Antitrust News e-newsletter

The Official Publication of the Antitrust & Trade Regulation Law Section

The 2010 Revised Horizontal Merger Guidelines – Structural Presumptions and Predictive Models

Article Date: Friday, December 17, 2010

Written By: Robin K. Vinson

Introduction
Antitrust law in the United States originated with the Sherman Act, which prohibited “every contract, combination . . . , or conspiracy, in restraint of trade,” and attempts “to monopolize any part of the trade or commerce.” 15 U.S.C. §§ 1-2. Subsequently, Section 7 of the Clayton Act provided that mergers subject to the Clayton Act are prohibited if their effect “may be substantially to lessen competition, or to tend to create a monopoly.” 15 U.S.C. § 18. The purpose of the Sherman Act “was the prevention of restraints to free competition in business and commercial transactions which tended to restrict production, raise prices, or otherwise control the market to the detriment of purchasers or consumers of goods and services, all of which had come to be regarded as a special form of public injury.” Apex Hosiery Co. v. Leader, 310 U.S. 469, 493 (1940). In that regard, the Clayton Act provided that restraints of trade are not prohibited unless they constitute a “substantial” lessening of competition. A merger is deemed likely to “create a monopoly” if it brings a suspected monopolist “substantially closer” to the “power to exclude competition when the monopolist desires to do so.” United States. v. du Pont, 353 U.S. 586, 592 (1957). The Supreme Court has emphasized that the “[s]ubstantiality” of lessened competition “can be determined only in terms of the market affected.” Id. at 593.

The Hart-Scott-Rodino Antitrust Improvements Act of 1976 requires persons (including corporations) to notify the Federal Trade Commission (“FTC”) and the Antitrust Division of the Department of Justice (“Antitrust Division”) (collectively, “Agencies”) of potential stock acquisitions of another corporation that exceed certain thresholds found in 15 U.S.C. § 18a. The parties seeking to merge must then wait 30 days following notification before the stock acquisition can be transacted. The notifications must “be in such form and contain such documentary material and information relevant to a proposed acquisition as is necessary and appropriate to enable the FTC and the Antitrust Division to determine whether such acquisition may, if consummated, violate the antitrust laws.” 15 U.S.C. § 18a(d)(1) (2006). The FTC or the Antitrust Division may also issue a “second request” for information if a merger is of particular interest. If either agency concludes after its preliminary review that the proposed merger will violate the antitrust laws, it may file suit in federal court and seek to enjoin the merger.

The Agencies have had a long history of proactively communicating with the public about their enforcement priorities, goals and processes in the analysis of competition issues. To provide guidance to the antitrust bar, business community and consumer groups, the Agencies published a set of parameters in the form of Horizontal Merger Guidelines (“Guidelines”) and have made updated revisions of those guidelines over the past two decades.

The Prior Guidelines
The former version of the Guidelines was issued in April 1992 and revised in April 1997. The Guidelines are meant to “articulate the analytical framework the agencies apply in determining whether a merger is likely substantially to lessen competition.” A principal goal of the Guidelines is “to reduce the uncertainty associated with enforcement of the antitrust laws.” 1992 Horizontal Merger Guidelines §§ 0.-0.1. The “unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise,” because “the result of the exercise of market power is a transfer of wealth from buyers to sellers or a misallocation of resources.” Id. § 0.1.

The 1992 Guidelines attempted to provide courts and businesses with a step-by-step understanding of the Agency’s assessment of mergers. Under those Guidelines, the Agencies first defined a relevant market and assessed whether the merger will increase concentration beyond an acceptable level in that market. Second, the Agencies assessed whether the merger raises concerns about potentially adverse competitive effects. Third, the Agencies assessed whether entry into the market would be sufficiently easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels. Fourth, the Agencies assessed whether the merger has the potential to generate efficiencies by permitting a better utilization of existing assets, thereby allowing the firm to reduce production costs (cost savings that would likely lead to lower prices). The ultimate determination is whether the merger will create or enhance market power.

In assessing the potential adverse competitive effects of a merger, the 1992 Guidelines provided that the Agencies will examine unilateral effects, that is, whether the merging firms may find it profitable to alter their behavior unilaterally following the merger, by elevating prices and suppressing output. Those Guidelines explained that substantial unilateral price elevation is unlikely unless there is "a significant share of sales in the market accounted for by consumers who regard the products of the merging firms as their first and second choices, and . . . repositioning of the non-parties' product lines to replace the localized competition lost through the merger [is] unlikely." Id. § 2.21. The Guidelines emphasized, however, that "market concentration affects the likelihood that one firm, or a small group of firms, could successfully exercise market power." Id. § 2.0. The 1992 Guidelines indicated that the Agency is less likely to object to a merger based on potential unilateral effects where the market is not highly concentrated (as measured by the Herfindahl-Hirschman Index ("HHI")) and the merging firms have a combined market share of less than 35%. Id. § 2.211.

The Proposed and Final Revised Guidelines

On April 20, 2010, after many months of dialogue with scholars, practitioners and interested parties, the Agencies announced the release of a new set of Guidelines ("Proposed Guidelines"). The Proposed Guidelines supplemented the 1992 Guidelines in many ways: they placed a lesser emphasis on market definition; they placed relatively greater emphasis on unilateral effects of a transaction, as compared with the potential for coordinated effects among market participants; they increased the HHI thresholds at which transactions will be marked for competitive concerns; and they addressed several new topics, such as effects on innovation markets and the market power exercised by buyers (monopsonies). Like the earlier versions, the Proposed Guidelines were designed to ensure "that mergers should not be permitted to create, enhance, or entrench market power or to facilitate its exercise." Unlike the 1992 Guidelines, however, the Proposed Guidelines stress that the Agencies are not limited to a single methodology for analyzing mergers. In particular, they note that "market definition is not an end in itself," but is merely one of an array of tools in the Agencies' arsenal. As more fully described below, the Proposed Guidelines reflect a desire to provide transparency in the evaluation process while allowing the Agencies increased flexibility to protect the public interest in open and honest competition.

After the comment period, the Agencies on Aug. 19, 2010 issued their Final Revised Guidelines which, in large part, mirror the Proposed Guidelines. The penultimate section of this article highlights various distinctions between the Proposed and Final Revised Guidelines.

Market Definition and Unilateral Effects. Like the Proposed Guidelines, the Final Revised Guidelines eschew the methodical, sequential approach of the 1992 Guidelines, providing that "merger analysis does not consist of uniform application of a single methodology." Final Revised Guidelines § 1. The Final Revised Guidelines state that a merger will be deemed to "enhance[] market power if it is likely to encourage one or more firms to raise price, reduce output, diminish innovation, or otherwise harm customers as a result of diminished competitive constraints or incentives." Id. They drastically reduce the role of market definition in the merger evaluation process. While the Final Revised Guidelines provide guidance regarding how relevant markets are to be defined and their concentration measured, they emphasize that conclusions surrounding market definition and concentration are to be treated as nothing more than one factor among many to be used in determining whether a proposed merger would reduce competition. The Final Revised Guidelines also make clear that unilateral effects analysis is to play a significantly expanded role in the Agencies' determination regarding a merger's effect on competition. Indeed, they provide that the Agencies may rely solely on a unilateral effects analysis to determine a merger's potential anticompetitive effects, without any requirement that the Agencies first define a relevant product market. Id. § 6.

The Final Revised Guidelines, then, reflect a shift in the focus of the Agencies' analysis of competitive effects. The Agencies appear now to be somewhat more concerned with the potential for "unilateral effects," produced by elimination of direct competition between the merging parties, such as the ability to divert sales between products sold by the previously competing firms. While the Final Revised Guidelines do not ignore the possible effects of coordinated post-merger conduct by all the participants in a market, the focus of coordinated effects analysis is now squarely on analysis of the ability of firms to observe and react to one another's visible market activities, with relatively less attention paid to conditions that might facilitate the more extreme instances of explicit agreements among competitors and efforts to punish deviations from such agreements.

The most significant change in the Guidelines since 1992 is the de-emphasis of market definition and corresponding increased focus on the actual competitive effects that are likely to result as a consequence of the transaction. Under the old orthodoxy, market definition played a central role in measuring the likely competitive effects of a transaction. However, under the new methodology first advanced in the April draft and subsequently adopted in the final version, market definition is not as crucial to the merger analysis. Adverse competitive effects, according to the Agencies, more directly address the central question of any merger analysis, which is whether the transaction may substantially lessen competition.

In the Final Revised Guidelines, the Agencies further refine the role market definition plays in the agencies' analysis. In the Proposed Guidelines, the agencies explained that they "define relevant markets to help analyze the competitive effects of a horizontal merger." However, the Final Revised Guidelines recast that role of market definition as germane only once the agencies "identify a potential competitive concern," at which point market definition serves two roles: specifying the line of commerce in which the competitive concern arises, and allowing the Agencies to identify market participants and measure shares and market concentration. Market definition historically has performed these functions in merger analysis, serving as the primary means for determining whether a transaction was likely to result in anticompetitive effects. However, the Final Revised Guidelines relegate market definition to a supporting role in analyzing the impact of competitive concerns that have already been identified.

By significantly de-emphasizing the importance of defining the relevant market and its level of concentration when determining whether market power exists, the Final Revised Guidelines may create tension with current antitrust case law. Federal courts have repeatedly recognized market definition as an indispensable first step when addressing the propriety of horizontal mergers. For example, the U.S. Court of Appeals for the District of Columbia Circuit stated that the FTC's ability to demonstrate that a challenged merger would produce anticompetitive effects hinged entirely on the proper definition of the relevant product market. FTC v. Whole Foods Mkt., 548 F.3d 1028, 1043 (D.C. Cir. 2008). The FTC had argued that market definition was only a means to an end and not an essential part of its case, but the D.C. Circuit concluded that only through examination of a particular market can the "probable anticompetitive effects of the merger be judged." Id. at 1036, (quoting Brown Shoe Co. v. United States, 370 U.S. 294, 322 n.38 (1962)). Indeed, a prima facie case that the defendants' conduct is likely "to lessen competition" (in violation of § 7 of the Clayton Act, 15 U.S.C. § 18) "rests on defining a market and showing undue concentration in that market." Id. In Chicago Bridge Iron Co. v. FTC, 534 F.3d 410 (5th Cir. 2008), the Fifth Circuit agreed that "typically the Government establishes a prima facie case by showing that the transaction in question will significantly increase market concentration, thereby creating a presumption that the transaction is likely to substantially lessen competition." Id. at 423. Neither court indicated that the FTC could prove its case merely by establishing that the merging firms sold differentiated products that were close substitutes, without also showing that the relevant market was sufficiently concentrated. See also United States v. Oracle Corp., 331 F. Supp. 2d 1098, 1117 (N.D. Cal. 2004) ("In a unilateral effects case, a plaintiff is attempting to prove that the merging parties could unilaterally increase prices. Accordingly, a plaintiff must demonstrate that the merging parties would enjoy a post-merger monopoly or dominant position, at least in a 'localized competition' space."); FTC v. CCC Holdings, Inc., 605 F. Supp. 2d 26, 68 (D.D.C. 2009).

In light of these precedents, the Final Revised Guidelines reflect a pro-enforcement perspective and an effort to forestall the various defenses raised by recent merging parties successfully to defeat horizontal merger challenges. In any event, the Guidelines have not been proffered as replacing current case law and are, of course, not binding on the courts. Notwithstanding the potential for conflict, since most horizontal merger investigations are resolved at the agency level, rather than challenged in court, the Final Revised Guidelines provide valuable insight into how best to address agency concerns in a non-adversarial environment.

Presumptions & Market Concentration. The Final Revised Guidelines also explain in more detail the role of market concentration measures and revise the concentration thresholds likely to trigger additional review. These revisions similarly update the Guidelines to reflect more accurately actual Agency practice. The Final Revised Guidelines appear to shift the burden of persuasion to the merging parties by creating presumptions once certain conditions exist and by creating thresholds that the parties must meet. For example, in Section 2.2.1 of the Final Revised Guidelines, the Agencies state that "[t]he business decisions taken by the merging firms … can be informative about industry conditions…. [I]f a firm sets price well above incremental cost, that normally indicates either that the firm believes it customers are not highly sensitive to price…or that the firm and its rivals are engaged in coordinated interaction." Final Revised Guidelines at Section 2.2.1. In addition, the Final Revised Guidelines suggest that "[t]he financial terms of the transaction may also be informative regarding competitive effects[:]…a purchase price in excess of the acquired firm's stand-alone market value may indicate that the acquiring firm is paying a premium because it expects to be able to reduce competition or to achieve efficiencies." Final Revised Guidelines at Section 2.2.1.

The Final Revised Guidelines provide long overdue revisions to the standards for assessing market concentration with the HHI. The threshold level below which the Agencies view markets as unconcentrated has been increased from 1000 to 1500. Mergers which result in HHIs of 1500 or less will be judged unlikely to have anticompetitive effects, and ordinarily not subjected to further analysis. Similarly, the threshold for markets the Agencies regard as highly concentrated has been increased from 1800 to 2500. The new standards could mean that fewer mergers should be challenged than would be the case following the standards from the 1992 Guidelines. In the view of most observers, though, the earlier standards had been relaxed by the Agencies for some time in practice, so the Final Revised Guidelines may aptly be seen as an effort to reflect actual Agency practice.

In Section 5.3, the Proposed Guidelines suggest the level of Agency scrutiny that a merger can expect based on post-acquisition levels of concentration. Under the new thresholds, an acquisition would be suspect if the post-acquisition market is highly concentrated (an HHI of 2500) and the change in the HHI is greater than 200. This presumption can be rebutted by persuasive evidence, according to the revised text, contained in proposed Section 5.3:

The purpose of these thresholds is not to provide a rigid screen to separate competitively benign mergers from anticompetitive ones .... Rather, they provide one way to identify some mergers unlikely to raise competitive concerns and some others for which it is particularly important to examine whether other competitive factors confirm, reinforce, or counteract the potentially harmful effects of increased concentration.

Under the 1992 Guidelines, a post-acquisition HHI of 2500 with a change of 200, for example, would not have necessarily meant that the parties had to prove easy entry conditions or that coordinated interaction is implausible. While such a merger may have been subject to heavy scrutiny, under the 1992 Guidelines, the investigating Agency had to convince itself that entry was difficult and that enhanced post-acquisition coordination was probable. The presumptions built into the Final Revised Guidelines in these sections may imply rigidity in analysis, thereby adopting a structural presumption that lies beyond the present level of economic knowledge or the actual practice of the parties. At the same time, the Final Revised Guidelines removed any reference to the 35% “safe harbor” which was present in the 1992 Guidelines and deleted the two-year benchmark for “timely, likely, and sufficient” entry into the market to prevent the enhancement of market power by a merged firm. These revisions could signal a more flexible, fact-intensive review of entry arguments by merger partners, and will allow the Agencies to consider entry that might occur sooner or later than two years, depending on the market. Under the Final Revised Guidelines, the parties will bear a significant burden of showing ease of entry where there is no history of the type of entry upon which the merging firms may rely.

Evidence of Adverse Competitive Effects. The Final Revised Guidelines include a new section which outlines the types and sources of evidence upon which the Agencies will base their conclusions about a transaction. The array of evidentiary sources include actual effects observed in consummated mergers; direct comparisons based on historical events, or “natural experiments”; market share information (HHI thresholds); actual head-to-head competition between the parties to a merger transaction; the role of a “maverick” firm in the market, and anecdotal evidence from customers and industry participants. While much of this section simply describes existing Agency practice, it nonetheless underscores the importance of this evidence and emphasizes the fact-specific nature of the Agencies’ inquiry. Finally, the Final Revised Guidelines discuss the significance of “upward pricing pressure,” (Section 6.1), notwithstanding the rejection of that test by the first court to consider it. The City of New York v. Group Health Inc., 2010 U.S. Dist. LEXIS 60196 (S.D.N.Y. May 11, 2010).

Guidance Regarding Effects Upon Various Subgroups and Monopsony Buyers.
The Final Revised Guidelines in several places emphasize the Agencies’ concern with the effect of mergers on identified customer groups, even if other customers in the relevant market will not be harmed. This is reflected in the discussion of Targeted Customers and Price Discrimination (Section 3) and Product Market Definition with Targeted Customers (Section 4.1.4), for example, as well as in the discussion of Pricing of Differentiated Products (Section 6.1), and Powerful Buyers (Section 8). These changes signal an increased interest in challenging proposed transactions that may impact particular subgroups within a relevant market.

In addition, the Final Revised Guidelines address groups of powerful buyers for the first time, a development applauded by interest groups traditionally affected by powerful buyers of goods and services. Final Revised Guidelines at Section 12. This section indicates that the Agencies may challenge mergers that harm sellers in upstream (or “buying side”) markets even if there is no injury to consumers in the downstream market. According to the Final Revised Guidelines, [m]ergers of competing buyers can enhance market power on the buying side of the market, just as mergers of competing sellers can enhance market power on the selling side of the market.” Final Revised Guidelines at Section 12.

Although there is considerable debate as to whether merger enforcement should be concerned with transfers between upstream sellers and buyers in the absence of harm to consumers in the form of higher prices, the new section reflects a growing sensitivity by the Agencies to the concerns of all stakeholders in the analytical process. Of course, a merger that creates a larger buyer may or may not harm consumer welfare. It has been observed that:

[i]nput prices can fall for two entirely different reasons, one of which arises from a true economic efficiency that will tend to result in lower prices for final consumers. The other, in contrast, represents an efficiency-reducing exercise of market power that will reduce economic welfare, lower prices for suppliers, and may well result in higher prices charged to final consumers. Antitrust must distinguish these two situations and pursue enforcement against the latter, but not the former.

Antitrust Enforcement in the Agricultural Marketplace: Hearing Before the Committee of the Judiciary, United States Senate, 108th Cong. (2003) (statement of R. Hewitt Pate, Assistant Attorney General, Antitrust Division).

There is support, though, for the proposition that monopsony raises competitive concerns in circumstances where buyers can depress input prices and thereby reduce the quantity of inputs purchased below competitive levels. The Agencies also acknowledged this point in the Competitor Collaborations Guidelines, which define monopsony as “the ability or incentive to drive the price of the purchased product, and thereby depress output below what likely would prevail in the absence of the relevant agreement.”

In any event, it is interesting to note the difference in the new section of the Final Revised Guidelines with the approach to buyer power in the Agencies’ 2007 Intellectual Property Report (“IP Report”). The IP Report prescribes rule of reason treatment for ex ante negotiations of licensing terms, citing “the strong potential for procompetitive benefits.” The examples offered in the IP Report of situations that would pose competitive problems under the rule of reason are quite limited. In this regard, a unified approach in both contexts would include an analysis of monopsony power to determine whether a predicted reduction in prices paid to upstream suppliers would be accompanied by a predicted reduction in output and a concomitant increase in downstream prices.

Changes from the April 2010 Proposed Guidelines

There are some other nominal changes between the Proposed Guidelines and the Final Revised Guidelines. For example, the hypothetical monopolist test, whereby the Agencies test the boundaries of a market by analyzing whether purchasers would substitute a product in the face of a small but significant and non-transitory increase in price (SSNIP), was retained in the Proposed Guidelines with one change. The Proposed Guidelines applied a 10 percent – instead of the prior five percent – SSNIP where explicit or implicit prices for the firm’s contribution to value could be identified. The Final Revised Guidelines eliminate that provision and simply rely on a five percent SSNIP, with the added caveat that the appropriate SSNIP to be applied may depend on the nature of the industry and the merging parties’ positions within it. In addition, when looking at potential unilateral competitive effects of a transaction (for instance, in a merger to monopoly), the Proposed Guidelines introduced the application of diversion ratios, which measure the percentage of unit sales diverted to a second product when the price of the first product increases. Diversion ratios may indicate the presence of upward pricing pressure on the first product as a result of the merger. However, several informal comments to the Proposed Guidelines noted that in almost any merger or acquisition there would be a diversion ratio of greater than zero, which, according to the Proposed Guidelines, would indicate some upward pricing pressure as a result of the merger. Possibly in response to this concern and the suggestion of possible over-enforcement, the Final Revised Guidelines note “[i]f the value of diverted sales is proportionately small, significant unilateral price effects are unlikely.”

Conclusion

The overwhelming reaction by the antitrust bar and consumer groups to the new Guidelines has been positive. A major theme of the revisions is the Agencies’ expressed desire to have more flexibility in assessing whether a merger is likely to lessen competition by not committing to any one particular methodology. In practice, businesses contemplating transactions should not anticipate dramatic changes in merger analysis, but should expect a process that is both more rigorous and more fluid, depending on the types of evidence available to the parties and the agencies. The Final Revised Guidelines demonstrate a flexible approach toward potential transactions and a tolerance for higher concentration levels in certain circumstances. At the same time, the de-emphasis of the role of market definition and skepticism of efficiency and ease of entry arguments could make anticompetitive behaviors harder to justify before the Agencies. Fortunately, the Final Revised Guidelines provide updated explanations of several of the analytical tools used by the Agencies in their review of potential transactions. On balance, the new Guidelines do not signify any revolutionary change from current merger analysis, but rather memorialize the methodologies already implemented by the Agencies. Thus, they should provide more useful guidance to parties as to how the Agencies are likely to evaluate a proposed merger or acquisition.

While they de-emphasize the role of market definition in the Agencies’ analyses of transactions, the Guidelines largely memorialize the Agencies’ existing practices in the merger review process. The new shift in focus could possibly be a response to the Agencies’ difficulties in sustaining their burden of proof concerning market definition in past unsuccessful merger challenges. By placing greater emphasis on evidence of a transaction’s competitive effects, the Agencies allow themselves more flexibility to avoid complicated market definition issues and instead address the central question posed by a transaction; namely, whether it will result in anticompetitive effects. Transacting parties, then, may need to be prepared to marshal evidence on a broader range of potential issues in defending their proposed transactions. Evidence of competitive effects also may be critical to parties that have already consummated transactions, which, as the Final Revised Guidelines make clear, remain subject to post-closing challenges. If there is a clear conclusion to be drawn by the Agencies' work, it would be that the Final Revised Guidelines reflect a desire by the Agencies to maintain an analytical flexibility while redressing some of the impediments to past merger challenges, which may portend increased antitrust scrutiny of mergers, as well as a likely increase in the number of actual challenges.

Robin Vinson practices in the Raleigh office of Smith Anderson Blount Dorsett Mitchell & Jernigan.