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## Revising the U.S. Merger Guidelines

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## Revising the Merger Guidelines

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### I. INTRODUCTION

The current U.S. Horizontal Merger Guidelines (“HMGs”) state: “[t]he Guidelines are designed primarily to articulate the analytical framework the Agency applies in determining whether a merger is likely substantially to lessen competition . . .”<sup>2</sup> As such, the Guidelines should provide transparency in current merger policy and enforcement, which is extremely important both in ensuring that businesses understand the ground rules for merger review and in providing self discipline on the agencies. In attempting to provide transparency, the Department of Justice (“DOJ”) and the Federal Trade Commission (“FTC”) have issued and revised Merger Guidelines entirely or in part 5 times over the last 40 years. However, the agencies have not done a significant overhaul of the HMGs since 1992, and have not addressed non-horizontal merger analysis in the Guidelines since 1984.

In September of this year, the DOJ and FTC indicated they are considering updating the HMGs again, but apparently have no plans for revising the guidelines for non-horizontal mergers. In an approach much more open than in past Merger Guideline revisions, the agencies have requested comments on 20 questions, some of which have many subparts.<sup>3</sup> The stated goals of this inquiry are to determine if updated guidelines could: (1) more accurately and clearly describe current Agency practice; and (2) reflect and incorporate learning and experience gained since 1992.

As a contributor to the 1992 Guidelines revision and the 1993 Statements of Antitrust Enforcement Policy in Health Care, I am aware of the challenges that face the agencies in achieving consensus on potentially revising a very important policy document. Both the current Horizontal and Non-Horizontal Merger Guidelines in many ways do not reflect the practices of the agencies. In addition, there has been substantial new learning since 1992 on the impact of horizontal mergers, and even more relating to the impact of vertical mergers since 1984.

All agree there are substantial differences between the potential lessening of competition from horizontal and vertical mergers. Horizontal mergers can lead to an immediate reduction in output and increased prices because a merger may make one firm out of two that are constraining each other’s prices, or may make coordination of pricing easier for the remaining firms. In contrast, anticompetitive theories relating to vertical mergers involve the merged firm expanding its output at the expense of its competitors, raising these rivals’ costs, and forcing a reduction in the sales of its competitors by more than any expansion of the merged firm’s output. The mergers that are most likely to cause competitive problems have been and will be horizontal, and revising the HMGs to reflect practice and learning is very important. However, the vertical part of the Non-Horizontal Merger Guidelines is even more out of touch with the

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<sup>2</sup> Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (Issued April 1992/Revised April 1997), available at <http://www.ftc.gov/bc/docs/horizmer.shtm>.

<sup>3</sup> Available at <http://www.ftc.gov/bc/workshops/hmg/hmg-questions.pdf>.

agencies' practices and learning, and they should also be revised if the agencies are serious about investigating and challenging vertical mergers.

## II. REVISING THE HMGS

In the agencies' contemplated revision of the HMGS, it is important to evaluate whether potential changes are related to existing agency practice or new learning. If the analyses or types of evidence being considered for inclusion in the HMGS have been used by the agencies for many years, then the HMGS should mention them with a short explanation as to why the agencies may consider them useful. If a change to the HMGS is based on new learning since 1992, then that change should be very carefully scrutinized. Research on competition and mergers continues over time. Consensus on some analyses eventually occurs, while other analyses fade away. For the HMGS to be useful over time, one needs to be sure that the analyses or types of evidence have been proven reliable, and are likely to continue to be used for some time.

The questions raised by the FTC and DOJ in their consideration of revising the HMGS reflect potential changes in virtually all aspects of those Guidelines. However, at least 12 of the 20 questions focus on market definition, inferences of market power from market shares, non-structural aspects of competitive effects analyses, and how the structural and non-structural analyses should relate to one another. Of the first 12 questions, Questions 2 (with 6 subparts) and 10 (with 8 subparts) sharply focus on the types of evidence and analysis that are used to evaluate competitive effects beyond market structure, presumably making these parts of the HMGS a top agency priority for revision.

Consider Question 2, which states "[s]hould the Guidelines be revised to address more fully how the Agencies use evidence about likely competitive effects that is not based on inferences drawn from increases in market concentration?" For transparency, the agencies presumably should mention the types of non-structural competitive effects evidence that the agencies give substantial weight. Moreover, the current HMGS already list examples of the types of evidence the agencies consider for product and geographic market definition (Sections 1.11 and 1.21), so listing examples of the types of non-structural evidences used in evaluating competitive effects would be an extension of existing practice.

Question 2 goes on to ask "[i]f such revisions are undertaken, what types of such direct evidence are pertinent? How should the following categories of evidence be used?" The agencies then specifically ask about evidence from consummated mergers, "natural experiments," merging firms' post-merger plans, customers' reactions to the merger, merging firms engaging in significant head-to-head competition, and historical evidence of actual or attempted coordination in the industry.

The language in this part of the question is misleading in one important aspect, which has substantive implications. The list of types of evidence contains only one example of "direct" evidence, and that is evidence from a consummated merger. A before-and-after study of the effects of a merger would be a "direct" measure if it controlled for other influences that affected the merged firm (e.g., changes in input costs) and other changes in general supply and demand factors. Since the vast majority of merger inquiries are attempting to analyze a merger that has not yet occurred, it is not surprising that the agencies use indirect evidence of competitive

effects, such as the other 5 examples. In considering whether to mention these other 5 types of evidence in the HMGs, it is important not to treat them as fundamentally superior to the indirect evidence that the agencies and courts have traditionally used—i.e., market shares and changes in market shares. Any changes in the types of evidence or analyses should caution against complete reliance on a single factor, except perhaps for truly direct evidence from a consummated merger.

Of the six areas mentioned in Question 2, the agencies have relied for decades on merging firms' post-merger plans, customers' reactions to the merger, merging firms engaging in significant head-to-head competition, and historical evidence of actual or attempted coordination in the industry. These types of evidence have stood the test of time, and should be mentioned in a revision of the HMGs. Two of the examples have seen substantial new learning since 1992, "natural experiments" and more sophisticated analyses of consummated mergers. These types of evidence, along with any other new learning since 1992, should only be included in a revision if they have been well tested and are also likely to stand the test of time.

"Natural experiments,"<sup>4</sup> have long been used in antitrust and other economic analyses, including analyses of alleged price fixing and estimation of damages in antitrust cases. They came to the forefront for the first time in merger analysis with FTC's successful challenge of the Staples-Office Depot proposed merger in the 1990s. An important part of the evidence the FTC put forward for both market definition and competitive effects arguably showed lower prices when the two merging firms competed in certain geographic areas, compared to areas where they did not. These analyses included company documents describing lower pricing in regions where more office superstores competed. In addition, there were econometric analyses of prices across geographic areas that measured the impact of the number and identity of office superstore competitors (and other office supply competitors), while attempting to control for important differences across the regions that could also influence prices.

Like other economic analyses, natural experiments analyses in mergers are only useful if (1) they reasonably fit the facts of the case, and (2) employ sound economic methodologies that are based on reliable information. The further away the experiment is from the facts of the case at hand, the less useful it is in assessing competitive effects. Moreover, one needs to check whether the results of the experiment are consistent with other economic analyses. If different aspects of the market are clearly inconsistent with the results of the natural experiment, then the experiment should also be given much less weight. Taking these and other cautions into account, the agencies' use of natural experiments since 1992 and the general acceptance of the analytic approach when done correctly suggest it is appropriate to mention this type of evidence in the HMGs. In addition, briefly explaining the use of natural experiments in the HMGs may influence the courts, which may be focusing too much on requiring exact boundaries for market definition and too little on competitive effects.

This abbreviated review of Question 2 suggests the type of analysis that should be considered before the agencies decide whether and how the HMGs should be updated. Question 3 (b) asks whether the HMGs should include "[h]ow to conduct 'critical loss analysis,' including the proper use of evidence regarding pre-merger price/cost margins." Question 10 (d) asks whether the HMGs should discuss "[t]he role of diversion ratios and price/cost

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<sup>4</sup> For more detail, see Mary Coleman & James Langenfeld, *Natural Experiments*, ISSUES IN COMPETITION LAW AND POLICY, Vol. 1, 743-772, (2008).

margins in evaluating unilateral effects.” Critical loss analysis and diversion analysis can be useful in both market definition and competitive effects analyses, and both have been increasingly used by the agencies since 1992.<sup>5</sup> More explanation of how the Agencies use critical loss analysis and diversion ratios may be useful in the HMGs. However, careful consideration should be given to any substantial changes in the current HMGs’ market definition approach that critical loss analysis attempts to address, as well as to adding diversion ratios for measuring potential competitive effects. These analyses have developed a great deal since 1992, but there may be less of a consensus on how to use them than other potential revisions.<sup>6</sup>

### III. REVISING THE NON-HORIZONTAL MERGER GUIDELINES

Many government officials have highlighted the limitations of the existing Non-Horizontal Merger Guidelines, and there have been calls to update the sections that deal with vertical mergers. In 2005, former Chairman Pitofsky stated that under the 1984 Guidelines none of five recent vertical challenges at that time would have been regarded as violations and “could not have been brought if the vertical guidelines were controlling.”<sup>7</sup> In contrast to the Horizontal Merger Guidelines that are so influential, the “vertical guidelines have been widely ignored.”<sup>8</sup>

The 1984 Non-Horizontal Merger Guidelines do not acknowledge the possibility of foreclosure as the basis for a merger challenge. Under “Post-Chicago” theories of vertical mergers, a vertically integrated firm could foreclose its rivals if there is “imperfect competition” in the pre-merger and post-merger environment. The literature identifies the two types of foreclosure identified in the investigations and challenges by the agencies: input foreclosure (where the integrated firm seeks to raise rivals’ costs) and customer foreclosure (where the integrated firm seeks to reduce rivals’ revenues). Input foreclosure can follow from a vertical merger when the upstream division of the integrated firm either stops supplying inputs to competitors of its downstream division, or continues to sell at a substantially increased price. Customer foreclosure can occur when an upstream firm acquires a downstream firm and the merger creates an incentive for the upstream firm to foreclose its rivals, leading to increased intermediate and final goods prices.

The FTC and the DOJ have used foreclosure arguments in challenging vertical merger cases.<sup>9</sup> Research has found that there were 23 merger consents or abandoned mergers that

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<sup>5</sup> See, for example, James Langenfeld & Wenqing Li, *Critical Loss Analysis in Evaluating Mergers*, ANTITRUST BULLETIN, Summer 2001, 299-337.

<sup>6</sup> See Joseph Farrell & Carl Shapiro, *Improving Critical Loss*, Antitrust Source, (Feb. 2008), available at <http://www.abanet.org/antitrust/at-source/08/02/Feb08-Farrell-Shapiro.pdf>, and Joseph Farrell & Carl Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition*, (November 25, 2008), available at <http://ssrn.com/abstract=1313782>, compared to Malcolm B. Coate & Joseph J. Simons, *Models, Mathematics and Critical Loss*, (November 3, 2009), available at SSRN: <http://ssrn.com/abstract=1346067>.

<sup>7</sup> Robert Pitofsky, *Antitrust: Past, Present, and Future of Antitrust Enforcement at the Federal Trade Commission*, 72 U. CHI. L. REV. 209, 221 (2005).

<sup>8</sup> *Id.* at 220. See also Thomas B. Leary, *The Essential Stability of Merger Policy in the United States*, 70 ANTITRUST L. J. 105, 120 (2002-03) and Timothy J. Muris, *Principles for a Successful Competition Agency*, 72 U. CHI. L. REV. 165, 184 (2005).

<sup>9</sup> Jeffery Church, *Vertical Mergers*, in 2 ISSUES IN COMPETITION LAW AND POLICY 1455 (Dale W. Collins ed., 2008) at 1460.

involved vertical anticompetitive theories during the 1990s and 3 cases since 2000. Consider a few case examples.

In 1995 the FTC obtained a consent in a merger between workstation manufacturer Silicon Graphics and graphics software firms Alias Research Inc. and Wavefront Technologies Inc. based on input foreclosure theories. Similarly, in 1999 the FTC staff raised input foreclosure concerns regarding book retailer Barnes & Noble's later abandoned acquisition of book wholesaler Ingram.<sup>10</sup> The DOJ challenged AT&T's acquisition of McCaw in the 1990s based on the potential for input foreclosure.<sup>11</sup> More recently, the FTC challenged Cytoc Corp.'s acquisition of Digene Corp. in 2003 on grounds that included an input foreclosure theory.<sup>12</sup>

Customer foreclosure arguments were used, among others, in the 1997 merger of Cadence Design Systems (an operator of integrated circuit layout environments) and Cooper & Chyan Technology (a producer of integrated circuit routing tool software) that resulted in a consent.<sup>13</sup> The FTC investigated the merger between Synopsys Inc. (a producer of front end tools for chip design) and Avanti Corp. (a producer of back end tools for chip design) in 2002 on similar grounds. Although FTC decided to close its investigation of the merger, Commissioner Leary cited the use of customer foreclosure theories in understanding the anticompetitive effects of the merger.<sup>14</sup>

It is not surprising that the Antitrust Modernization Commission recommended updating the Non-Horizontal Merger Guidelines to incorporate the new thinking about vertical mergers and to provide transparency in how the agencies analyze these non-horizontal mergers.<sup>15</sup> However, there are a number of challenges to revising the Non-Horizontal Merger Guidelines that need to be considered.

First, the current economic models describe possible anticompetitive effects from vertical mergers, but the new economic models depend on a variety of conditions, many that are not easily observed. However, even horizontal mergers of firms in an oligopoly may lead to a variety of changes in the market, depending on assumptions about the ways in which competitors behave that can be difficult to observe. In part, this is why the HMGs devote a great deal of analysis to competitive effects, and may devote more if they are revised.

Second, many of the new economic models do not address all of the potential pro-competitive effects of vertical integration and, in particular, the benefits of eliminating double marginalization in vertical cases. An inquiry into the likelihood of the elimination of "double-marginalization" or other efficiencies can be done, and the agencies have done so in the past.

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<sup>10</sup> Richard G. Parker, Senior Deputy Director, Bureau of Competition, Federal Trade Commission, Address at the International Bar Association (Sep. 28, 1999) *available at* <http://www.ftc.gov/speeches/other/barcelona.shtml>.

<sup>11</sup> Steven C. Sunshine, Deputy Assistant Attorney General, Antitrust Division, U.S. Department of Justice, Remarks Before the American Bar Association Section of Antitrust Law (Apr. 5, 1995) *available at* <http://www.usdoj.gov/atr/public/speeches/2215.pdf> at 8-11.

<sup>12</sup> See FTC Press Release, *FTC Seeks to Block Cytoc Corp.'s Acquisition of Digene Corp.* (June 24, 2002) *available at* [http://www.ftc.gov/opa/2002/06/cytoc\\_digene.shtml](http://www.ftc.gov/opa/2002/06/cytoc_digene.shtml).

<sup>13</sup> See FTC complaint in the Matter of Cadence Design Systems, Inc., *available at* <http://www.ftc.gov/os/1997/05/cadence.pdf>; See statements by Commissioners Pitofsky and Steiger *available at* <http://www.ftc.gov/os/1997/05/state01.htm>. Consent was subsequently given on this merger.

<sup>14</sup> *Id.*

<sup>15</sup> Antitrust Modernization Commission, Report and Recommendations 68 (2007), *available at* [http://www.amc.gov/report\\_recommendations/amc\\_final\\_report.pdf](http://www.amc.gov/report_recommendations/amc_final_report.pdf), at 68.

Third, vertical theories are said to lack any systematic empirical basis. It is true that economic research on vertical restraints has yielded some mixed results, and there is relatively little recent research specifically devoted to the impact of non-horizontal mergers. There is also empirical research questioning whether horizontal merger enforcement has demonstrably improved welfare, but there still is a consensus that some horizontal mergers should be challenged.

Fourth, there were few vertical mergers investigated or challenged under the eight years of the Bush administration. However, there were several notable vertical merger challenges under the Clinton administration. To the extent the Obama administration's non-horizontal merger policy is more like the policy that prevailed under President Clinton than President Bush, there are enough cases that follow the new economic literature to provide guidance for revising the vertical portions of the 1984 Guidelines. It is highly unlikely that economic thinking about non-horizontal mergers will change substantially in the near future, and it is equally unlikely that the types of vertical cases will be radically different than the ones brought in the 1990s.

Finally, there has been a concern that revised guidelines would lead to too much enforcement. Agency staffs, however, would likely limit their investigations to the vertical theories discussed in the revised guidelines, which presumably would not result in over-enforcement.

Given the substantial new thinking that has occurred since 1984 and the agencies' track record on the types of vertical mergers that are investigated and challenged, the Non-Horizontal Merger Guidelines should be revised. The format can be similar to that found in the 1984 U.S. and 2007 E.C. Guidelines. That is, the revision should describe a set of theories of anticompetitive effect and the factual circumstances in which those theories may apply. The E.C. Guidelines follow this approach in a structured analysis that applies market power screens, identifies a coherent theory of anticompetitive harm that has factual relevance, and assesses the nature and magnitudes of merger-related efficiencies. In effect, the E.C. has already done much of the difficult work, and the agencies should be able to build on that platform.