Are the New Guidelines Representational Art Or Pop Art in the End?

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The 2010 Merger Guidelines, following in the tradition of previous Guidelines, seek to provide a representational portrait of the analytical underpinnings of current enforcement policy.[1] Such transparency is indisputably a sound objective; the agencies should be applauded for undertaking this project so that those who do not practice before the agencies on a routine basis are not misled by the existence of out-of-date Guidelines. As discussed further below, however, certain features described in the Guidelines would have benefited from more refined focus and insight rather than broad impressionistic strokes. Moreover, as with pop art, to the extent that the 2010 Guidelines contain untested methods of identifying competitive harm or deviate from established case precedent, the 2010 Guidelines run the potential of becoming out of date as these theories are later modified or rejected. Failing to reflect the case law from which the agencies derive their enforcement power, particularly as it relates to the importance of market definition, inferences from market shares, and the importance of noneconomic evidence, is perhaps too avant-garde an exercise for merger guidelines.

The original 1968 Guidelines explained where, as a matter of prosecutorial discretion, the Agencies would *not* challenge a transaction.[2] The new Guidelines similarly provide this guidance in a few new areas, for instance in footnote 14, where they recognize that consumer welfare might be better served by the agencies taking into account out-of-market efficiencies that outweigh potential harm to the delineated market and are inextricably linked to the merger. It would have been useful if the 2010 Guidelines had included more indications of where the agencies would not take action, for instance, with respect to repositioning, entry, and high margin industries. Two other areas where the 2010 Guidelines would have benefited from a more detailed explanation are the discussion of non-price effects, such as quality and variety, in Section 1; and the reduction in product "variety" and innovation concerns raised in Section 6.4.

As with earlier versions of the Guidelines, the 2010 Guidelines also discuss what information would be useful to present to the agencies. Again, such transparency is right in line with what guidelines are supposed to do. The 2010 Guidelines would have benefited as well by providing more guidance on how the agencies will weigh the various types of information they obtain rather than merely providing a comprehensive checklist.

Issuing the new Guidelines is a major step, and there is a considerable downside to including less-tried theories and methodologies or deviating substantially from established principles of law and economics. Concepts embraced in the new Guidelines but not yet widely accepted by the antitrust community or courts include the use of the upward pricing pressure model (including its

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[1] U.S. Dep't of Justice & Federal Trade Comm'n, Horizontal Merger Guidelines (2010) [hereinafter 2010 Guidelines], *available at* http://www.ftc.gov/os/2010/08/100819hmg.pdf.

[2] U.S. Dep't of Justice, Merger Guidelines (1968), *available at* http://www.justice.gov/atr/hmerger/11247.pdf.

dismissal of diversion ratios to products sold by non-merging firms) for differentiated products and the use of high margins to create presumptions of lack of demand responses, narrow markets, and market power.[3] As stated in the Verizon et al. submission, "the tools included in the Guidelines' toolbox must be based on consistently and unquestionably reliable methodologies that identify anticompetitive mergers. Such tools are those that are backed by a broad consensus, by empirical research, and by the test of time."[4]

It is precisely because courts (and foreign jurisdictions) might rely on the 2010 Guidelines, as they have with prior guidelines, that it is potentially harmful to include unproven economic theories or methodologies.

Developing trends are better reflected in speeches and papers than in guidelines; they can then be discussed and, if needed, dismissed, as thinking evolves. Moreover, the 2010 Guidelines state that they are intended to "assist the courts in developing an appropriate framework for interpreting and applying the antitrust laws in the horizontal merger context."[5] It is precisely because courts (and foreign jurisdictions) might rely on the 2010 Guidelines, as they have with prior guidelines, that it is potentially harmful to include unproven economic theories or methodologies.

There is a clear distinction between having guidelines that reflect best-in-class tools and thinking in analyzing mergers but remain true to the law and legal principles, and those that raise less developed or accepted economic or legal principles. Like its predecessors, the 2010 Guidelines are not the law, but rather a reflection of enforcement policy. Section 7 of the Clayton Act is several decades old and has a well-established body of case law. If, as some commentators suggest, the 2010 Guidelines are intended to provide the underlying framework for an improvement in the agencies' track record when bringing merger challenges, then enforcement policy (and the Guidelines) would benefit from responding to the messages that the courts have been sending, rather than trying to change the approach that the courts take. A major concern with the 2010 Guidelines, therefore, is the extent to which they deviate from the law, which could decrease—rather than increase—the agencies' litigation success rate. I discuss a few examples below.

One area where the 2010 Guidelines deviate from the law is the apparent shifting of the burden of proof based upon the margins of the transaction parties. Section 2.2.1 appears to shift to the parties the burden of establishing that any pricing above some measure of cost does not result from market power or coordination.[6] Commissioner J. Thomas Rosch properly noted that higher margins can result from circumstances apart from anticompetitive conduct, such as exogenous factors or the type of industry involved.[7] For instance, in technology markets, higher profit margins can be a direct consequence of effective and robust competition, as firms successfully differentiate and out-innovate competitors in response to customer demand. Moreover, such "rewards" may be fleeting as other firms respond and reposition. A healthy marketplace requires that firms

[3] For a discussion of some of the issues with the economic screens and tests, see Dennis W. Carlton, Comment on Department of Justice and Federal Trade Commission's Proposed Horizontal Merger Guidelines (June 4, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00034.pdf; Joseph J. Simons, Comments to the Federal Trade Commission and Department of Justice Antitrust Division: Margins in Merger Analysis (June 4, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00019.pdf. These topics would be better discussed outside of the Merger Guidelines.

[4] Joint Submission of Verizon Communications Inc., The Biotechnology Industry Organization, The Financial Services Roundtable, Microsoft Corporation, The National Association of Manufacturers, and the U.S. Chamber of Commerce to the U.S. Department of Justice and Federal Trade Commission for the Horizontal Merger Guidelines Revision Project at 1 (June 4, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00022.pdf.

[5] 2010 Guidelines, *supra* note 1, § 1.

[6] This language was somewhat improved from the April draft of the Guidelines, which suggested that high margins *ipso facto* resulted from market power or coordination.

[7] Statement of Commissioner J. Thomas Rosch on the Release of the 2010 Horizontal Merger Guidelines (Aug. 19, 2010), *available at* http://ftc.gov/os/2010/08/100819hmgrosch.pdf.

be permitted to recoup their upfront investments as well as to be compensated for the risks that result from failed endeavors. Similarly, the assertion that a high purchase price may indicate that the acquiring firm is paying a premium to reduce competition is inappropriate.[8] Particularly in industries with high fixed costs and sunk investment, a firm may pay a premium for many pro-competitive (or competitively neutral) reasons, such as synergies or better access to financing.

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In another departure from the case law, the 2010 Guidelines appear to relax the requirement of delineating a cognizable relevant market in which the transaction may have a substantial effect on competition. Since at least *duPont*, determination of a relevant market has been a "necessary predicate" to a Clayton Section 7 claim.[9] The statute itself requires a lessening of competition in a line of commerce. While courts have incorporated information beyond market shares into the consideration of whether the transaction will harm competition since at least *General Dynamics*, the 2010 Guidelines appear to go much further by relaxing and potentially omitting the need to delineate a cognizable relevant market.[10] Yet, in spite of these changes, the new Guidelines maintain presumptions of illegality (albeit "rebuttable") based on market shares and concentration in markets that are narrowly defined to eliminate "more distant" competitors or to include a subset of "target" customers.[11] Such presumptions of illegality not only raise the likelihood of false positives, but ultimately of more agency losses in court.

Sections 3 and 6.1 of the 2010 Guidelines deviate from the law by permitting challenges based on a single or a few injured parties—the so-called "targeted customers." It is inevitable that for some mergers there are some unhappy or even adversely impacted customers. Clayton Section 7 has a "substantial" element to it, and the agencies would be remiss not to look at the impact of the merger from a total consumer welfare standard rather than from gerrymandered markets delineated narrowly around complaining customers. The analysis should include recognition that inframarginal customers may complain even though they will not actually be harmed, perhaps because they fail to recognize that they will be protected by the existence of marginal customers. The approach taken in these sections is likely to raise evidentiary issues in satisfying the substantiality element of the statute.

The entry discussion also contains some elements that depart from case precedent, such as *Baker Hughes*.[12] Although the new Guidelines clarify that the parties need not prove that entry would be at the scale and strength of one of the merging firms,[13] the continued inclusion of this benchmark in the Guidelines remains troubling and departs from case precedent. As some respected economists point out,[14] this standard may require a demonstration that post-merger price will be below pre-merger levels rather than merely sufficient to replace the lost output. The objective should be maintaining—not improving upon—the competitive status quo ante.

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8 2010 Guidelines, *supra* note 1, § 2.2.1.

9 United States v. E.I. du Pont de Nemours & Co., 353 U.S. 586, 593 (1957); Brown Shoe Co. v. United States, 370 U.S. 294, 324 (1962).

10 2010 Guidelines, *supra* note 1, § 4.

11 *Id.* § 4.1.4. Further, the identification of "safe harbors" has been removed from the Guidelines.

12 United States v. Baker Hughes Inc., 908 F.2d 981 (D.C. Cir. 1990).

13 2010 Guidelines, *supra* note 1, § 9.3 ("Entry by a single firm that will replicate at least the scale and strength of one of the merging firms is sufficient. Entry by one or more firms operating at a smaller scale may be sufficient if such firms are not at a significant competitive disadvantage.").

14 Elizabeth M. Bailey, Gregory K. Leonard & Lawrence Wu, Comments on the 2010 Proposed Horizontal Merger Guidelines (June 3, 2010), http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00012.pdf.

The slant towards economic formulae and theories, particularly concerning the implications of margins and incremental costs also raises concerns given recent jurisprudence. As Commissioner Rosch indicates:

> [C]ourts have relied on empirical evidence instead of economic evidence, and have considered economic evidence as corroborative of that empirical evidence, if they have considered it at all. . . . Time and again, appellate courts have rejected "high" prices as a basis for inferring market or monopoly power. The district courts have likewise eschewed reliance on economic models based on margins for a variety of reasons, including their complexity, because margins are dependent on exogenous factors, or because the use of such economic simulation models, in the absence of substantial, verified efficiencies, will almost always predict a transaction will have price effects.[15]

Courts will review the entire evidentiary record—documents, data, and testimony—rather than allowing economic models and theories alone to win the day.

Finally, the modifications of the SSNIP test based on value-added profit calculations[16] could result in false positives because the set of competitors will be artificially narrowed and exclude competitive constraints on prices. For example, applying a 5 percent value added SSNIP test to the mark-up on a retail item may yield a SSNIP threshold on the final product of less than a penny in some cases. Also, this calculation is likely to raise evidentiary problems for both the government and the parties, as well as miss what should be the focus—i.e., whether there will be an impact on the price or output of the products and services actually bought by consumers.[17] The relevant product or service is what the consumer buys and at what price—not what each supplier might add to the product and at what profit to the supplier for that particular input to the finished product.

In sum, the agencies are to be commended for replacing the outdated Guidelines with a more accurate description of the types of evidence and analysis they are currently deploying. The 2010 Guidelines, though, fall a little short of the mark as a complete representational work of art in not providing a robust discussion for the business community regarding certain of the newer aspects of the 2010 Guidelines, how the various features will be balanced, and when a transaction will not be challenged by the agencies. Moreover, the new Guidelines suffer to the extent that they deviate from well-established principles, particularly in determining market definition and, ultimately, competitive harm. Pop art has its place in merger analysis—but the Merger Guidelines are not the best place for its debut. ●

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15 Rosch Statement, *supra* note 7 (citations omitted).

16 Although the 2010 Guidelines removed the reference to "specific contribution of value," example 10 remains.

17 Bailey et al. Comments, *supra* note 14.