Comments on the Draft Horizontal Merger Guidelines (released April 20, 2010)

Kent Bernard

I. Introduction

Guidelines serve two interrelated functions.

1. They give the world guidance in predicting whether and on what grounds the Agencies promulgating the guidelines determine that a particular transaction will be challenged.

2. They allow the actors (business people here) to make intelligent decisions about the kinds of actions that they legally may take.

When the revision to the Horizontal Merger Guidelines ("Guidelines") was first proposed, many of us who have practiced as antitrust lawyers over the years hoped that the agencies would not only amend the HHI criteria to more accurately reflect the standards being applied in the cases, but also would investigate to see what actually happened in those cases where divestitures were required, and those where they were not required. Did prices go up as a result of the merger? Did the divested product actually reach the market? Did the retained product actually reach the market? Based on that kind of solid factual foundation, the Agencies could determine how the existing Guidelines should be changed to lead to better real world results.

Unfortunately, that is not the analysis that was done. What we have is a draft that fulfills neither of the key functions that guidelines are supposed to serve. Instead, it is almost a discussion paper of various economic theories and approaches that the agencies could use to challenge a potential transaction. Where the old Guidelines provided off ramps, the new ones eliminate them. Put differently, there are no longer guidelines to what is legal; only guidelines of ways that something may be deemed to be illegal.

Even the much touted adjustment of the HHI standards does not solve the problem. Before you get to an HHI analysis, you need to define a market. And the new Guidelines go out of their way to deemphasize the importance of true market definition.

The 1992 Guidelines, as revised in 1997, were tremendously influential in large part because they laid out in understandable terms ways to analyze potential transactions, in accordance with the case law, and allowed predictability going forward. They provided not only a roadmap to the necessary conditions for the agencies to make out a claim, but also by implication the sufficient conditions for ending an investigation. Because they provided such a clear framework and structured approach, other jurisdictions patterned their own guidelines after them. And for those jurisdictions lacking in a long history of competition law merger enforcement, they provided a ready guide. Those strong points, the roadmap, the conditions and the predictability, are all gone in the latest draft. The current draft revised Guidelines collect economic theories that could be used to condemn a transaction, but do not enable us to predict whether the data even exist to make them applicable. We have gone from a roadmap to an abstract painting.

While perhaps not as outrage provoking as the unlamented 1985 DOJ Vertical Restraints Guidelines – widely perceived as a brief for increased tolerance of vertical restraints – the current draft Horizontal Merger Guidelines do appear to reflect an advocate's view. In this case, the underlying current seems to be that the current Guidelines needed to be replaced to allow a focus on certain economic theories such as Upward Pricing Pressure, an offshoot of Unilateral Effects theory. Indeed, the draft Guidelines can probably fairly be viewed as a plea to the Courts to stop focusing on markets and case-law and to allow the agencies to block transactions based on new economic theories. What is missing though is any empirical evidence to support such a break from well established, existing law. What transactions are being cleared now that "should be" blocked? And what is the basis for such an argument? Shouldn't we insist that any new approach show that it can accurately predict which transactions will cause harm to competition (and perhaps equally as important, which will not) before we jettison a system that works?

The fact that the government loses a case is not, in and of itself, a reason to change the guidelines. And changing guidelines does not change the law.

II. <u>The De-emphasis of Markets</u>

It is stated on page 2 that "The unifying theme of these Guidelines is that mergers should not be permitted to create, enhance, or entrench market power or to facilitate its exercise". But to exercise market power, you need a market or, in the language of Section 7, a line of commerce. You cannot exercise power, or even measure it, in a vacuum. Defining a market may well not be an end in and of itself. But we would respectfully submit that it is a precondition for analyzing market power, or any impact on competition. The fact that market definition can be a difficult process does not mean that it can be swept under some analytical rug. Courts have certainly taken it as a requirement under the statute. If Guidelines are meant to produce cases that could be won, then the de-emphasis of market definition would seem to be a risky approach. Even if you can argue that market definition is not always necessarily the first step in the analysis, it is a necessary one under the law.

To go on to say, as the draft does, that a merger <u>enhances</u> market power if it is <u>likely to encourage</u> firms to harm customers by various listed actions, is to cut analysis free from fact. From a legal enforcement perspective, it should not matter whether or not something "encourages" a party to act in a given way, unless we also have evidence that the party is <u>able</u> to act in that way. For example, if at the end of the day the resulting company cannot profitably raise prices, then the issue of whether something "encouraged" it to raise prices, is irrelevant.

And we certainly should not condemn a merger on the ground that it may "diminish" innovation (Guidelines, page 2) unless we are prepared to explain: (1) how we measure innovation to begin with, (2) why more of that is always better than less of it, and (3) how whatever we determine drives innovation is altered by the merger at issue. Those foundations are nowhere to be found in the Guidelines.

What we do have is a list of tools or techniques. Indeed, the draft seems to reflect an internal tension between the traditional language of antitrust (see Section 2, paragraph 1 – "the central question of whether a merger may substantially lessen competition") and an apparent desire to overlook that basic definition in favor of new enforcement theories. So while Section 4 of the draft states that market definition is not an end in itself, and that agencies need not start with it, the same section goes on to state that "the evaluation of competitive alternatives to customers is always necessary at some point in the analysis (Section 4, page 7).

The evaluation of competitive alternative products to customers is what we used to call defining the market. It is something that the Courts look for and insist upon. For the agencies to assert that the market definition process is not critical, but simply a useful exercise, is to ignore a rather large and deep body of case-law.

III. <u>Market Participants and the HHI Revision</u>

Given the de-emphasis of product market definition, the softening of the definition of market participation is not wholly surprising. Comparing Sections 3.2 of the existing Guidelines and 5.1 of the proposed Guidelines, you see that the old 2 year test for future entry as allowing such products to be counted has vanished. The closest that we come to recognizing that future products are relevant is the phrase that products that will come into the market in the "near future" will be counted (Section 5.1). This may be a more flexible approach, but it also gives less predictability.

Whatever comfort may come from adjusting the HHI criteria in the Guidelines to more closely match what the Agencies actually have done recently, is drained away by the de-emphasis on defining markets to begin with. Unless there is a robust process for determining a market, measurements within that market (such as the HHI) are not meaningful. And indeed if the market is never defined at all, then there is no way to even begin to calculate HHI numbers.

IV. <u>Focus on Unilateral Effects</u>

Unilateral effects theory may accurately predict results in a small number of potential transactions under certain tightly defined factual situations. But speaking from the perspective of one who spent the bulk of his career counseling business people, it is highly doubtful that the data needed for an actual analysis based on unilateral effects theory will exist in most cases (especially where the products at issue are not commodities, and there is more than one seller of each). And to impose the requirements of such a theory on the general run of transactions as a screening tool, will be hugely expensive and inefficient.

The underlying theory is that sales lost from one product will, in whole or part, be gained on the other product owned by the merging firms. So if one company makes pens and it acquires a company that makes mechanical pencils, then even though the two products are not in the same "market" based on the SSNIP test, if the merged company imposes a large increase (say 100%) on the price of pens and enough people go over to the merged company's mechanical pencils, the net result <u>may</u> be profitable and, if it is, the acquisition <u>may</u> lead to a prince increase on pens. And even this hypothetical analysis of what may happen depends upon the amount of diversion captured, and the profit margins on the two products.

But even "profit" is a conclusion that rests on the definition of "cost", a term that itself has a rich variety of definitions in the business world. Even leaving aside the difficulties of using marginal cost measures in a real world context, what a business person looks at as "cost" in terms of making business decisions (such as pricing) varies. At one end, we have what may be called "cash costs." These are what you pay for raw materials and other directly measurable parts of the product. Then we move to look at manufacturing costs that include labor. Here is where things begin to get interesting. Softer elements begin to enter the picture—health plan contributions, pension accruals, overtime….real costs, to be sure, but harder to pin down. Once you start having to make "simplifying assumptions" to have the theory operate, you decrease the ability to measure real world impact.

While not expressed in the exact terms of Unilateral Effects theory, this "profitable diversion" approach has been lurking around the FTC for years, in the form of hostility towards out-licensing as a merger remedy. The argument has always been presented that the merged company wouldn't "mind" the loss of some sales if it increased price because it would get a royalty if those sales went to the third party who took the license. As a matter of theory, this is questionable. As a matter of fact, it is often flat wrong, or requires data that simply are not part of a normal business environment. And once you start creating data specifically for legal analysis or litigation, then you have moved away from the universe of what the parties can do and into a hypothetical one of what they might do (if they agreed with the analysis).

In the current Guidelines, Section 2 provides an explanation when the requirements of unilateral effects theory are not likely to be met. It provides an off ramp, where the parties can try to show the agency that there is no need to pursue the matter further. The Guidelines tied the theory back into the real world of facts and business decisions. The proposed guidelines eliminate that off ramp, leaving the parties to guess at their peril whether they will have to defend an assault based on economic theory that, even if borne out, would not lead to increased prices or other competitive harm based on the actual facts of the case.

A prediction of whether it is more likely than not that the merged company in our example above would double the price of its pens would require estimates of sales that would be lost by the first product, the percentage of those sales that are likely to be gained by the second product, and the <u>future</u> profit margins on both products. To establish profit margins requires an examination of costs and internal cost accounting – *<u>it doesn't matter whether an economist or lawyer thinks that a price increase would be profitable; the issue is whether the business person thinks so and would do it.</u>* Finally, while it is not often stated in the paradigm, the unilateral effects analysis needs to establish that the gain for the second product is likely to be sustainable for at least some defined period of time, or the strategy will not be long term profitable. All of these will be predictions, since none of the actions will have taken place ex ante.

Further, section 2.1.1 of the draft Guidelines provides that while evidence of observed post-merger price increase is given substantial weight, the reverse is <u>not</u> true. The absence of such an effect may not be even a defense, since the restraint in terms of pricing may be the result of fear of post-merger review and action by the agencies. This comes perilously close to "heads I win, tails you lose". What the Agencies seem to be saying is that if the theory accurately predicts the facts, we should use the facts. If the theory does not accurately predict the facts, we should ignore the facts and believe the theory.

How is a court supposed to analyze such an argument? Is there a parallel to here to the 1993 Supreme Court decision in <u>Brooke Group</u> on predatory pricing, with the Agency/plaintiff having to prove possible/probable sufficient recoupment on the second product to make the price increase on the first net profitable? To what level of proof must the evidence rise – possible, probable, more likely than not? What if there is no evidence of any such plans to raise prices, but the agency theory predicts that there should be? How does that factor in to the legal picture?

V. <u>Innovation</u>

Section 6.4 of the proposed Guidelines talks about whether the merger "is likely to diminish innovation competition by encouraging the merged firm to curtail its innovative efforts below the level that would prevail in the absence of the merger". This simply cannot be the test actually applied. On its face it would condemn just about every transaction in research based industries. Take a simple example – each of the two merging companies has a research program for designing widgets, as do 20 other companies. After the merger, the new company combines the widget projects and cuts the combined spending by 25%. This is referred to as integration savings, and is much sought after in deals. But on the above definition, it could trigger an enforcement action.

The underlying flaw in the Guidelines' attempt at innovation analysis is the failure to deal with two basic and preliminary issues: (1) how you measure innovation; and (2) whether more innovation always is better than less. Once you resolve those issues, (3) you need to be able to explain what actually drives innovation in the market at issue, and how the transaction being examined impacts those drivers.

Taking the first issue, you can measure innovation in a variety of ways: by the number of people in R&D; the number of projects; the amount of money spent, the relative rank of the corporate employee leading the effort, etc. How do the Agencies propose to measure innovation, and how can we know that in advance?

But this only sets the stage. It assumes that more innovation (based on some quantitative assessment) is always better than less. While this is plausible, and certainly want to encourage research (at least in the medical and scientific fields), it is really more an article of faith than of proof that more R&D (at least in the sense of more spending, and perhaps even more projects) gives you better results. The debate among the FTC opinions in Genzyme (2004) highlights this very issue. If you measure the "amount" of innovation just by the dollar spend, you ignore the fact that some research is more productive than others. Businesses spend considerable time, and money, trying to make sure that they are putting the most effort where it will be the most productive, even if that results in a decrease of overall spending. Such decreases in spending, whether caused by mergers or internal review, are not necessarily anticompetitive.

Finally, do we really have a workable model of innovation? Is there any reason to assume that the pricing models underlying unilateral effects analysis apply to a context as ever changing, distinctive and vibrant as innovation? Where is the analysis, much less the evidence?

Clearly if someone is acquiring a company to kill its late stage R&D on a compound that will compete with the acquiring company's product, the existing Guidelines and law let the Agencies attack it. The proposed Guidelines would allow attacks on very early stage projects, based on the idea that the "overall" amount of innovation would be decreased by the merger. One legitimately could argue that such attacks, and required divestitures, by themselves may decrease innovation.

VI. Conclusions

The critic H.L. Mencken once wrote "For every complex problem, there is a solution that is simple, neat and wrong." The problem here was to update existing Guidelines to more accurately reflect what the Agencies currently are doing, and to see how merger enforcement based on the approaches taken has actually impacted pricing and competition in the real world, all so that we can better tune our efforts going forward. That is indeed a complex problem.

The simple and neat solution was to drop the connections between the Guidelines and facts on the ground, and to let what used to be Guidelines become a laundry list of theories that the Agencies might use, with no way to determine what theory will be used in which contexts, nor how one could use the Guidelines to show the agencies that no action is required in a given case. They even deprive the Courts of standards to judge the validity of cases brought, and ask that existing case-law be disregarded to the extent that it does not blend with the new economic constructs. This was the wrong way to go back in 1985 with the Vertical Restraints Guidelines, as was recognized very quickly at the time. It is the wrong way to go today with the Merger Guidelines.

.

Kent S. Bernard
Adjunct Professor
Fordham University School of Law

http://law.fordham.edu/faculty/14245.htm