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Indicate Greater Scrutiny of High
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I. INTRODUCTION

On August 19, 2010, the Department of Justice and the Federal Trade Commission (the "Agencies") released the final version of their revised Horizontal Merger Guidelines ("Guidelines"),² which are used by the Agencies to analyze the competitive implications of mergers between direct competitors. Whereas the prior version of the Guidelines had sought to provide a precise, step-by-step framework for analyzing horizontal mergers—centered around defining a "relevant market" and measuring market concentration—the new revisions envision a much more flexible approach. The revised Guidelines de-emphasize market definition and the calculation of market shares, and can instead be likened to a "tool box" of techniques for analyzing the competitive implications of horizontal mergers. This new analytical approach has important implications for analyzing M&A transactions. It also indicates greater Agency scrutiny of such transactions in industries characterized by differentiated products and high levels of research and development ("R&D") spending—such as the high tech and pharmaceutical industries.

Importantly, the methods for analyzing horizontal mergers and acquisitions that are set forth in the new Guidelines are not new—they reflect practices that the Agencies have used since the last version of the Guidelines was published in 1992.³ The new Guidelines are also generally consistent with the approach taken in the Merger Guidelines Commentary, which the Agencies published in 2006 during the Bush Administration. As a result, the new Guidelines are more of an effort to increase transparency rather than to effect fundamental change. Additionally, as demonstrated by a recent court ruling against the FTC,⁴ the impact of the Guidelines will also be restrained by the fact that courts hearing merger challenges will likely continue to consider market definition central to the antitrust assessment of mergers. Indeed, the final version of the Guidelines contains a statement emphasizing that the Agencies will ordinarily rely on market definition and market share arguments in a merger challenge.

Below we describe several changes to the new Guidelines that indicate greater scrutiny of transactions in high tech and pharmaceutical markets.

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² U. S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines* (2010), available at <http://www.ftc.gov/os/2010/08/100819hmg.pdf>.

³ U. S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines* (1992, rev'd 1997), available at <http://www.ftc.gov/bc/docs/horizmer.shtm>.

⁴ See *FTC v. Lundbeck, Inc.* (D. Minn. Aug. 31, 2010).

II. DIRECT EVIDENCE OF COMPETITIVE EFFECTS

Applying traditional market definition analysis to markets with highly differentiated products is frequently like fitting a square peg into a round hole. Different products typically compete along a spectrum, and are substitutable with one another to varying degrees. Seeking to draw a clear line as to which products are "in" and which are "out" of the market can often be arbitrary. The revised Guidelines recognize this, explaining that setting a precise boundary for the "market" results in an oversimplification that "cannot capture the full variation in the extent to which different products compete against each other."⁵ On the other hand, the use of the market definition paradigm has been useful to provide discipline for the competitive analysis of merger transactions—for example, as a restraint on the possibility of challenging mergers based on insignificant competitive effects.

The new Guidelines' de-emphasis of market definition provides increased legitimacy to a trend at the Agencies to focus mainly on the likely real-world "competitive effects" of mergers and acquisitions.

For example, imagine a highly competitive market for software products designed to assist with a particular business process. Several companies may offer a premium suite of products (with varying degrees of specialization), whereas other companies may offer niche products competitive with specific applications within the suite, perhaps customized for a particular industry. Consider a proposed acquisition by a manufacturer of the most popular suite of the manufacturer of a popular niche product aimed at the insurance industry. Defining markets and measuring market shares in that industry might suggest no competitive issue (because of the large number of competitors), but the Agencies might be concerned that insurance companies view the merging parties' products as their first and second choices.⁶ The Agencies might consider whether the combined company post-merger may raise the price of the niche insurance product with the expectation that most customers disappointed with the higher price will turn instead to the company's most popular suite as the next best alternative. Under the new Guidelines, instead of having a debate over which products are "in" or "out" of the market, the parties and Agencies can instead focus on whether—in the "real world"—customers of the insurance product faced with a price increase could switch to the second best selling suite in enough numbers to make the proposed price increase unprofitable.

In pharmaceutical markets, a similar "competitive effects" issue could arise if, for example, a brand name manufacturer sought to acquire a generic substitute for one of its drugs. In such a case, the Agency would point to the competitive effects of the transaction—i.e., the possibility that the brand name manufacturer won't introduce (or will delay introducing) the generic and the corresponding impact on prices. The Agencies could engage in this analysis without necessarily having to explain why the "market" should be drawn to exclude the important brand name drug alternatives that treat the same condition (the inclusion of which would result in low market shares for the merging parties). Of course, in each case, the Agencies would still need to explain the competitive significance of these other competing products, and why competition from these products would not be sufficient to counteract any attempt by the merging parties to increase prices post-merger.

⁵ Guidelines, *supra* note 2, §4.

⁶ *Id.* §§2.1.4, 3.

The Guidelines discuss several types of evidence of potential "competitive effects" that the Agencies may focus on in merger challenges. For example, there may be evidence of head-to-head competition between the merging parties' products that resulted in lower prices (an effect that would arguably be lost by the merger) or, if the challenge is to a consummated transaction, evidence showing that one (or both) of the competing drugs' prices was actually increased post-merger (although such evidence was not persuasive in the FTC's recent case against Ovation, which is discussed below). Merging parties will want to carefully examine such evidence when assessing the antitrust implications of their transaction.

III. EXPANDED DISCUSSION OF PRICE DISCRIMINATION

In a similar vein, the revised Guidelines illustrate a greater willingness on the part of the Agencies to pursue theories of competitive harm based on alleged effects on narrow categories of customers that can be specifically targeted for a price increase. The Guidelines provide that "[w]here price discrimination is feasible, adverse competitive effects on targeted customers can arise, even if such effects will not arise for other customers."⁷ They continue: "[w]hen discrimination is reasonably likely, the Agencies may evaluate competitive effects separately *by type of customer*."⁸ This suggestion that the Agencies might focus on narrow categories of customers in markets characterized by price discrimination is important for high tech and pharmaceutical companies that operate in markets with high R&D costs and relatively low manufacturing costs. In such markets, there is frequently a strong incentive to supply product to as many customers as possible, and this can lead manufacturers to try to "price discriminate" by providing special discounts to customers unwilling to pay the prices paid by others. The new Guidelines suggest that in such circumstances the Agencies will examine the impact of any transaction on the prices paid by each separate category of customers.

IV. SHIFT IN EMPHASIS FROM "COORDINATED EFFECTS" TO "UNILATERAL EFFECTS"

Competitive harm from "coordinated effects" occurs where the higher market concentration post-merger leads to a greater chance of concerted action between the firms remaining in the market. Competitive harm from "unilateral effects" relates solely to a reduction in competition between the merging parties. More specifically, where the producer of one product acquires a close substitute product, it may have an incentive to increase prices on one of the products post-acquisition because some of the resulting lost sales will be captured by the substitute product. Because high tech and pharmaceutical markets are often characterized by highly differentiated products and fierce competition between competitors, mergers and acquisitions in these markets more frequently raise issues of unilateral effects than coordinated effects—especially if the firm is acquiring a close substitute. While prior versions of the Guidelines emphasized "coordinated effects" as a central concern of merger review, the new Guidelines place much more emphasis on "unilateral effects." This increased focus on unilateral effects reflects current Agency practice, but leads inevitably to increased scrutiny of transactions in high tech and pharmaceutical markets—especially, as noted, where the merging parties sell differentiated products that may be viewed as close substitutes for one another.

V. HIGH MARGINS

⁷ *Id.* §3.

⁸ *Id.* (emphasis added).

In evaluating the potential for post-merger "unilateral effects," the new Guidelines explain that the Agencies will consider whether a merger is likely to lead to upward pricing pressure ("UPP") on the price of one (or both) of the merging parties' products.⁹ One key technique described in the Guidelines for assessing the potential for UPP is to calculate the amount of revenue that a merging party could recapture from the second party's product in the event that the first party raised its price. This amount is highly influenced by the size of the margins earned by the second party on its product.

In high tech and pharmaceutical markets, products are frequently sold at high margins because most of the costs of selling a product come from R&D costs, not manufacturing costs. These high margins typically have nothing to do with whether a particular market is competitive or whether a manufacturer has market power. Even the most highly competitive markets, for example, will include numerous competitors that are earning apparently high margins (not taking into account R&D costs). But because the technique described in the Guidelines will indicate greater UPP for products with higher margins, this technique (if applied mechanically) is more likely to suggest competitive problems with mergers and acquisitions in high tech and pharmaceutical markets as compared to many other industries.

VI. EFFECTS ON INNOVATION

Although the Agencies have regularly focused on how a proposed merger or acquisition might affect innovation, that concept was not well articulated in the 1992 Guidelines. The revised Guidelines specifically identify innovation as an issue to be addressed in merger review. The Guidelines note that, in some transactions, a merger may reduce incentives to continue with existing product development efforts and thereby reduce innovation, while in other cases, it may bring together complementary capabilities that may spur greater innovation. Obviously, these issues are frequently important in analyzing high tech and pharmaceutical transactions, where innovation plays a key role in both competition and business rationale for M&A transactions. As in all issues in merger analysis, the outcome will be highly fact-specific.

VII. CONCLUSION

The new Guidelines indicate a tendency on the part of the Agencies to define narrower markets, and a willingness to challenge horizontal mergers or acquisitions based on an alleged impact on a narrow set of customers. These and other changes indicate increased scrutiny of M&A transactions in high tech and pharmaceutical markets, although that does not mean that the Guidelines portend a dramatic change in future enforcement levels. As noted, these changes to the Guidelines reflect current agency practice as it has evolved over the past two decades. As participants in the high tech and pharmaceutical industries can attest, the Agencies already aggressively investigate their transactions. The possibility of dramatic change is, moreover, tempered by the influence of long-term career staff and by the oversight of courts, which tend to rely on precedent and, as noted, may resist discarding the centrality of market definitions to merger analysis. (Indeed, just recently a federal court rejected an FTC challenge to a pharmaceutical transaction on market definition grounds.)¹⁰ Accordingly, a key effect of the new Guidelines is to clarify our understanding of how the agencies are actually operating, and provide

⁹ *Id.* §6.1.

¹⁰ *See* FTC v. Lundbeck, Inc. (D. Minn. Aug. 31, 2010).

an explanation for the high level of Agency enforcement activity in the high tech and pharmaceutical industries.

We also believe that, while it does present some risks, the more holistic approach advocated by the new Guidelines creates opportunities for effective advocacy by the merging parties and their defense counsel. The limitations inherent in "market definition" arguments can also apply to defensive arguments, and there is frequently a very good story to tell concerning the likely competitive effects of an M&A transaction. Indeed, for years our discussions with the Agencies have focused on competitive effects rather than defining markets and calculating concentration levels. In making such arguments, defense counsel will now be equipped with a more precise and transparent understanding of the considerations that the Agencies are actually taking into account in evaluating whether to challenge a proposed merger. Moreover, there is nothing to stop defense counsel from focusing on market definition with the Agencies on the basis that, if the merger is ultimately litigated, that is how the courts will analyze it.