- Court:
  - Reframed unilateral effects in terms of a negative defense in rebuttal to the *PNB* presumption, so that the merging parties had the burden of production of showing that unilateral effects were unlikely
  - Findings with respect to market definition make out a prima facie showing of unilateral effects:
    1. H&R Block and TaxACT products were differentiated in price
    2. H&R Block and TaxACT products were close substitutes to each other
       - Although not each other's closest substitutes
    3. (Most) other products were distant substitutes
       - But Intuit was a close—indeed, the closest—substitute to both H&R Block and TaxACT
    4. High barriers to entry made expansion or repositioning difficult

Unilateral effects in *H&R Block*

- Defendants' rebuttal
  1. Pledge to maintain TaxACT's current prices (more of a fix)
     - *Defendants*: Would maintain current prices for three years
       - Argument: no price changes → no diversion → no anticompetitive unilateral effect
     - *Court*: Not a defense even assuming truthfulness
       - Can create diversion in other ways
         - Could manipulate other variables (e.g., reduce functionality of free products) to make paid, more functional products more attractive)
         - Could market free products less aggressively and more selectively
  2. Two-brand strategy
     - *Defendants*: Will maintain both brands—HRB (high end) and TaxACT (low-end)
     - *Court*: Subject to anticompetitive manipulation in the attributes of products
  3. Combined firm's market share too low
     - *Defendants*: Combined share is only 28.4%
       - Below the 35% required in some cases and the 1992 Guidelines
     - *Court*: There is no market share threshold for unilateral effects
       - Consistent with the 2010 Guidelines
  4. Merging parties not each other closest substitutes
     - *Defendants*: Intuit is the closest DDIY substitute to both HRB and TaxACT
       - As required by some courts and the 1992 Merger Guidelines
     - *Court*: Not required to be each other's closest substitute (consistent with the 2010 MG)

Merger simulation in *H&R Block*

- *Court*: Merger simulation also shows likely unilateral price increase
  - Merger simulations supposedly predict quantitatively the level of the combined firm's profit-maximizing price increase postmerger
  - Warren-Boulton did a merger simulation showing a likely substantial unilateral price increases in all three DDIY products following the merger
  - Predicted price increases postmerger—
    - TaxACT 83%
    - HRB 37%
    - TurboTax 11%

The quantification of a price effect resulting from a merger is called a merger simulation

Merger simulation

- Problems with merger simulation
  - Only as good as the model, the data, and the parameter estimates that go into the simulation
  - Often predict “hard to believe” price increases
  - Small changes in the model specification or the parameter estimation methods can result in big changes to the predicted postmerger price increases
  - Very few studies testing the accuracy of postmerger simulation with the use of actual postmerger data
    - That is, few studies examine how close or how far the simulated results are from what actually happened

Overall, courts have been very reluctant to give much weight to merger simulations

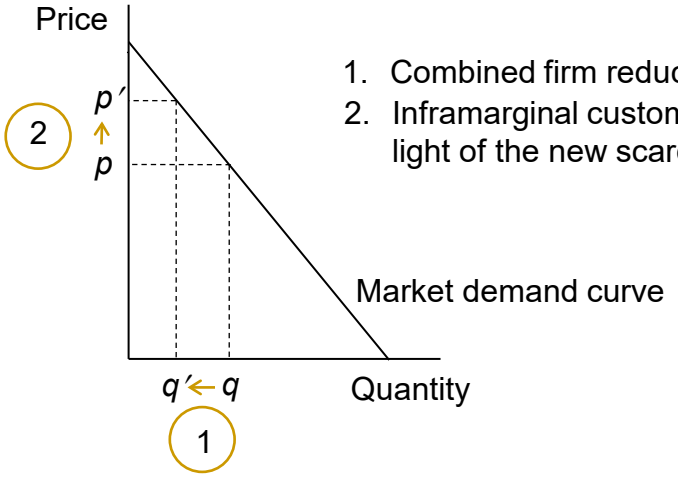
Merger simulation in *H&R Block*

- Warren-Boulton model: Used a very simple model—
  - Diversion ratios between HRB and TaxACT
  - Price-cost margins of the two products
  - A Bertrand pricing model
- The opinion did not give the details of the Bertrand pricing model
- But we will look at a "gross upward pricing pressure index" (GUPPI) simulation model in Class 14

Upward Pricing Pressure Defenses: Entry/Expansion/Repositioning

Entry/Expansion/Repositioning

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



1. Combined firm reduces production and creates a "hole" in output
2. Inframarginal customers bid up the price to clear the market in light of the new scarcity at premerger prices

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

A problem for the merging parties with this defense is that the evidence of the likelihood of entry/expansion/repositioning is in the hands of third parties

Entry/Expansion/Reposition

- 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
    - 2023: Tracks the requirements of the 2010 Guidelines, but with significantly less commentary
  - Guidelines requirements—Entry must be:
    1. Timely
    2. Likely
    3. Sufficient
    4. (Sometimes included:) Not the result of an anticompetitive effect of the merger
  - Courts have adopted these requirements

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

Entry/Expansion/Repositioning

1. Timely
   - 2010 Guidelines
     - "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."
   - 2023 Guidelines
     - "*To show that no substantial lessening of competition is threatened by a merger, entry must be rapid enough to replace lost competition before any effect from the loss of competition due to the merger may occur.* Entry in most industries takes a significant amount of time and is therefore insufficient to counteract any substantial lessening of competition that is threatened by a merger. Moreover, the entry must be durable: an entrant that does not plan to sustain its investment or that may exit the market would not ensure long-term preservation of competition."

Entry/Expansion/Reposition

2. Likely
   - 2010 Guidelines
     - "*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."
   - 2023 Guidelines
     - "*Entry induced by lost competition must be so likely that no substantial lessening of competition is threatened by the merger.* Firms make entry decisions based on the market conditions they expect once they participate in the market. If the new entry is sufficient to counteract the merger's effect on competition, the Agencies analyze why the merger would induce entry that was not planned in pre-merger competitive conditions."

Entry/Expansion/Reposition

3. Sufficient
   - 2010 Guidelines
     - Even where timely and likely, entry must be sufficient to deter or counteract the competitive effects of concern
       - "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." (Sufficient condition)
   - 2023 Guidelines
     - "Even where timely and likely, the prospect of entry may not effectively prevent a merger from threatening a substantial lessening of competition*. Entry may be insufficient due to a wide variety of constraints that limit an entrant's effectiveness as a competitor. Entry must at least replicate the scale, strength, and durability of one of the merging parties to be considered sufficient.* The Agencies typically do not credit entry that depends on lessening competition in other markets." (Now a necessary condition)
   - Additional requirement
     - "When assessing the sufficiency of entry, the relevant question is whether the potential entrants *would enter and expand beyond their own existing growth plans* to replace the void created by the elimination of the competitive intensity of the acquired firm."[1]

[1] United States v. JetBlue Airways Corp., No. CV 23-10511-WGY, 2024 WL 162876, at *32 (D. Mass. Jan. 16, 2024).
[2] *Id*. (internal citations omitted).

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
    - The staff then calls the identified firms 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

NB: 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

- Defendants' argument
  - Argued that eighteen companies offered DDIY products through the Free File Alliance and that any of them could expand to mimic TaxACT postmerger
    - Although the defense probably could not identify any particular firm that would so expand
  - Identified TaxSlayer (2.7% market share) and TaxHawk (3.2% market share) as the most viable expansion candidates, and the court focused on them

Entry/Expansion/Repositioning

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

Illustrates the problem that the most compelling evidence is not under the control of the merging firms. Testimony by the alleged new entrant that it will not enter/expand/reposition sufficient to offset the anticompetitive effect is the kiss of death for the defense

Entry/Expansion/Repositioning

- TaxSlayer—
  - Established in 2003
  - Family business
  - While more ambitious than TaxHawk, TaxSlayer showed concerning limitations:
    - Market share remained essentially flat (2.5% in 2006 to 2.7% in 2010) despite significant marketing spending
    - Growth came from "maintaining the same slice of an expanding pie" rather than gaining market share
    - Heavy reliance on sports sponsorships (Gator Bowl, NASCAR) for marketing—not scalable

Entry/Expansion/Reposition

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

Entry/Expansion/Repositioning

- Concluding comments
  - Almost impossible to make out the defense in an agency investigation
    - The agency starts by insisting that the potential entrants be identified by name
    - It then calls each of the identified firms and asks: “Would you enter this market if prices increased by 5% to 10%?”
    - The company almost always answers “no”
      - Can be a kneejerk reaction
      - Can be a “go away staff” reaction
      - Can be an informed “no”
    - The 2023 Merger Guidelines are explicit that in the face of a prima facie entry defense, the agencies will “analyze why the merger would induce entry that was not planned in pre-merger competitive conditions”[1]
      - The idea here is that if entry as did not occur premerger, why would the putative entrant enter postmerger (especially if the prevailing price would only increase by a SSNIP)?
  - Some business realities
    - As a general rule of business behavior, firms do not enter existing markets just for margin
    - They almost always require some nonprice competitive advantage against incumbent firms to cause them to entry
    - The problem is that entry can too easily precipitate a price war and destroy the pre-entry margin that made entry attractive in the first instance

[1] 2023 Merger Guidelines § 3.2.

Upward Pricing Pressure Defenses: Efficiencies

Efficiencies defense

- The concept
  - Merger efficiencies are consequences of the merger that enhance the merged firm's ability and incentive to compete by lowering prices, improving quality or service, or accelerating innovation
  - The Merger Guidelines and the courts recognize that efficiencies resulting from a merger can be so substantial as to offset the merger's anticompetitive tendencies

    Since the consumer welfare standard looks to harm to consumers, only efficiencies that are passed on to customers either directly or indirectly are cognizable in the defense

  - However—
    - In highly concentrated markets, courts require "proof of extraordinary efficiencies"
    - Historically, the agencies and the courts have found the claimed efficiencies were—
      - Not cognizable, or
      - Insufficient to negate the merger's anticompetitive tendencies

Efficiencies defense

- Common efficiencies (what matters to courts)
  - Marginal-cost savings
    - Reduce per-unit costs → creates downward pricing pressure
  - Increased output/production
    - Remove capacity bottlenecks so the firm can serve more units at the same or lower price
  - Improved quality/service
    - Hold price but raise reliability, support, or features → lower effective price
  - Accelerated innovation
    - Shorten development cycles and deliver new/better features sooner
- Reduced fixed costs—Not an antitrust efficiency
  - A major benefit to the merging firms in many mergers is the merged firm's ability to eliminate duplicative infrastructure or operations
  - But while reduced fixed costs lower the merged firm's total costs, it creates no incentive for the firm to lower its prices
    - Recall the "profit parabola"—reduced fixed cost increase the height of the parabola, but does not change price where the merged firm maximizes its profits

Efficiencies

- Efficiencies as a merger defense under the Merger Guidelines
  - Four requirements
    1. Merger specificity
    2. Verifiability
    3. Sufficiency
    4. Not anticompetitive
  - "Passed on" to consumers
    - "Sufficiency" is measured by the effect on consumers, so that efficiencies are cognizable only to the extent they are passed on to consumers

Application in *H&R Block*

- Defendants' argument: Merger will create two types of efficiencies—
  - Cost savings
    - TaxACT has lower labor costs in Cedar Rapids than HRB has in Kansas City
    - TaxACT is simply more cost conscious
  - IT-related efficiencies
    - Two types of IT consolidation

Application in *H&R Block*

- Court's analysis
  - Merger specificity
    - *Rule*: If a party can achieve a saving standing alone, it is not merger-specific
    - Cost efficiencies
      - HRB could achieve at least some of the {redacted} cost savings on its own by relocating {redacted} and taking a more cost conscious attitude toward them
      - The efficiencies related to bringing HRB's outsourced functions in-house could be accomplished without the merger
    - IT-related synergies
      - Claimed IT efficiency is not discounted for whatever savings HRB could obtain by {performing the first consolidation} on its own
      - Defendants did not present evidence explaining why, as a technical matter, {performing the first consolidation} would not be feasible

Rejected

Application in *H&R Block*

- Court's analysis
  - Verifiability
    - *Rule*: Claimed efficiencies need to be verified by a qualified independent third-party and not based solely on management judgment.
    - TaxACT
      - Based its cost savings on management judgments rather than a detailed analysis of historical accounting data by an independent third party:

> "While reliance on the estimation and judgment of experienced executives about costs may be perfectly sensible as a business matter, the lack of a verifiable method of factual analysis resulting in the cost estimates renders them not cognizable by the Court."

    - HRB
      - HRB's internal costs did rest on ordinary-course accounting/ planning documents
      - BUT—
        - HRB's failure to achieve predicted efficiencies in its RedGear acquisition undercuts its credibility
        - Requires claimed efficiencies to be independently verified, which HRB did not do

Rejected

Application in *H&R Block*

- Court's analysis
  - Sufficiency
    - *Rule:* The efficiencies must be sufficiently large in magnitude to prevent the risk of a substantial lessening of competition in the relevant market.
    - *Pass-on to consumers*: Defendants did not address
    - *Magnitude: Implicitly*, the court held that, to the extent there were cognizable efficiencies, they were too small in magnitude to constitute the "proof of extraordinary efficiencies" necessary to rebut the government's prima facie case against a merger with "high concentration levels."

Implicitly rejected

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
  - 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
  1. "Acceptance" by lower courts
     - 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
  3. "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."[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).