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DOJ and FTC Issue Revised Horizontal Merger Guidelines

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INTRODUCTION

Last week, the Department of Justice and Federal Trade Commission jointly released revised Horizontal Merger Guidelines (“New Guidelines”). The New Guidelines replace the 1992 Horizontal Merger Guidelines, which were last revised thirteen years ago (“Old Guidelines”). The New Guidelines state that they are meant to “outline the principal analytical techniques, practices, and the enforcement policy of the [agencies] with respect to mergers and acquisitions involving actual or potential competitors (‘horizontal mergers’) under the federal antitrust laws.”

Although the revisions in the New Guidelines are largely evolutionary and in many cases merely reflect a codification of existing agency practice, some changes might lead the agencies to challenge mergers that would have been permitted in the past. These include changes deemphasizing the importance of defining relevant markets and adopting new unilateral effects theories. Whether these changes will actually lead to stricter enforcement is an open question.

BACKGROUND

The Old Guidelines were “designed primarily to articulate the analytical framework the agency applies in determining whether a merger is likely substantially to lessen competition” The guiding principle was that “mergers should not be permitted to create or enhance market power or to facilitate its exercise.” The Old Guidelines approached the analysis of a proposed merger with a series of well-defined steps. First, the agencies would assess “whether the merger would significantly increase concentration and result in a concentrated market, properly defined and measured.” Second, the agencies would assess whether the merger “raises concern about potential adverse competitive effects.” Third, the agencies would assess “whether entry [by new competitors] would be timely, likely and sufficient either to deter or to counteract the competitive effects of concern.” Fourth, the agencies would assess “any efficiency gains that reasonably cannot be achieved by the parties through other means.” And finally, in some cases, the agencies would assess whether the merger would prevent one party to the transaction from failing—*i.e.*, exiting the market.

WHAT’S NEW?

At a high level, the New Guidelines are similar to the Old Guidelines. As before, they “describe the principal analytical techniques and the main types of evidence on which the agencies usually rely to predict whether a horizontal merger may substantially lessen competition.” The guiding principle is that “mergers should not be permitted to create, enhance, or entrench market power or to facilitate its exercise.”

But in a fundamental change, the New Guidelines discard the step-by-step analysis prescribed by the Old Guidelines. The New Guidelines state that “merger analysis does not consist of uniform application of a single methodology,” and that the agencies will “apply a range of analytical tools to . . . evaluate competitive concerns . . .” Thus, in any given case, the agencies may approach the analysis in a completely different manner based on the facts, circumstances, and agency experience, rather than adhering to a fixed, step-specific analysis. Additionally, although the ultimate focus of the analysis has not necessarily changed, the New Guidelines reflect significant departures from the Old Guidelines’ treatment of “market definition,” “unilateral effects” and “coordinated effects”:

Market Definition – Under the Old Guidelines, the first step in any analysis was to define a relevant product and geographic market, in which the agencies would analyze the potential impact of the proposed merger. Under the New Guidelines, an evaluation of market concentration in a “properly defined” market is now optional, at least in the agencies’ preliminary analysis. The New Guidelines state that “[t]he measurement of market shares and market concentration is not an end in itself, but is useful to the extent it illuminates the merger’s likely competitive effects. . . . The Agencies’ analysis need not start with market definition.” Thus, the agencies may evaluate the proposed merger using theories of harm that do not require use of a market definition, although the New Guidelines acknowledge that the agencies will “normally identify one or more relevant markets” and that “evaluation of competitive alternatives available to customers is always necessary at some point in the analysis.”

When the agencies choose to start with market definition under the New Guidelines, the primary methodology for defining that market is similar to the Old Guidelines, which applied the “hypothetical monopolist” test to find a product market and a geographic market. This test defined a market by finding the smallest set of products where a hypothetical monopolist controlling such products could profitably impose a small but significant and nontransitory increase in price (“SSNIP”). The New Guidelines introduce a potential alternative method of defining markets based on “critical loss analysis,” a method so far typically used in analyzing the incentives of a single firm rather than a market-wide phenomenon. The test calculates the quantity of sales that a company would have to lose for a price increase to be unprofitable—if the company has high margins, it takes less in lost volume to make a price increase unprofitable. The New Guidelines suggest that the same analysis could be used in defining the contours of the relevant market, and state that high margins indicate that the merging companies face inelastic demand (with few substitutes). Therefore, depending on how it is implemented, the use of the critical loss test in defining markets may lead the agencies to support narrow markets.

Unilateral Effects – Under the Old Guidelines, the agencies would focus on whether the proposed merged entity would have the ability to “unilaterally” exercise market power by, for example, raising prices or reducing output. The New Guidelines contain significant and controversial modifications to this analysis.

The New Guidelines retain the basic principle that unilateral effects analysis should focus on direct competition. However, they eliminate the Old Guidelines’ market-share presumptions; thus, under the Old Guidelines a merger resulting in low market share in

a "defined market" would not usually raise concerns about unilateral effects. However, under the New Guidelines, the agencies may rely on "any reasonably available and reliable information to evaluate the extent of direct competition" between merging firms' products, suggesting that market shares may be less significant in assessing potential unilateral effects.

The New Guidelines also introduce a new set of analyses that the agencies may use in assessing potential unilateral effects. First, the agencies may attempt to assess a "diversion ratio" between merging firms' products and the "value of diverted sales." Diversion ratios calculate the proportion of sales of one of the merging firms that would be captured by the other merging firm in response to a price increase. As the New Guidelines indicate, the value of diverted sales (after taking into account the profit margins) "can serve as an indicator of the upward pricing pressure on the [merged firm's] product . . ." This methodology – often referred to in the economics literature as the upward pricing pressure ("UPP") test – provides for analysis of the expected effects of the merger without having to gather data from other competitors. However, if the agencies do not take into account some expected efficiencies from the merger, and/or entry or repositioning by other competitors, the UPP method consistently suggests that any transaction where the merging parties have competing products would result in price increases. The New Guidelines do not provide any detail on how this method may be implemented by the reviewing agencies, raising serious questions about the direction the agencies may go.

Second, the New Guidelines expressly acknowledge that they review the potential effects the merger will have on non-price effects, like potential harm to innovation and product variety. For example, in evaluating a merger, the New Guidelines indicate that agencies may consider whether a merger would diminish research spending because the products of one merging firm's innovations would compete with products of the second firm. The agencies may also consider whether the merger will lead to an anticompetitive reduction in product variety that is material and "is largely due to a loss of competitive incentives attributable to the merger."

Coordinated Effects – Although the analysis of coordinated effects is similar to that of the Old Guidelines, the New Guidelines clarify that the agencies may challenge a proposed merger based on adverse coordinated effects – *i.e.*, the perceived ability of firms post-closing to engage in "coordinated," albeit lawful behavior—even without specific evidence showing precisely how the coordination likely would take place. According to the New Guidelines, the agencies are likely to challenge a merger if three criteria are met: (1) the merger significantly increases concentration (*i.e.*, reduces the number of firms) and results in a moderately or highly concentrated market; (2) the market shows signs of vulnerability to coordinated conduct; and (3) the agencies have a credible basis to conclude that the merger may enhance that vulnerability.

Other Provisions – There are several other provisions of the New Guidelines that largely reflect existing agency practice:

- *Identification of Market Participants.* The New Guidelines eliminate the confusing distinction made by the Old Guidelines between "uncommitted entrants" (firms that could enter without incurring significant sunk costs) and "committed

entrants" (firms that would have to incur significant sunk costs to enter). Under the New Guidelines, firms that are committed to entering the market or that would rapidly enter the market in response to an SSNIP are considered market participants. Other possible entrants are evaluated using the criteria of timeliness, likelihood, and sufficiency.

- *Concentration.* The New Guidelines continue to assess concentration in a defined market by using the Herfindahl-Hirschman Index (a mathematical formula used by the agencies to measure market concentration), though the agencies plan to use less stringent thresholds in applying the formula. However, the new thresholds are unlikely to shift agency practice because the previous thresholds have long been understood to be too stringent and not reflective of actual agency practice. In addition, the New Guidelines note that where it is difficult to calculate market shares (the sole input of the Herfindahl-Hirschman Index), the agencies can look in part to the number of significant competitors to determine the competitiveness of the market.
- *Entry.* Both the Old and New Guidelines credit "entry" only if it is found to be timely, likely, and sufficient to counteract any anticompetitive effects. The New Guidelines clarify that the agencies will focus on specific firms' possible entry decisions only if they have necessary assets for entry, or have unusually strong incentives to enter. The New Guidelines define entry to be "timely" if it would deter anticompetitive effects by rendering any anticompetitive action unprofitable. Entry is defined to be "likely" if it would be profitable. Entry is defined to be "sufficient" if it would "replicate at least the scale and strength of one of the merging firms" and entry by smaller firms may be sufficient if they "are not at a significant competitive disadvantage." The New Guidelines also specify that "[m]arket values of incumbent firms greatly exceeding the replacement costs of their tangible assets may indicate that these firms have valuable intangible assets, which may be difficult or time consuming for an entrant to replicate."
- *Efficiencies.* Both the Old Guidelines and the New Guidelines credit efficiencies only if they are merger-specific and cognizable. The New Guidelines remain skeptical about whether research and development efficiencies are generally cognizable, although they will be considered as long as they are not based on an anticompetitive reduction in product variety.
- *Failing Firms / Exiting Assets.* The agencies' analysis of the failing firm defense remains essentially the same under the New Guidelines. Only in extremely limited circumstances will the agencies allow a transaction that would otherwise be prohibited due to the fact that one of the firms is failing: (1) the failing firm must be unable to meet near-term financial obligations; (2) the failing firm must be unable to reorganize under Chapter 11; (3) the failing firm must be unable to elicit reasonable alternative acquisition offers; and (4) absent the transaction, the failing firm would exit the relevant market.
- *Monopsony.* The Old Guidelines state that the enhancement of market power of buyers (rather than sellers), known as monopsony power, is analyzed in a way "analogous" to the framework of the Old Guidelines. The New Guidelines similarly state that the agencies "employ essentially the [same] framework . . . on

the selling side of the market" to evaluate monopsony power. The New Guidelines also clarify that reductions in prices paid by a merged firm need not be anticompetitive and could result from lower transaction costs or volume-based discounts.

- *Partial Acquisitions.* The New Guidelines point out several ways that partial acquisitions can result in anticompetitive effects. Partial acquisitions can: (1) give the acquiring firm the ability to influence the target's competitive conduct; (2) reduce the incentive of the acquiring firm to compete; or (3) allow the acquiring firm to access competitively sensitive information about the target. Partial acquisitions are analyzed much like mergers, and anticompetitive effects can be offset by cognizable efficiencies.

IMPLICATIONS

The New Guidelines are largely evolutionary and reflect existing agency practice. However, they may create a somewhat broader set of grounds for the agencies to attack mergers they believe could be harmful. Most notably, according to the New Guidelines, the agencies need not define a market and instead may rely on new unilateral effects theories such as UPP. On the other hand, it is not clear how some of these concepts will be applied by the agencies, how the courts will incorporate some of these new ideas into their analyses, and whether the courts will be willing to abandon case law that has relied on the importance of market definition in merger-related litigation. Thus, even if the New Guidelines cause the agencies to bring more challenges to mergers, the courts may curtail any drive by the agencies to challenge mergers more aggressively, at least in the short term.

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