Freeborn

Your Future Is Our Purpose

Merger Enforcement in the United States:
What is driving the antitrust enforcement agencies?

by Jeffery Cross, Partner

A FREEBORN & PETERS LITIGATION TEAM WHITE PAPER

ABOUT THIS WHITE PAPER:

With several high profile mergers in the last couple of years challenged by the antitrust enforcement agencies, Jeffery Cross, a Partner in the Litigation Practice Group, explores the guideposts used by enforcement agencies responsible for merger analysis, in "What's Driving Today's Merger Enforcement?" The article was also published in the February-March 2014 issue of *Today's General Counsel*.

With several high profile mergers in the last couple of years challenged by the antitrust enforcement agencies, it is appropriate to consider what factors the agencies are considering.

Mergers and acquisitions are generally evaluated pursuant to Section 7 of the Clayton Act. This statute is forward looking and asks whether the future effect of a merger or acquisition "may be substantially to lessen competition, or tend to create a monopoly."

Merger law, however, has been primarily shaped by the Department of Justice Antitrust Division and the Federal Trade Commission. The United States Supreme Court has not issued a substantive merger decision since 1974. Court decisions are few because few merger cases are litigated to conclusion. For example, for the fiscal year ending September 30, 2012, 1,429 mergers were reported to the government pursuant to the Hart Scott Rodino Act. Only ten matters were challenged in court. However, none were litigated to conclusion. Rather, most mergers are resolved by either consent decrees or the parties abandoning the mergers.

Given the fact that merger analysis is primarily shaped by the enforcement agencies, what are their guideposts? The agencies have released guidelines to help the business and legal communities understand the agencies' approach. The Department of Justice issued its first guidelines in 1968. These were revised in 1982 and 1984. In 1992, the Department of Justice and the Federal Trade Commission issued joint guidelines for horizontal mergers. In 1997, the 2 joint guidelines were revised to address efficiencies. In 2006, the agencies published commentary to the guidelines. In 2010, the agencies issued new guidelines.

Prior to the 2010 horizontal merger guidelines, the primary predictor of future anticompetitive effect was "market structure." The guidelines reflected what was called the "structure-conduct-performance paradigm." Market structure, consisting of the number and relative size of competitors, was deemed an appropriate predictor of future anticompetitive effects. To determine market structure, the relevant market had to be defined and then market shares determined. To determine the relevant market, a test known as the "hypothetical monopolist" test was used. A product was identified and then the agencies considered the substitutes that consumers would turn to in response to a small but significant non-transitory increase in price (also called the "SSNIP" test). The agencies frequently used a hypothetical price increase of five to ten percent. If consumers turned to another product in response to this hypothetical price increase, that product was included in the market. This process continued until consumers did not substitute any additional products in response to the SSNIP. A hypothetical company that controlled all of the products that were substitutes was a "hypothetical monopolist." This same process was applied to determine both the relevant product and geographic markets.

Once the relevant markets were determined, market shares were calculated. In the early days of merger enforcement, the government looked at four-firm and eight-firm concentration ratios. More recently, the agencies have used the Herfindahl-Hirschman Index ("HHI"), which is the sum of the squares of the market shares. This index is used that to reflect the competitive significance of large companies. A market with one large company with 80 percent of the market and four small companies with each only 5 percent of the market each will have a much higher HHI (6500) compared, for example, to five companies each with 20 percent of the market (2000). The agencies use the size of the post-merger HHI as well as the change in HHI from premerger to post-merger to predict future anticompetitive effects.

The 1992 horizontal merger guidelines remained unchanged for seventeen years. The agencies, however, began to use other tools to predict future anticompetitive effects. This anomaly between the guidelines and actual practice lead to criticism of the agencies by the bar and business leaders. In addition, it resulted in some significant court losses for the government. Although the guidelines are not binding on the courts, many used them as persuasive guideposts for the application of Section 7 of the Clayton Act. The courts, therefore, were applying the 1992 guidelines, but the government was asserting a different analysis.

Market power is the ability to raise prices or reduce output without losing so much market share that the price increase is unprofitable.

In 2010, the Department of Justice and Federal Trade Commission substantially revised the horizontal merger guidelines. The 2010 guidelines downplayed the role of market structure as a predictor of future anticompetitive effects. Instead, the new guidelines emphasize a theory known as unilateral competitive effects. This theory was applied to both homogeneous products and differentiated product. Because the latter are much more common, the theory of unilateral competitive effects for differentiated products has become a key focus of merger enforcement. This is borne out by studies of consent decrees entered into by the merging parties and the government as well as closing statements for mergers that the agencies issue after deciding not to challenge a merger. The importance of the unilateral competitive effects theory for differentiated products is also borne out by a recent study of FTC staff memos seeking approval for requests for additional information from the merging parties (so-called "Second Requests").

What is the theory of unilateral competitive effects for differentiated products and how does it work in practice?

As an initial matter, it is important to note that the 2010 horizontal merger guidelines specifically state that "[t]he unifying theme of [the] Guidelines is that mergers should not be permitted to create, enhance, or entrench market power or to facilitate its exercise." What is "market power?" To an economist, market power is the ability to raise prices or reduce output without losing so much market share that the price increase is unprofitable. This is a fundamental concept at the heart of the unilateral competitive effects theory for differentiated products.

Most goods are "differentiated products." This means that they vary in many ways, including color, shape and other features. Breakfast cereal is a classic example of differentiated products. Breakfast cereals vary in terms of texture, shape, basic ingredients, sugar coating and many other aspects. Consumer demand for breakfast cereals also varies, some preferring corn flakes, others shredded wheat, some toasted oats, and others sugar coated cereals with or without colored marshmallows.

The theory behind unilateral competitive effects is that a merger between two differentiated products will allow the merged party to exercise market power because consumers view the acquired product to be a close substitute for the acquiring product. Basic economics tells us that any increase in price will lead to a loss of customers. Most producers face downward slopping demand curves. So if the acquiring company raises price, it can expect to see some of its customers seek substitutes. In the cereal example, let's suppose Company A, which makes corn flakes, seeks to acquire Company B, which makes toasted wheat cereal. If Company A were to raise its price of corn flakes after the merger, some percentage of customers would substitute shredded wheat, others toasted oats and others a rice cereal. The question is whether a sufficient number of customers would substitute the toasted wheat cereal formerly owned by Company B so that the number of customers diverting to the acquired product combined with its margin would make the corn flakes price-increase profitable. A price increase that is profitable in this way is by definition an exercise of market power.

The 2010 horizontal merger guidelines expressly state that the agencies may apply such an analysis without actually determining a relevant market and calculating market shares. This is because the hypothetical monopolist test and its application of a hypothetical SSNIP are imprecise and subject to possible manipulation.

But in many respects, the tests are inter-related. After all, the hypothetical monopolist test used to define a relevant market is essentially asking about the diversion of consumers from one product to another as a result of a price increase.

How do the agencies determine the diversion and profit margins necessary to apply the theory of unilateral competitive effects for differentiated products. In some instances, there may be actual historical events where prices were increased and the substitution to other products can be observed. Such historical events are called “natural experiments.” Another type of evidence the agencies will employ are so-called win/loss data where a company will record what its price was and whether it won sales or lost sales. Another type of evidence is internal company documents that reflect how the company makes pricing decisions.

The agencies also employ a variety of econometric tools to determine if a merger of differentiated products will enable the merged entity to exercise market power. One such tool is known as the “gross upward pricing pressure index” or GUPPI. This measures the diversion ratios and the margins for the diverted products. It also provides a credit for hypothetical efficiencies. It involves the use of first order differential calculus and generally requires the assistance of an economist. Another tool is merger simulation, which takes into account the elasticities of demand and applies principles of linear algebra to determine the profitability of a merger under certain scenarios.

A company considering a merger is likely to want to employ all of these tools, including determining market definition and market shares to calculate HHIs. In addition, it behooves a company considering a merger to undertake a careful review of its internal documents to make sure they do not contradict the otherwise procompetitive evidence in support of the merger.

The bottom line is that the governmental agencies have much more flexibility in analyzing the potential future anticompetitive effects of a merger and merging companies need to be prepared to respond to this flexibility.

ABOUT THE AUTHOR:

Jeffery Cross
Partner

311 South Wacker Drive
Suite 3000
Chicago, IL 60606

(312) 360-6430

jcross@freeborn.com

Jeffery M. Cross is a Partner in the Litigation Practice Group and a member of the Antitrust and Trade Regulation Group at Freeborn & Peters LLP in Chicago. He has over 38 years of experience litigating antitrust cases and counseling on antitrust issues, including mergers and acquisitions. He also has taught antitrust law for the last 12 years as an adjunct professor at John Marshall Law School in Chicago.

ABOUT FREEBORN & PETERS LLP

Freeborn & Peters LLP is a full-service law firm headquartered in Chicago, with international capabilities. Freeborn is always looking ahead and seeking to find better ways to serve its clients. It takes a proactive approach to ensure its clients are more informed, prepared and able to achieve greater success – not just now, but also in the future. While Freeborn serves clients across a broad range of sectors, it has also pioneered an interdisciplinary approach that serves the specific needs of targeted industries, including food, private equity and venture captial, transportation, and insurance and reinsurance. Freeborn is a firm that genuinely lives up to its core values of integrity, caring, effectiveness, teamwork and commitment, and embodies them through high standards of client service and responsive action. Its lawyers build close and lasting relationships with clients and are driven to help them achieve their legal and business objectives.

Call us at **(312) 360-6000** to discuss your specific needs. For more information visit: **www.freeborn.com**

CHICAGO
311 South Wacker Drive
Suite 3000
Chicago, IL 60606
(312) 360-6000
(312) 360-6520 fax

SPRINGFIELD
217 East Monroe Street
Suite 202
Springfield, IL 62701
(217) 535-1060
(217) 535-1069 fax

DISCLAIMER: This publication is made available for educational purposes only, as well as to provide general information about the law, not specific legal advice. It does not establish an attorney/client relationship between you and Freeborn & Peters LLP, and should not be used as a substitute for competent legal advice from a licensed professional in your state.

© 2014 Freeborn & Peters LLP. All rights reserved. Permission is granted to copy and forward all articles and text as long as proper attribution to Freeborn & Peters LLP is provided and this copyright statement is reproduced.