Unit 3A: Assessing Merger Antitrust Risk: An Introduction

Professor Dale Collins
Merger Antitrust Law
Georgetown University Law Center

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Topics

- Merger antitrust risk
- The governing statute: Section 7 of the Clayton Act
- Assessing substantive risk
- Synergies/efficiencies
- Structuring the defense

Substantive Risk:
Assessing Competitive Effects

Clayton Act § 7

- Provides the U.S. antitrust standard for mergers

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

  - *Simple summary*: Prohibits—
    - acquisitions of stock or assets that
    - "may substantially lessen competition or tend to create a monopoly"
    - "in any line of commerce" (product market)
    - "in any part of the country" (geographic market)

Called the *anticompetitive effects test*

Called the *relevant market*

- Other statutes
  - Sherman Act §§ 1-2 and FTC Act § 5 also regulate mergers
  - BUT these statutes are either coextensive or less restrictive than Clayton Act § 7[2]

[1] 15 U.S.C. § 18 (emphasis added; remainder of section omitted).

[2] Progressives and Neo-Brandeisians argue that Sherman Act § 2 and FTC Act § 5 can reach certain mergers that Section 7 may not reach. This view has yet to be tested in court.

Distinction: Downstream and upstream markets

- *Downstream market*: Sellers merge; any anticompetitive harm is sustained by customers
- *Upstream market*: Buyers merge; any anticompetitive harm is sustained by suppliers, including workers in labor markets
- These slides address downstream markets only
  - Upstream merger effects raise different and less-developed analytical issues, which we will consider later in the course

Anticompetitive effects in downstream markets

- *Modern view under the consumer welfare standard*:[1] Transaction threatens—with a reasonable probability—to hurt some *identifiable* set of customers in the (downstream) market through:
  - Increased prices
  - Reduced market output
  - Reduced product or service quality
  - Reduced rate of technological innovation or product improvement
  - (Maybe) reduced product diversity[2]

These are called *anticompetitive effects*

A firm that has the power to produce or strengthen an anticompetitive effect is said to have *market power*

- Forward-looking analysis
  - Compare the postmerger outcomes with and without the deal
  - Can view potential competitors today as future competitors tomorrow

[1] The modern view dates from the late 1980s or early 1990s, after the agencies and the courts had assimilated the 1982 DOJ Merger Guidelines.

[2] The idea that reduced product diversity may be a cognizable customer harm was formally introduced in the 2010 DOJ/FTC Horizontal Merger Guidelines. A reduction in product diversity is typically accompanied by a reduction in costs, so the balance of whether a reduction in product diversity is anticompetitive or procompetitive can often be difficult to determine and hence is rarely a driver in merger antitrust decision making.

Assessing Substantive Risk in Downstream Markets

A practical framework

- The framework works very well in predicting enforcement outcomes
- The framework does not attempt to describe—
  - how the agencies actually work,
  - how they explain their decisions, *or*
  - how they litigate their decisions in court
- It is *not* defense-biased, although it may appear so to some on a first reading
  - A biased framework is not helpful to the client
  - The client needs accurate predictions, not wishful thinking
- Later in the course, we will examine—
  - How the agencies explain their enforcement decisions, *and*
  - How they advocate their positions in court

Assessing substantive antitrust risk

- So how do the DOJ/FTC approach merger antitrust investigations?
  - They ask a simple, basic question:

Is the merger likely to result in anticompetitive harm to any identifiable customer group?

  - If the answer is YES, the investigating agency will find a way to package it into a theory of anticompetitive merger harm under merger antitrust law precedent and the Merger Guidelines and pursue enforcement action
  - If the answer is NO, the investigating agency will close the investigation without taking enforcement action (and, in most cases, without providing any explanation of their decision)
- This is *the* central question in most merger antitrust investigations
  - It will drive almost everything we do in this course

During the Biden administration, the heads of the FTC and the Antitrust Division frequently said that they would consider factors in addition to a merger's effects on customer groups in assessing its legality. But the administration brought only one horizontal challenge that could not have been predicted from the agency's expressed view of the transaction's effects on customers. *See* United States v. Bertelsmann SE & Co. KGaA, 646 F. Supp. 3d 1 (D.D.C. 2022) (finding the merger would likely produce an anticompetitive reduction in compensation to authors in a book publishing merger with no allegation that the merger would adversely affect downstream customers).

Assessing substantive antitrust risk

- So how do the DOJ/FTC approach merger antitrust investigations?

Rule 1. *Absent compelling evidence of significant customer harm in other dimensions, only price increases count*

- Recall that a merger is anticompetitive if it is reasonably likely to result in—
  - Increased prices
  - Decreased product or service quality
  - Decreased rate of technological innovation or product improvement
  - [Maybe] decreased product variety
- But economic theory is not well-developed in predicting—
  - The consequences of the transaction for nonprice market variables
  - The implications of changes in nonprice market variables for consumer welfare
- *Practice implication*: The agencies need strong direct evidence to proceed on a theory other than a price increase

The default test for the agencies and the courts is to look for anticompetitive price effects: Almost every merger antitrust complaint alleges that the merger is likely to increase prices in a downstream market

Assessing substantive antitrust risk

- Harm can be to *any identifiable group of customers*

  Rule 2. *The agencies believe that no customer group is too small to deserve antitrust protection*

  - The merger does not have to affect all customers
  - Sufficient if it affects some identifiable group of customers
    - That is, a group that can be identified through objective criteria
  - Some common groups
    - Customers in a particular geography
    - Customers of a particular type of product
    - Customers of a particular type of product in a particular geography

- The agencies will seek to define the relevant market around the customer group threatened with harm
  - Success in court has been mixed—Courts have required market definitions to make "sense" in the context of the industry
    - Not always consistent with the market definition paradigms in the case law and 1992 Horizontal Merger Guidelines
    - 2010 Horizontal Merger Guidelines and 2023 Merger Guidelines were drafted in part to provide more flexibility in market definition

Much more on this beginning in Class 5

Assessing substantive antitrust risk

- The size of the deal is irrelevant

  Rule 3. *The agencies believe that no merger is too small to challenge*

  - Indeed, there are staff members at the agencies who prefer to challenge small deals—or equivalently, small parts of large deals—because the costs of litigation to the parties typically outweigh the benefits of a successful defense in court
  - Practice implications
    - The merging parties in small deals will often terminate their merger agreement and walk away from the deal at the end of an investigation rather than put the agency to its proof in litigation
      - Seeing the parties abandon a deal at the end of an investigation does not necessarily mean that the deal was anticompetitive—just that it was too costly to defend compared to the expected benefits
    - The merging parties in large deals where the problem areas are small almost always will agree to a divestiture consent decree rather than delay the closing through the end of litigation (if the investigating agency is willing to agree to a consent settlement)
      - If the agency is unwilling to accept a consent settlement and the benefits of the deal are substantial, the parties will often "litigate the fix," that is, enter into a definitive agreement with a buyer to divest the apparently problematic lines of business and then force the agency to litigate the adequacy of the "fix" in court
    - This cost-benefit calculus prevails even when the merging parties have a high degree of confidence that they would ultimately prevail in litigation

Assessing substantive antitrust risk

- Important factoids in agency prosecutorial decision making
  - Key factors in the decision to challenge horizontal mergers:
    1. The existence of incriminating documents (or occasionally incriminating public statements)
    2. Closeness and uniqueness of competition between the merging parties
    3. The number of other significant competitors
    4. Customer complaints
    5. "Natural experiments" (past events that can be probative of the transaction's likely effect)
    6. History of actual or attempted collusion/coordination in the market
  - The Merger Guidelines are rarely invoked by the agencies or the parties during the agency's assessment of a transaction
    - The 2023 Guidelines are sufficiently broad and unpredictive that they can be used to support any enforcement decision (the same was true of the 2010 Guidelines)
    - That said, the agencies will invoke the Guidelines retroactively when *explaining* an enforcement decision
    - The agencies also cite the Guidelines in their court filings, and courts are increasingly citing the Guidelines in opinions as "informative," if not as "authority" (much to the consternation of defense counsel)
  - Formal market definition and HHIs play essentially no role and are rarely addressed in the investigation (although they are important in litigation)
    - Very information-intensive approach of questionable probative value
    - Consequently, not particularly useful for screening by either agencies or parties

Another basic distinction

- Truth v. evidence
  - The agencies (and the courts) deal in *evidence*
  - Having the truth on your side but being unable to prove it will not win the day
  - The investigating staff also needs evidence to be able to prove its case to the agency decision makers and, if necessary, in litigation

So what are the sources of evidence?

Major sources of evidence

- Preconsummated (pending) transactions
  - Ordinary course of business documents of the merging firms
  - Company responses to second requests
    - Includes responsive documents and responses to data and narrative interrogatories
  - Interviews/testimony/public statements of merging firm representatives
  - Interviews with knowledgeable customers
  - Interviews with competitors
  - Customer and competitor responses to DOJ Civil Investigative Demands (CIDs) or FTC subpoenas
  - Analysis of bidding or "win-loss" data
    - Including the ability of customers to "play" the merging firms off one another
  - "Natural" experiments
  - Expert economics analysis
- Consummated (closed) transactions
  - Observed effects
    - Most notably, price increases in the wake of the merger
  - PLUS all of the evidence probative in preconsummated transactions

Defense menu in horizontal transactions

- In decreasing order of strength—

Empirically, these are the only defenses that work

1. Parties do not compete with one another (and are unlikely to compete significantly with one another in the foreseeable future)
2. Parties compete only tangentially
3. Parties compete but have significant other close and effective competitors
4. Parties do compete and have few existing competitors, but movement into the market—
   - is easy (no barriers to entry, expansion, or repositioning), *and*
   - would occur quickly if the merged company acted anticompetitively

   Called an *ease of entry* defense
5. Some other reason deal is not likely to harm any identifiable group of customers
   - Efficiencies
   - Countervailing buyer power

- Special cases
  - Parties have competed in the past, but because of changing conditions would not compete with each other in the future even absent the merger
    - Includes the "failing company" defense
    - Invoked with some frequency but almost always fails for lack of proof of the essential elements of the defense[1]

[1] We will examine the details of the failing company defense later in the course.

Role of synergies/efficiencies

- Some definitions
  - *Synergies*: Business benefits created by the transaction, such as lower costs, better or broader products, improved service, or faster product development
  - *Efficiencies*: The antitrust term for synergies to the extent they benefit customers or reduce the transaction's likely anticompetitive effects
- Role in structuring the defense:
  - Explain why the buyer is doing the deal and paying any acquisition premium without relying on customer-harming price increases
  - Help show that the transaction will make customers better off rather than harm them
  - Are most persuasive when supported by ordinary-course deal planning, operational data, and business documents
- Proving efficiencies
  - Modern antitrust law imposes several strict requirements on proving the existence and effect of synergies
  - We will examine those in detail later in the course

Structuring the Defense

Canonical structure of a complete defense

- The best way to assess the substantive risk is to develop the defense with the supporting evidence
- Canonical structure of the initial presentation of a complete defense
  1. The parties and the deal
     - Brief overview of the merging parties
     - Brief overview of the deal (including terms, timing, and conditions precedent)
  2. The deal rationale
     - Ideally, a rationale that both makes the deal in the profit-maximizing interest of the acquiring company's shareholders *and* in the interest of customers ("win-win")
       - In other words, the deal is procompetitive
     - Include any cost, cross-marketing, or product development deal synergies
  3. The market will not allow the deal to be anticompetitive
     - This is equivalent to saying that customers could protect themselves from harm if the merged firm sought to act anticompetitively

The best defense is a good offense:
The transaction is affirmatively procompetitive, and *the market would not allow the deal to be anticompetitive even if the combined firm tried*

Some key questions

- All transactions - deal rationale and customers
  - Why are the companies doing the deal? How does the buyer expect to recoup any premium?
  - Will the combination likely increase prices to any identifiable customer group?
    - The business people will know—you just have to get them to tell you the truth
  - What synergies are expected? Is there ordinary-course evidence of likelihood, magnitude, and timing?
  - Will the deal improve products, services, or innovation?
  - What will customers say? Are some likely to support the deal? Why?
  - For likely complainers, can their concerns be neutralized—for example, by extending premerger contract protections?

Some key questions

- All transactions - evidence and witnesses
  - What do the company documents say?
    - Reason for the deal; competition between the parties; likely competitive effect; premerger landscape; postmerger operations
  - Does each party have good witnesses?
    - Strategic rationale and synergies; each business line likely to be investigated
  - Will the agency have customers willing to testify against the deal at trial?
  - Are competitors or other parties likely to assist the agency?
    - Competitor evidence can help agencies understand the market
    - BUT unsupported competitor claims that a deal is anticompetitive are given little weight

Some key questions

- Horizontal transactions
  - Are the merging companies strong and close competitors with one another?
  - How many other effective competitors does each merging party have?
  - Do customers "play" the merging parties off one another to get better prices or other deal terms?
  - In bidding situations, do the merging firms frequently bid against one another? How many other bids do they usually face? Do they frequently find themselves competing against one another in the "best and final" round of bidding?
  - Are the conditions in the marketplace conducive to direct oligopolistic coordination on price?
    - If not, is there another mechanism for oligopolistic coordination (e.g., coordinated capacity reductions)?
  - Is the target firm a "maverick" that engages in disruptive market conduct, such as aggressive discounting?