An Inside Look at the Heinz Case

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Introduction

The last issue of this magazine carried two thoughtful articles by David Balto and William Kolasky on the so-called "efficiency defense" in merger analysis,(2) with particular emphasis on the recent case involving Heinz and Beech-Nut baby foods.(3) There are many statements in both articles with which I agree, and some with which I disagree, and I may have the opportunity to address these questions at greater length in the future. The purpose of this short comment, however, is not to "reply" to these articles but rather to "explain" my vote in the Heinz case. David Balto's call for greater transparency in the treatment of efficiency claims by the antitrust agencies(4) is well founded, and this comment is a modest, individual contribution toward that end.

In the Heinz case, I voted with Chairman Pitofsky and Commissioner Thompson to support the complaint. Commissioners Anthony and Swindle dissented. The vote lineup apparently surprised some people, and I therefore specially welcome this opportunity to discuss my reasons for voting the way I did.(5) (Up to now, I have not been free to do so because the District Court only recently dismissed the case as moot after the parties abandoned the transaction, following the D.C. Circuit's reversal and remand.) The reader should understand, however, that there is a distinction between this explanation of why I had "reason to believe" that the proposed transaction violated the law, based on the information available at the time, and the final conclusions I may have formed on the facts of the Heinz case, had it been tried in the agency. The comment also should not be construed as a full critique of the contrasting judicial decisions in the case.

I. The Market Definition Issue

The analysis of this case, like every merger case, began with an effort to define the market and the players in it. Before turning to efficiencies, it is necessary to digress briefly and discuss this issue because it had a significant impact on the way I viewed the efficiency claims.

At first glance, the matter seemed simple and straight forward. For at least forty years, there have been three significant players in the baby food business: Gerber (the U.S. market leader), Heinz and Beech-Nut. The case thus looks like a 3-2 merger with a very low potential for entry, and there is a broad consensus in the economics community that 2-1 and 3-2 combinations are likely to be particularly troublesome. In addition, there was no claim that any of the competitors was failing and, though the baby food business appeared to be stagnant, there was no claim that the industry faced dramatic changes (comparable, for example, to recent claims in defense-industry mergers). In the language of the Court of Appeals: ". . . no court has ever approved a merger to duopoly under similar circumstances."(6) The absence of precedent was not decisive for me, but I believed that some extraordinary justifications were required if the transaction really was a 3-2 merger. But, was it?

The parties challenged the simple 3-2 analysis on two grounds. First, they argued that Heinz and Beech-Nut did not really compete with one another because each was strong in different areas of the country, with minimal horizontal overlaps. Second, they argued that Heinz and Beech-Nut did not really compete at the consumer level, which they claimed is the only one that counted. I did not believe that either objection was well founded.

As to the first objection, it is true that neither Heinz nor Beech-Nut had the full national coverage of Gerber. Beech-Nut sales were concentrated in the Northeast and in California; Heinz sales were concentrated in the South, the Midwest, the Upper Plains and the Pacific Northwest. It is not accurate to characterize Heinz and Beech-Nut as regional players, however. They can and do ship across the country from their single plants, located in Pennsylvania and New York, respectively. Moreover, they do have significant geographical overlaps. The Circuit Court noted, "there are at least ten metropolitan areas in which Heinz and Beech-Nut both have more than a 10 per cent market share and their combined share exceeds 35 per cent."(7)

There is another way to look at the Heinz/Beech-Nut regional separation, to the extent it does exist. The reasons for the separation were not clear - - there was no obvious relationship to distributional costs from plants located in adjacent Northeastern states and no suggestion that differences in taste played a part (if, indeed, babies' collective tastes could be discerned). It appeared likely that the regional patterns evolved through decades of essentially passive competition (tacitly acknowledged by the parties), under which Heinz and Beech-Nut failed to challenge one another aggressively. It would be perverse to permit parties to merge just because they have not chosen to compete hard in the past.(8)

The second objection was that the merger should not be viewed as a 3-2 combination because Heinz and Beech-Nut do not compete at the consumer level. Consumers do not view the brands as substitutes and generally only one of them is available in a given store. (Gerber is ubiquitous.) Heinz and Beech-Nut rivalry is thus limited to competition for the number two slot on grocery shelves, primarily through the offer of so-called "slotting allowances." The argument, accepted by the District Court, is that these allowances do not necessarily benefit the ultimate consumer and are thus competitively insignificant.

Note that this argument is problematic for one of the same reasons as the regional separation argument, discussed above. The fact that parties have historically chosen to compete in a way that is not particularly effective does not mean that they should be allowed to merge and cease competing altogether. But, there is an even more fundamental reason for rejecting this objection to a 3-2 analysis. Competition at the wholesale level is important in its own right, wholly apart from the effect it may have on ultimate consumers. As the Court of Appeals noted, "no court has ever held that a reduction in competition for wholesale purchasers is not relevant unless the plaintiff can prove impact at the consumer level." (9) Although it is reasonable to assume that a reduction in wholesale competition will have some impact on retail prices to ultimate consumers, the Commission is not required to show it; the wholesale market by itself is a "line of commerce" within the meaning of Section 7.

II. The "Efficiencies" Issue

The parties argued vigorously that the merger would create a stronger competitor which would be better able to launch a vigorous attack on the entrenched position of the industry leader, Gerber. The argument was supported by a substantial number of retail customers and by internal documents and studies. I do not know whether these arguments would have proven persuasive after a full administrative trial, but I would like to highlight some issues that were particularly important in shaping my preliminary views.

First, there appeared to be a fundamental disconnect between the way the parties thought about some efficiency arguments and the way I thought about them. Their arguments was focused, in part, on the claim that the combination would improve the efficiency of the Beech-Nut operation.(10) I found it difficult to conceptualize efficiency improvements in an entity that will disappear. For me, the issue was the impact of the combination on the efficiency of the surviving entity, Heinz, which is a different question. (I suspect there is a deeper way to look at these questions but I have not seen it articulated.)

Moreover, whatever these efficiency improvements might be, there was an initial question of whether they were merger related. I believe there is likely to be a merger-specificity issue whenever, as here, rationalization of productive capacity is asserted as an efficiencies defense. Liberalizing trends in antitrust enforcement -- including, most notably, passage of The National Cooperative Research and Production Act(11) - - have made it easier for parties to rationalize by contractual or joint venture arrangements short of outright merger. If such rationalization is not a viable option, I would like to know why. If it is simply more difficult to implement these alternative arrangements than it is to manage a merged entity, the relevant merger-specific efficiencies may be these transaction cost savings rather than the overall rationalization savings.

I also was not persuaded that the ability to surmount limitations imposed by pre-existent management policies is necessarily a merger-specific efficiency. The parties claimed that the merger would facilitate the introduction of innovative new products because Heinz currently is reluctant to invest the necessary funds absent the broader presence on supermarket shelves that it would obtain by merger.(12) The argument would have greater force if Heinz were a small company with limited resources. But Heinz is a very substantial company, with a broad supermarket presence, and it also happens to be the largest baby food seller in the world. If Heinz really believed its own innovation story, I should think it would be far less expensive for the company to modify its own market-penetration hurdles for these innovative products than to spend $180 million to buy a competitor.

Beyond merger specificity, I also have some question about the weight to be given claimed savings that result from the consolidation of headquarters and the elimination of duplicate management functions. My uneasiness results from a sense that the argument proves too much. Of course it costs less to have only one CEO with supporting staff, rather than two. By this standard, monopolies should always be more efficient, but we know they are not. I tend to assume, consistent with what I perceive to be the bias of our merger law, that the preservation of independent decision-makers may contribute to efficiency in the long run, above and beyond the immediate effects on price competition.(13) As Tom Campbell stated, when discussing innovation almost twenty years ago: ". . . it is better to have an extra player in the market because you never know what serendipity will create."(14)

Although I had these initial reservations about the parties' efficiency claims, I want to emphasize that I would not have required a separate demonstration that the claimed efficiencies would be "passed on" to ultimate consumers. In my view, this is likely to be a sterile inquiry, for reasons similar to those mentioned above in the discussion of "wholesale" versus "retail" competitive effects.(15) I do not want to get bogged down here in the debate about the extent to which distributional effects are significant in antitrust. All I am saying is that if it is fair to assume generally that wholesale competition will ultimately benefit consumers, it is also fair to assume generally that cognizable efficiencies will ultimately do so as well.

Let me provide an alternative, and perhaps more provocative, explanation for my willingness to indulge this general assumption. The "pass on" debate assumes that the balance between the likely price effects resulting from increased concentration and the offsetting effects of assumed efficiencies can be calculated with some precision. This is simply not so. It may be useful to balance these predictions, in a gross way, but I believe we deceive ourselves and interested observers if we pretend that fine points like pass on can make the process more exact and objective.

III. A Process Issue

The D.C. Circuit Court opinion opens with a discussion of the appropriate standards for granting a preliminary injunction.(16) The opinion asserts that the Commission is not subject to the same stringent tests as private parties who seek interim relief. I believe this view is correct, but acknowledge that the relaxed standard raises some conceptual issues.

As the Court points out, the test in Section 7 is whether the effect of a proposed merger "may be to substantially lessen competition, or tend to create a monopoly."(17) It then says that the Commission meets its "likelihood of success" burden when seeking a preliminary injunction by raising "questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC on the first instance and ultimately by the Court of Appeals."(18)In other words, it apparently is enough if there are substantial questions about whether there will be substantial effects.

What happens when a standard of this kind is applied in conjunction with the "reason to believe" standard that Commissioners are supposed to apply when voting out an administrative complaint or applying for injunctive relief? The Supreme Court has described the reason-to-believe standard merely as "a threshold determination that further inquiry is warranted."(19) Is this standard for Commission action the same as the test for granting a preliminary injunction that was articulated by the Heinz court, i.e., the presence of questions that are "fair ground" for further inquiry? Semantically, it is difficult to distinguish between these two. If tests are the same, it might suggest that a district court should not independently weigh the underlying merits when the Commission seeks a preliminary injunction.

Neither the District Court nor the Court of Appeals seemed to take this view because they each discussed the merits in considerable detail. It is hard to quarrel without sounding presumptuous and, in addition, the alternative of full deference to the Commission's "reason to believe" determination could create an awkward dichotomy between the standards applied to Commission actions and similar actions by the Antitrust Division. However, the general fuzziness of the law in this area does raise questions that may be of some theoretical interest. Should an individual Commissioner apply the "reason to believe" test generously when voting on whether to seek a preliminary injunction because a district court will also look at the merits independently? Or, should a Commissioner apply the "reason to believe" test restrictively because it is possible that a district court may defer to the agency, and the preliminary injunction decision is likely to be outcome determinative?(20) Fortunately, subtle shadings of this kind are very difficult to incorporate in the real world decision-making process (at least, for me), so the issue may not be of great practical importance.

Conclusion

Some commentators have expressed concern that the successful prosecution in Heinz amounted to a root-and-branch repudiation of the "efficiencies defense."(21) In my view, these fears are unfounded. In the first place, favorable factors - - whether called "efficiencies" or simply the "business justification for the transaction" - - are routinely considered within the agency when deciding whether to challenge a transaction in the first place.(22) Experienced counselors know that many mergers are cleared despite concentration levels well in excess of those presumptively suspect under merger guidelines. The Heinz case will not change this practice. Moreover, as noted above, there were some particular problems associated with the efficiencies claimed in the Heinz case that will not necessarily be present in other cases. The Circuit Court discussed the evidence on efficiencies in some detail and even those who disagree with some of the conclusions cannot fairly read the opinion as dismissive of the defense.(23)

Finally, it is important to remember that the Heinz case was a 3-2 merger, without any showing of easy entry, failing firms, or a distressed industry. The ultimate lesson of the case was expressed by the Court of Appeals, as follows:

> ". . . the high market concentration levels present in this case require, in rebuttal, proof of extraordinary efficiencies, which the appellees failed to supply."(24)

The Court thus endorsed a "sliding scale" approach to merger jurisprudence: the greater the risk of competitive harm, the greater the burden of justification. Wholly apart from the individual merits of the Heinz case, I believe that this is sound policy.

It is fair to ask what the term "extraordinary efficiencies" means in practical terms,.(25) and I have tried to suggest what it meant to me in the context of the Heinz case. My problems with the efficiency claims were primarily qualitative rather than quantitative. Parties who propose a 3-2 merger bear a heavy burden of demonstrating that the elimination of the third competitor is essential for achievement of the promised benefits, and I did not believe that they had met this burden when I voted for the complaint in Heinz.

This comment is not intended to be critical of the first-rate counsel who argued for the parties. They were thorough and imaginative. But, essentially, they were forced to argue that present competition between Heinz and Beech-Nut had been so flabby for so long that the merger could not do any harm and might just do some good. In short, the efficiency claim was that the merger could transform a longtime lazy triopoly into a dynamic duopoly. That's a hard sell.

1. Commissioner, Federal Trade Commission. This comment is adapted from a speech given on December 4, 2001, before the Association of the Bar of the City of New York and has been published in Antitrust, Spring 2002, Vol. 16, No. 2,

at 32.

2. David Balto, The Efficiency Defense In Merger Review: Progress or Stagnation, Antitrust, Fall 2001, Vol. 16, No. 1 at 74; William J. Kolasky, Lessons from Babyfood: The Role of Efficiencies in Merger Review, Antitrust, Fall 2001, Vol. 16, No. 1, at 82.

3. FTC v. Heinz, 116 F. Supp. 2d 190 (D.D.C. 2000), rev'd 246 F.3d 708 (D.C.Cir. 2001).

4. Balto supra note 1, at 80.

5. As always, I do not purport to speak for any other Commissioner and these views do not necessarily foreshadow future positions of the Commission as a whole. I would like to acknowledge the help of an advisor, Holly Vedova, in the preparation of this paper.

6. 246 F.3d at 717.

7. Id. at 718, n. 14.

8. We would give short shrift to an analogous argument that a merger is unlikely to cause much incremental harm because supra-competitive prices are already prevalent in the industry.

9. 246 F.3d at 719 (citing cases).

10. See, e.g., Kolasky supra note 1, at 85-86.

11. 15 U.S.C. §§ 4301-4305 (1994). The statute guarantees rule-of-reason treatment for ventures that satisfy certain criteria.

12. 246 F.3d at 722-24. Heinz's CEO apparently testified that "Heinz would not provide marketing support to a new product unless it was in more than 80 percent of shelves." Kolasky supra note 1, at 87.

13. A related argument is that efficiencies should be discounted because the combination will reduce the variety of products offered to consumers. This consideration was actually present in the Heinz case, and might have become an issue had the case proceeded to administrative trial. For a general discussion of the significance of product variety, see Thomas B. Leary, The Significance of Variety in Antitrust Analysis, 68 Antitrust L.J. 1007 (2001).

14. Thomas J. Campbell, Luncheon Panel Discussion, Has Economics Rationalized Antitrust? 52 Antitrust L.J. 607, 619 (1983).

15. I recognize that the Commission staff has argued in court that there should be a showing that efficiencies will be passed on. In my view, any such argument goes too far.

16. 246 F.3d at 713-15.

17. Id. at 714.

18. Id. at 714-15 (citing cases).

19. FTC v. Standard Oil Company of California, 449 U.S. 232, 241 (1980).

20. If the injunction is granted, the parties are likely to abandon the transaction (as happened in this case); if it is denied, the assets are likely to be scrambled and administrative action may be unavailing. The District Court was clearly wrong when it gave conclusive weight to the private risks in this situation, but it is also clear that it would be wrong to treat the proceeding as if it were merely a "preliminary" matter. See 246 F.3d at 726-27.

21. See, e.g., Kolasky supra note 1.

22. See, e.g., Statement of the Commission in AmeriSource Health Corporation/Bergen Brunswig Corporation, FTC File 011-0122, <www.ftc.gov/os/2001/08/amerisourcestatement.pdf>, referring specifically to the importance of efficiencies in the Commission's unanimous decision not to challenge a 4 to 3 merger.

23. The court noted that Heinz still might carry the day in an administrative trial.

24. 246 F.3d at 720.

25. Balto supra note 1 at 78.