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Antitrust and the Horizontal Merger Guidelines of the U.S. Department of Justice and the Federal Trade Commission

As the Obama Administration takes office, faced with a worldwide economic crisis unique in modern times, one result confidently expected will be a record number of mergers and acquisitions intended to answer the recession through a combination, in many cases involuntary, of right-sizing and necessary efficiencies. The chaos in the financial markets, the subprime mortgage market meltdown, and the arrival of the recession, all will continue to contribute dramatically to business combinations intended to reduce duplicative overheads and create new strategic alliances to compete more effectively with lower labor cost offshore alternatives. Declining interest rates, and a continuing flood of foreign investment into the U.S., will contribute to the trend as well, despite the distinctly more conservative availability of bank financing to the acquisition market.

For the pre-merger notification process, this should mean a new record in filings, coupled with extraordinary pressure on the review process, in order to speed all but the most significant overlap combinations through the regulatory process and back into business. This would follow a significant decline in U.S. and worldwide merger activity during 2008 versus prior years.

Pre-merger notifications filed under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (“HSR”) with the Department of Justice (“DOJ”) and the Federal Trade Commission (“FTC”) (collectively, the “Agencies”) followed this curve, with acquisitions subject to pre-merger filings during fiscal 2008 down about 20% from 2007. “Second requests” from the DOJ or the FTC were issued in only about 2.5 percent of the total filings, and some 35 of those cases resulted in some further action, ranging from “fix-it-first” divestitures to abandonment of the proposed deal. As the U.S. economy stumbled, M&A issues often centered on “No MAC” clauses and negotiated terminations of many transactions, especially those dependent on third-party financing.

Under the Bush Administration, and despite the precarious economy, merger scrutiny and antitrust enforcement was energetic, with the DOJ’s efforts decidedly more directed against price-fixing and anti-competitive cartels, especially in the international arena, and with the FTC taking the far more active hand in M&A. At the same time, productive FTC and DOJ efforts continued to expedite the review process. On the judicial side, the Roberts Supreme Court decided three key antitrust cases in 2006 which had direct effects on business combinations and tactics in 2007-08. *Illinois Tool Works, Inc. v. Independent Ink* unanimously reversed long-standing precedent and held that the seller of a tying product that was patented was no longer

presumed to have market power. *Texaco v. Dagher* held that a “lawful, economically integrated” joint venture between two hitherto competitors (Texaco and Shell) in other markets was a single actor for purposes of setting its prices, and not an illegal price-fixing scheme between the otherwise competitive co-owners. *Volvo Trucks North America, Inc. v. Reeder-Simco GMC, Inc.* clarified the standards for secondary-line price discrimination claims under the Robinson-Patman Act. In 2007 the Court, in a landmark 5-4 decision in the *Leegin* case, expressly overruled a basic principle of U.S. antitrust law, and held that all resale price maintenance agreements, minimum as well as maximum, would now be evaluated under the “Rule of Reason.” Since 1911, agreements requiring distributors and other resellers to resell only at a price prescribed by the manufacturer had been deemed *per se* illegal under U.S. antitrust laws, meaning that no competitive defense could save them. In 1997, the Supreme Court had held in *State Oil Co. v. Kahn* that *maximum* resale price maintenance would be tested under the Rule of Reason, while *minimum* resale price maintenance remained *per se* illegal. *Leegin* expanded Rule of Reason analysis to all resale price maintenance.

On the Agency side, bid-rigging and price-fixing dominated the Agencies’ criminal cases, and then a vigorous inter-Agency debate erupted over the DOJ’s perceived (at least by the FTC) more lenient announced position with respect to single-firm conduct under § 2 of the Sherman Act.

In March 2006, the FTC and the DOJ released their joint “*Commentary on the Horizontal Merger Guidelines*,” which highlighted how the Agencies have applied their joint “Horizontal Merger Guidelines” to actual fact patterns. And in December 2006, the DOJ amended its 2001 “*Merger Review Process Initiative*” to further “streamline” the merger review process, notably by limiting the second request response parameters somewhat and under certain conditions. The FTC had previously implemented its very similar “*Reforms to the Merger Review Process*,” limiting the persons (35) and documents (those produced within two years) subject to production, by disclosing the competitive effects theories being applied to the proposed combination, by reducing the required production of backup files, and by permitting more protective privilege logs for various levels of employees.

This advisory summarizes HSR and provides a detailed description of the Merger Guidelines, which provide the framework for the substantive analysis applied by the Agencies to mergers and acquisitions. Also, a few, simple guidelines to follow when dealing with the Agencies appear at the end of this advisory.

I. Hart-Scott-Rodino

HSR provides the regulatory framework under which parties to certain mergers and acquisitions meeting the HSR filing threshold requirements (and not otherwise exempt) must notify, and receive clearance from, the DOJ and the FTC before consummating the proposed transaction.

In general, reportable proposed acquisitions of voting stock, non-corporate interests, or assets are notified to the DOJ and the FTC through the filing by each party of a notification form containing detailed information about the proposed transaction, their corporate structures and their U.S. businesses. The filing is accompanied by any competitive or market related studies and reports used by the parties in reviewing the proposed transaction, the so called “Item 4(c) documents,” which are named for the corresponding reporting item in the notification form. Item 4(c) documents can be a trap for the unwary, as analyses prepared by a party or an advisor can create a roadmap to antitrust concerns that might have otherwise passed unnoticed. The failure to produce Item 4(c) Documents, or to file the notification form, can result in heavy penalties of up to \$11,000 per day, such as the \$550,000 failure-to-produce fine levied on Iconix Brand Group in October 2007, the \$250,000 failure-to-file penalty imposed on a hedge fund manager in May 2007, and the \$1.1 million failure-to-file settlement by ValueAct Capital in December 2007.

The FTC has advised that the voluntary submission of certain commonly-requested documents may expedite the Agencies’ review process. These include:

1. Organization Chart.
2. Strategic Plan for the past three years.
3. Marketing Plans for the past three years.
4. List of Products manufactured and sold.
5. List of products in development.
6. List of top 10 customers with contact information (for overlap products).
7. List of competitors with contact information (for overlap products).
8. Market share information (for overlap products).

The parties should be prepared to provide this information promptly upon the request of the Agencies and should consider whether providing any of this information with the initial filing is prudent.

Upon filing of the notification forms and receipt by the FTC of the acquiring party’s filing fee, the parties must then wait a specified period, usually 30 days (15 days in the case of a cash tender offer or a bankruptcy sale), before they may complete the transaction. The parties usually request “early termination” of the waiting period; however, since grants of early termination are announced publicly, many prefer to simply let the waiting period expire, to preserve confidentiality.

If, during the initial waiting period, the Agency reviewing the deal determines that further review of the proposed transaction is warranted, the Agency can issue a formal “second request” for additional information or documentary materials from the parties. A second request extends the waiting period for a specified period, usually 30 days (ten days in the case of a cash tender offer or a bankruptcy sale) after all parties have complied with the second request (or, in the case of a tender offer or a bankruptcy sale, after the acquiring person complies). Effectively, a second request means several months or more of delay in the typical transaction.

As complying with a second request can require substantial time and effort from the filing parties, the waiting period can be extended well beyond the period in which the parties are willing to close the transaction.

A. Filing Thresholds.

Effective February 2001, HSR amendments raised the transaction level reporting threshold to \$50 million and created different filing fee plateaus. Companies no longer had to report transactions under \$50 million, a substantial increase from the prior threshold of \$15 million, and the previous 15% size-of-transaction threshold for acquisitions of voting securities was eliminated. This new threshold became an absolute floor, and no transaction resulting in the acquisition of voting securities, non-corporate interests or assets of less than that amount is reportable.

Effective each February, the HSR thresholds adjust, as required to be done annually by the 2001 amendments, to reflect increases in the U.S. gross national product.¹ For all transactions completed after the 2009 annual adjustments, unless a filing is underway, a pre-merger notification is required when the buyer will hold voting securities, non-corporate interests or assets valued in excess of \$65.2 million (previously \$63.1 million), if one party has annual net sales or total assets valued at or more than \$13.0 million (previously \$12.6 million) and the other party has annual net sales or total assets valued at or more than \$130.3 million (previously \$126.2 million). If the size-of-transaction exceeds \$260.7 million (previously \$252.3 million), then the preceding size-of-person test is irrelevant. Corresponding adjustments apply to joint ventures, and to incremental acquisitions of voting securities, non-corporate interests or assets of a foreign persons by a U.S. person, and vice versa. Elimination of the “size of person” test for transactions over \$260.7 million subjects to

¹ Section 8 of the Clayton Act prohibits a person from serving as a director or officer of two competing corporations if certain thresholds are met. The prohibition against interlocking directors applies if a corporation has more than \$10 million (as adjusted) in capital, surplus and undivided profits; however, if either corporation has less than \$1 million (as adjusted) in competitive sales, then the prohibition does not apply. As adjusted, Section 8 now applies to corporations with more than \$26,161,000 in capital, surplus and undivided profits, while it does not apply to corporations with less than \$2,616,100 in competitive sales.

filing (and the 30-day waiting period) certain high-tech and LBO transactions which were formerly exempt, which is a result intended by the antitrust regulators to subject significant “dot com” and leveraged deals to at least cursory scrutiny.

The filing fee plateaus have also increased to \$65.2 million, \$130.3 million, and \$651.7 million, with fees at those levels of \$45,000, \$125,000, and \$280,000, respectively.

B. Partnership and LLC Transactions.

One principal exception from the original and long-standing application of HSR was changed in 2005. Since its original enactment, HSR did not require notification filings for formations and acquisitions of partnerships unless the acquirer would hold 100% of the partnership. Effective in 2005, the notification and waiting period requirements apply to formations and acquisitions of partnerships, limited liability companies and other unincorporated entities where the acquirer obtains control (defined as the right to 50% or more of the profits or 50% of more of the assets in the event of dissolution). The 2005 rules also extended the prior intra-person exemption to partnership holdings as well as to corporate stock holdings, but the extension of the filing requirements to non-corporate entities has had substantially more practical effects than did the extension of the intra-person exemption.

C. NAICS Codes.

Effective July 2001, the transaction parties are required to report product information, including related U.S. revenues, in the HSR notification form using the North American Industrial Classification System (“NAICS”) in lieu of the Standard Industrial Classification system (“SIC”) formerly used; conversions from the 4-digit SIC codes to the 6-digit NAICS codes, and other NAICS related information, are found on the Bureau of the Census home page (<http://www.census.gov/epcd/www/naics.html>). HSR amendments effective December 2005 updated the NAICS reporting base year from 1997 to 2002.

D. Foreign Acquisitions.

Effective April 2002, certain previously exempt, entirely foreign acquisitions became subject to HSR where the acquired person’s U.S. sales or assets exceed (with the February 2009 adjustments) \$65.2 million.

E. Merger Review and Second Requests

In response to continuing requests for relief from the burdensome second request process, the Agencies have implemented a series of streamlining improvements to the process, most recently the 2006 reforms summarized above. But complying with second requests remains an awesome, very time-consuming and

expensive process, and the related costs and delays often make negotiated settlements appear far more attractive than otherwise might be the case.

As an alternative to issuing a second request, where the Agencies realize they will not finish their internal review during the initial waiting period, the Agencies have been increasingly willing to suggest that the parties “re-file” their notification forms to re-start the 30-day waiting period. Faced with the very undesirable prospect of receiving a second request, the parties usually comply, with no additional filing fee required if the refiling occurs within two business days of the withdrawal of the original filing. Any new Item 4(c) documents must also be submitted with the refiling. This practice has been criticized as back-door avoidance of the limits of the waiting periods, but when a second request is the alternative, the parties are often well-advised to comply with a re-file request.

While fewer proposed mergers have been subject to HSR reporting requirements following the threshold amendments of 2001, the standard of legality of Section 7 of the Clayton Act has remained unchanged, and the FTC and the DOJ have devoted significant time and effort to identifying unreported, frequently consummated, mergers that may pose competitive concerns. The primary purpose of HSR was to avoid the difficulties of trying to “unscramble the eggs” by trying to unwind a completed merger, but the intensely-litigated *Chicago Bridge* case and the more recent *Dairy Farmers Association* and *Waste Industries* cases demonstrate that the Agencies will challenge an unreported, consummated merger where it is warranted.

II. Merger Guidelines.

The recent substantially increased HSR activity emphasizes the constant importance to American business of the guidelines used by the Agencies to assess whether to challenge acquisitions or other combinations reported to them.

The Agencies’ joint “Horizontal Merger Guidelines” were last substantially revised in 1997, updating the guidelines issued jointly in 1992, separately by the DOJ in 1984, and separately by the FTC in 1982. The 1997 action marked the second time that guidelines or revisions were issued jointly by the Agencies.²

Since the issuance of the 1997 revisions, there have been several of the most widely publicized merger actions

² In March 2002, the FTC and the DOJ signed a Memorandum of Agreement allocating industry sectors between the two Agencies (both of which have concurrent HSR jurisdiction) so that clearance delays would be limited or eliminated. The Agreement (<http://www.ftc.gov/opa/2002/02/clearance.htm>) followed negotiations with Congress regarding review of media mergers. But the accord collapsed in May 2002 after objections from Senator Hollings, so the Agencies have returned to their case-by-case allocation of lead clearance authority. Together with the recently updated “Merger Review Process Initiative” and the “Guidelines for Merger Investigations,” the Agreement had been an attempt to expedite the HSR review process.

by the DOJ and the FTC in many years, and the litigation decisions of the Agencies will be very closely watched to assess the effect of the recession and the expected surge in combinations.

In almost all of these cases, “efficiencies” arguments would seem to have supported the proponents, but were not given much apparent weight by the Agencies, and even less by the courts. However, efficiencies arguments are still a central focus of major pending deals, and efficiencies were cited as one reason for the FTC’s decision not to challenge the AmeriSource/Bergen combination of the third and fourth largest drug wholesalers, and the FTC decision to close its investigation of Sunoco’s acquisition of the Coastal Eagle Point Oil Company, and the clearance of the *Whirlpool/Maytag* merger, announced in March 2006. It is still fair to say that efficiencies arguments receive a much friendlier reception at the Agencies than they do in the courthouse.

Section 7 of the Clayton Act makes it illegal for two companies to merge “where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.” The Merger Guidelines clarify how the Agencies will analyze efficiency claims in mergers under their review in order to provide the public, the Agencies themselves, and prospective merging firms with a clearer roadmap for determining whether expected efficiencies will lead merging firms to lower prices, create new products, or otherwise enhance competition.

The Merger Guidelines also make clear what merging firms must do to demonstrate claimed efficiencies, although in the first significant interpretation of the 1997 revisions, *FTC v. Staples, Inc.*, the court found that the claimed efficiencies lacked credibility, and gave them little weight. One of the latest cases centering on efficiencies issues, *AmeriSource/Bergen*, cited efficiencies but upheld the combination independently. And the *Oracle/PeopleSoft* and *H.J. Heinz/Beech-Nut* proposed mergers show that the Agencies will strongly dispute efficiencies arguments, and the “Against Giants” defense as well, where the Agencies believe that the mergers will have anti-competitive effects, and the courts will agree. *Whirlpool/Maytag* was based in part on efficiencies arguments, but the key to that clearance was the DOJ’s conclusion that the combined company could not exercise market power in the sense of effective price control.

The 1997 revisions to the Merger Guidelines made an important contribution by signaling when efficiencies are most likely to matter and when they will virtually never make any difference in the analysis, and they provide some guidance as to which types of efficiencies that firms claim as merger-related savings are in fact more likely (and which are less likely) to be credible and substantial.

During the HSR waiting period, the companies involved must take special care to avoid any “gun-jumping” transfer of control, or any information exchange beyond that strictly necessary for the due diligence and efficiencies arguments necessary to formulate the deal and disclose and defend it properly. In the Input/Output/DigiCourse transaction, and in the Gemstar-TV Guide transaction, and most recently in the settlement of gun-jumping charges in the *QUALCOMM/Flarion* case, the Agencies extracted substantial civil penalties for premature acquisition of control while the deal was being investigated, and even in one case where HSR had been cleared by the Agencies. The Agencies are serious about HSR, and the recent decision in the *Omnicare/UnitedHealth* case, permitting a private treble damage case to proceed based on gun-jumping, demonstrates that competition as usual is the only safe advice prior to HSR clearance, and that any contract provisions beyond “business in the ordinary course” could be suspect.

A. Purpose and Underlying Policy Assumptions

The Merger Guidelines provide a valuable indication of when the Agencies are likely to challenge an acquisition or merger. While the Merger Guidelines improve the predictability of the Agencies’ enforcement of the antitrust laws, the Agencies emphasize that they will apply the standards of the Merger Guidelines reasonably and flexibly to the particular facts and circumstances of each proposed merger. Moreover, while the Merger Guidelines are helpful guides to the courts, they are not binding in court, and the FTC has instituted proceedings, for example the long-litigated *Chicago Bridge* case, to break up an acquisition which had been cleared under HSR only months before.

There has also been recently a continuing emphasis by the Agencies on the so-called “unilateral effects” of a merger, requiring an often-extensive economic analysis of the power of the combined company unilaterally to affect prices following the merger. There is continuing debate as to whether this is truly a change in the direction of merger analysis, or simply a new nomenclature for the standard analysis as it has developed in recent years. In the September 2004 decision in *U.S. v Oracle*, the District Court all but equated the unilateral effects doctrine with traditional market power concepts -- does the combined company have the ability to raise prices without effective counter from other market participants? The same focus resulted in the clearance without conditions of *Whirlpool/Maytag*. The process under this approach “fast forwards” to a study of the hypothetical *combined* company and the market influences it will possess, rather than the step-by-step approach of standard analysis under the Merger Guidelines.

The unifying theme of the Merger Guidelines is that mergers should not be permitted to create, enhance or facilitate the exercise of “market power.” Market power is defined as the ability of one or more selling firms to maintain prices above competitive levels profitably for a significant period of time (“monopoly power”) or the ability of one or more buying firms to depress prices below competitive levels and thereby depress output (“monopsony power”). While attempting to prevent mergers that may harm competition, the Agencies try to avoid unnecessary interference with “that larger universe of mergers that are either competitively beneficial or

neutral.” However, the Merger Guidelines reflect the Congressional intent that “merger enforcement should interdict competitive problems in their incipiency.”

The Merger Guidelines describe the five-step analysis that the Agencies will employ in determining whether to challenge a horizontal merger.³ First, the Agencies assess whether the merger would result in a significant increase in concentration in a defined and measured market. Second, the Agencies consider whether the merger raises concerns about potential anti-competitive effects in the market in question. Third, the Agencies analyze the likelihood of timely and meaningful entry by other firms into the relevant market that would counteract the anti-competitive effects of the merger. Fourth, the Agencies balance any gains in efficiency that cannot be achieved by the parties to the merger by other means. Finally, the Agencies take into consideration whether, but for the merger, either party to the transaction would be likely to fail and exit the market.

B. Market Definition and Measurement

In deciding whether to challenge a horizontal merger, the Agencies will analyze the likelihood that a merger would produce market power within a relevant market. A “relevant market” consists of both: (i) a product (or service) or group of products (or services), and (ii) a geographic area. This analysis in most cases will be absolutely critical in determining the antitrust result, since by definition the broader the market, the smaller the market shares of the merger participants, and therefore the less likely a challenge to their combination.

1. Product Market

The general rule when determining a relevant product market is that “[t]he outer boundaries of a product market are determined by the reasonable interchangeability of use [by consumers] or the cross-elasticity of demand between the product itself and substitutes for it.” Interchangeability of use and cross-elasticity of demand look to the availability of substitute commodities, that is, whether there are other products offered to consumers which are similar in character or use to the product or products in question, as well as how far buyers will go to substitute one commodity for another. In other words, the general question is “whether two products can be used for the same purpose and, if so, whether and to what extent purchasers are willing to substitute one for the other.” Whether there are other products available to consumers which are similar in character or use to the products in question is termed “functional interchangeability.”

To define the relevant product market, the Agencies attempt to ascertain the smallest group of products that includes each product produced or sold by the merging firms and all reasonable substitutes. In this regard, the Agencies attempt to predict the impact on consumer demand for the product in question if a hypothetical monopolist imposed a “small but significant and nontransitory” increase in price. If the price increase would cause enough buyers to switch to other products so that the price increase would be unprofitable, the next best substitutes for the product are added to the product group. The test is repeated and the product group enlarged

³ A horizontal merger is a merger between firms that are in the same product and geographic market.

until the hypothetical monopolist could profitably impose the price increase on a group of products that includes a product of the merging firms. The relevant product market is generally the smallest group of products that satisfies this test.

The prices used in the analysis are usually the prevailing prices of the products of the merging firms and their possible substitutes at the level of the industry under examination (e.g., retail, wholesale, etc.). The Merger Guidelines specifically provide, however, that if pre-merger circumstances are suggestive of coordinated interaction on the part of participants in the relevant market, the Agencies will use a price more reflective of what they consider to be a competitive price.

In most cases, a hypothetical price increase of five percent lasting “for the foreseeable future” will be used, although the Agencies retain flexibility to use a price increase of greater or less than five percent where appropriate, given the nature of the industry. The Merger Guidelines explicitly lay to rest a common misconception about the five percent test: it is not a tolerance level for price increases but rather a tool for reaching the Agencies’ definition of the relevant product market. The “unilateral effects” approach discussed above would also interdict the analysis at this point, and consider the combined company’s market power as a key and perhaps controlling element of the analysis exercise.

A market may include submarkets, and courts apply the “practical indicia” factors to determine whether a submarket exists, including “industry or public recognition of the submarket as a separate economic entity, the product’s peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors.” The unbiased views of the participants are often of critical importance: “Analysis of the market is a matter of business reality -- a matter of how the market is perceived by those who strive for profit in it.”

In the September 2004 District Court decision in *U.S. v. Oracle*, the Court concluded after an extensive factual analysis that the prosecutors had not proven their asserted product market by a preponderance of the evidence, and therefore the rest of their case was not entitled to any presumption of illegality, since their predicative burden had not been met. The 2006 *Whirlpool/Maytag* clearance showed that the Agencies will reach their own, largely factual conclusions about the relevant products and relevant markets, and will include potential participants on the fringes as well as established competitors in such markets.

2. Geographic Market

A geographic market is that geographic area “to which consumers can practically turn for alternative sources of the product and in which the antitrust defendant faces competition.” The test used in defining a geographic market resembles that used in the definition of a product market. If the “small but significant increase in price” by the hypothetical monopolist (in the location of each merging firm or each plant of a multi-plant firm) would cause enough buyers to shift to other geographic areas so that the price increase would not be profitable to the monopolist, the locations where the next best substitutes for the merging firms’ products are

produced or sold are added to the geographic market, until the Agencies identify an area in which this price increase would be profitable.

Stated differently, the issue is whether producers of the merged firms' product in other geographic areas place a significant constraint on the ability of the merged firms to raise price or restrict output. As a general proposition, an area is a separate geographic market if a change in the price of a product in that area does not, within a relevant period of time, induce substantial changes in the quantity of the product sold in other areas for use in the original market. From a "unilateral effects" perspective, would the combined company have the power within a relevant market to raise prices? Would it be expected to do so? Has there been evidence of similar activity in this industry in the past? In *U.S. v. Oracle*, the DOJ had alleged a U.S.-only market, but the Court concluded that a worldwide market was much more likely, with substantial dilutive effects on the alleged market shares of the participants. *Whirlpool/Maytag* concluded that the entire U.S. was the relevant market, affected to a significant degree by offshore-controlled participants.

3. Identification of Firms Participating in the Relevant Market

Apart from the firms that currently produce and sell in the relevant market, the Agencies will also treat the following types of firms as market participants:

- firms that would be likely to produce and sell the relevant product in the relevant market within one year, without the expenditure of significant irretrievable costs of market entry or exit, in response to a "small but significant and nontransitory" increase in price;
- firms that recycle or recondition durable products, if product market analysis indicates that such products should be included in the relevant market; and
- vertically integrated firms that produce the relevant product but also consume their own production, which may respond to a price increase by selling or increasing production of the relevant product.

One must also be mindful of the recent approaches to companies by category -- perhaps superstores are a separate market from smaller retailers, despite their equivalent product offerings. Perhaps smaller market participants which could quickly expand are proper participants, as found by the District Court in *U.S. v. Oracle*, and by the DOJ in *Whirlpool/Maytag*.

4. Market Shares and Concentration

Market shares are normally calculated on the basis of the total sales or capacity of the firms included in the relevant market together with such sales or capacity that likely would be devoted to the relevant market in response to a small but significant and nontransitory price increase. Market shares can be expressed either in dollars or physical terms and can be measured by sales, shipments, production, capacity or reserves.

Market concentration is a function of the number of competing firms in a market and their respective market shares, and is an indicator of whether a firm or a small group of firms could successfully exercise market power. The Agencies use the Herfindahl-Hirschman Index (“HHI”) as an aid to determine market concentration. The HHI is calculated by adding the squares of the individual market shares of the firms in the relevant market.⁴ The HHI reflects the distribution of market shares and gives proportionately greater weight to the market shares of larger firms. For example, the HHI of a market in which a large number of firms each control a small market share will be a relatively small number and the market will be deemed unconcentrated. Alternatively, the HHI of a market in which a small number of firms control a large market share will be a relatively large number and the market will be considered concentrated.

In utilizing the HHI, the Agencies will consider both the level of market concentration after the merger and the increase in market concentration caused by the merger. If the “unilateral effects” approach is in play, it will not be concentration as such which will influence the conclusion, but rather the expected result on market prices which can be predicted from the combination. But, as emphasized in *U.S. v. Oracle*, to have a credible claim of “unilateral effects,” there must be a credible demonstration of localized competition, with convincing evidence of a demonstrable product market and a demonstrable geographic market. Where the “unilateral effect” is not apparent or is contradicted by market facts, as in *Whirlpool/Maytag*, the merger proceeds uninterrupted.

The basic HHI standards for judging horizontal mergers are the following:

a. Unconcentrated Markets

- If the post-merger HHI is below 1,000, it is unlikely that the merger will be challenged except in extraordinary circumstances.⁵ The mergers challenges data released in December 2003 confirmed this conclusion.

b. Moderately Concentrated Markets

- If the post-merger HHI is between 1,000 and 1,800, it is unlikely that the merger will be challenged if it produces an increase in the HHI of 100 points or less. Mergers producing an increase in the HHI of more than 100 points in moderately concentrated markets “potentially raise significant competitive concerns” and the Agencies may challenge the merger unless an analysis of the factors set forth below indicate that the merger should be allowed. However, the mergers challenges data released by the Agencies in 2003 demonstrated that less than 5% of challenged mergers in the years 1999 through

⁴ For example, a market consisting of four firms with market shares of 30 percent, 30 percent, 20 percent and 20 percent has an HHI of 2600 ($30^2 + 30^2 + 20^2 + 20^2 = 2600$). If one of the 30 per cent companies merges with one of the 20 per cent companies, the HHI would increase to 3800, and market power would be presumed under the Merger Guidelines.

⁵ The rationale is that implicit coordination between firms in an unconcentrated market is difficult, and that there are prohibitions against explicit collusion in Section 1 of the Sherman Act.

2003 had post-merger concentrations below 1,800, so this threshold is a ceiling which is exceeded with impunity.

c. Highly Concentrated Markets

- If the post-merger HHI is above 1,800, a merger is unlikely to be challenged if it produces an increase in the HHI of less than 50 points. Mergers producing an increase in the HHI of more than 50 points in highly concentrated markets require further analysis of the factors set forth below. Mergers producing an increase in the HHI of more than 100 points in highly concentrated markets are presumed to create, enhance or facilitate market power. This presumption may be rebutted, however, by a showing that the factors set forth below make it unlikely that the merger will create, enhance or facilitate market power, in light of market concentration or market shares or other pertinent factors.

This formulation in the 1992 Guidelines was a notable change from the 1984 Guidelines, which stated that a merger in this category would likely be challenged absent extraordinary circumstances. In addition, this formulation more accurately reflects the actual practice of the Agencies, and is consistent with the “unilateral effects” approach to a proposed combination. Courts also accept undue concentration as creating a presumption that the transaction will substantially lessen competition, and the burden then shifts to the proponents of the merger to rebut the presumption by showing that market-share statistics give an inaccurate prediction of the proposed acquisition’s probable effect on competition.

Also, the mergers challenges data released by the Agencies in December 2003 demonstrated that even when the post-merger market concentration reached 2,500, only 13% of the deals were challenged, and almost 25% of all challenged combinations had post-merger shares above 7,000, indicating an 80+% share of the defined market. More than half of the challenged transactions had post-merger shares exceeding 4,000, indicating combined market shares between 40-60%. However, in certain sectors, such as petroleum, and in bank mergers, lower shares were far more frequently challenged.

C. Anti-competitive Effects

After defining the relevant market and determining the market concentration, the Agencies consider the potential anti-competitive effects, including the “unilateral effects,” arising out of the merger. Such anti-competitive effects may arise because the merger may facilitate coordinated interaction among the firms remaining in the market or facilitate the post-merger firm’s ability to exercise market power unilaterally. Some commentators in fact have suggested that the unilateral effects approach has developed as a partial answer to cases that seem to warrant a challenge despite the apparent lack of any evidence of potential collusion.

1. Coordinated Interaction

The Agencies will attempt to determine whether a merger will diminish competition by making it more likely that firms remaining in the relevant market may engage in coordinated interaction. Coordinated interaction consists of accommodating actions by a group of firms that have the effect of enhancing profits and limiting competition. Such behavior includes both tacit and express collusion and may be unlawful in and of itself.

The Agencies attempt to determine whether conditions of a particular market are conducive to or may hinder firms reaching terms of coordination. In general, the facts that the Agencies consider include the degree of product or firm homogeneity (the more homogeneous, the more conducive to coordination), the availability of key information about rival firms and their products (more available information is deemed to facilitate coordination), and coordinated firm practices that are not necessarily violations of the antitrust laws such as standardization of pricing. The District Court considered these concepts at length in *U.S. v. Oracle*, and found the evidence of coordinated effects to be simply unconvincing. In *Whirlpool/Maytag*, coordinated interaction was certainly a specter in the case, but the clearance did not give it separate attention.

2. Unilateral Action

The Agencies will also attempt to determine if the merger will facilitate the surviving entity's ability to diminish competition unilaterally. As noted above, this approach has gained considerable force in recent analyses. Facts the Agencies may consider include the level of product differentiation in the market, on the theory that a merger between firms that have distinguishable products may enable the merged firm to restrict competition unilaterally by raising the price of both products. Alternatively, the Agencies will consider whether a merger between firms that produce homogenous products may enable the merged firm to raise the price of the product and leave the consumer with fewer competing alternatives. In either case, particular scrutiny will be given to mergers that result in the post-merger firm holding a 35% share of the relevant market, although this is not any sort of exclusive litmus test. And price increases as such are not required -- it is enough to conclude that prices, even if not increased, would have been lower but for the merger. Again, *U.S. v. Oracle* is instructive for the Court's examination of the likely constraints on a merged company's possible attempt to raise prices or take other anti-competitive action unilaterally, and *Whirlpool/Maytag* emphasizes that the absence of pricing power is almost determinative on the central issue of anticompetitive effect.

D. Ease of Market Entry

The third issue the Agencies will consider is ease of market entry. The issue of entry barriers is a critical qualitative factor, for if entry barriers are very low it is unlikely that market power, whether individually or collectively exercised, will persist for long. Conversely, if entry barriers are high, the effect may be to exacerbate any market power conferred by the merger. In this analysis, evidence of actual entry, especially recent and frequent new entry, is probative, as is evidence of failed entry or the absence of entry over long

periods of time. “The existence and significance of barriers to entry are frequently, of course, crucial considerations in a rebuttal analysis . . . [because] [i]n the absence of significant barriers, a company probably cannot maintain supra-competitive pricing for any length of time.”

Under the Merger Guidelines, there are three important components to the entry analysis. First, the entry must be timely; the test applied is whether entry would occur within two years. Second, the entry must be likely, considering feasibility, economic incentives and technological requirements of entering the market. Finally, the entry must be sufficient, such that new competition will bring prices to at least their pre-merger levels.

In analyzing whether entry would be timely, it is not enough to show that someone could construct a plant or commence providing a service within two years. The Agencies will consider the entire entry process, from identifying the profit opportunity to marketing the product or service, to the point at which competition provided by new entrants would counteract any price increases facilitated by the merger.

In assessing whether entry would be likely, the Agencies try to determine whether the expected profits justify risking the costs necessary for entry. In estimating an entrant’s expected profits, the Agencies consider general market risk, the maturity of the relevant market, the risk that the entrant will not achieve the desired level of sales, and the possible reactions of incumbent firms. Although the 1984 Guidelines required entry to be likely in the face of a five percent price increase, the 1992 Merger Guidelines further require entry to be likely for the entering firm assuming that prices fall to pre-merger price levels within two years. The rationale for this rule is that the Agencies postulate that new entry will depress the price to at least the level that existed prior to the merger.⁶

The final issue the Agencies consider in entry analysis is whether entry can occur at a sufficient scale to counteract any price-raising impact of the merger in the market. If the incumbent firms could still profitably raise prices as a result of the merger, conceding the loss of sales to the new, but small-scale entrants, then the anti-competitive effects in the market are not outweighed by the potential for entry. For these purposes, sufficient scale involves an inquiry into the size of the entrant’s productive capacity and the entrant’s ability to sell enough of the product within the two-year period to counteract merger-induced price increases.

In short, if the post-merger structure of a market, based on a market share analysis, is such that there would appear to be a significantly increased risk of anti-competitive practices, the Agencies must be convinced that timely, sufficient entry, such as was demonstrated in *Whirlpool/Maytag*, is likely to occur in response to such practices before they will conclude that ease of entry outweighs anti-competitive concerns.

⁶ The circular reasoning of this aspect of the entry test will make the entry argument more difficult for those defending the merger, since if entry likelihood is tested by pre-merger price levels (or lower) then why haven’t new firms in fact entered the market?

E. Enhanced Efficiencies

The fourth issue in the Agencies' analysis is whether enhanced efficiencies arising out of the merger outweigh the risk of anti-competitive effects. The 1997 revisions to the Merger Guidelines accept the fact that while competition usually spurs firms to achieve efficiencies internally, mergers nevertheless have the potential to generate significant efficiencies, "By permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction. Indeed, the primary benefit of mergers to the economy is their potential to generate such efficiencies. Efficiencies generated through merger can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products."

For example, the 1997 revisions recognize that merger-generated efficiencies may enhance competition by permitting two ineffective, high-cost competitors to become one effective, lower-cost competitor. As the revisions state: "In a "coordinated interaction" context (see above) marginal cost reductions may make coordination less likely or effective by enhancing the incentive of a maverick to lower price or by creating a new maverick firm. In a "unilateral effects" context (see above) marginal cost reductions may reduce the merged firm's incentive to elevate price."

The 1997 revisions recognize that efficiencies also may result in benefits in the form of new or improved products, and may result even when price is not immediately and directly affected. However, even when merger-induced efficiencies enhance a firm's ability to compete, the merger may have other effects that may lessen competition and ultimately make the merger anticompetitive.

There is substantial debate in the Federal courts regarding whether and to what extent efficiencies are relevant as a defense to the government's otherwise prima facie case; the latest Supreme Court pronouncement stated flatly that "[p]ossible economies cannot be used as a defense to illegality in Section 7 merger cases." The Merger Guidelines in this respect suggest that efficiencies arguments may receive a slightly more friendly hearing at the Agencies level than in Federal court, and the *AmeriSource/Bergen* decision supports this view, but the institution of the case to block *Lockheed/Northrop*, the opposition to the *AA/BA* alliance, perhaps even the Microsoft monopoly litigation, and certainly the *H.J. Heinz/Beech-Nut* litigation suggest that even the Agencies are giving little attention to efficiencies arguments in the face of demonstrable and serious competition concerns, but *Whirlpool/Maytag* revived the efficiencies argument to a plateau of prominence, especially at the Agencies' level.

Under the Merger Guidelines, the Agencies will consider only so-called merger-specific efficiencies, meaning those likely to be accomplished with the proposed merger and unlikely to be accomplished absent either the merger or another means having comparable anticompetitive effects. This was a specific factual conclusion in *Whirlpool/Maytag*. If a merger affects only when and not whether an efficiency would be achieved, then only the timing advantage will be considered "merger-specific." Only alternatives that are "practical" will be

considered, not less restrictive alternatives that are merely theoretical, but divestitures or licensing could be considered “practical.”

Since efficiencies details are uniquely in the possession of the merging firms, they are difficult to verify and quantify, and even good faith projections may not be realized; therefore efficiency claims must be substantiated so that their likelihood and magnitude, their costs and timing, their effects on the ability and incentive to compete, and why they are “merger-specific” can be assessed. If efficiencies are vague or speculative or cannot be verified, they will not be considered. Verified merger-specific efficiencies not arising from anticompetitive reductions in output or service are so-called “*cognizable efficiencies*” and will be assessed, net of their costs.

The Agencies “will not challenge” a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market; the Agencies in their prosecutorial discretion may also consider efficiencies in another market which are so inextricably linked with the relevant market that a divestiture or other remedy could not eliminate the anticompetitive effect without also sacrificing the efficiencies, but this will be rare. To make the requisite determination, the Agencies consider whether “cognizable efficiencies” likely would be sufficient to reverse the merger’s potential to harm consumers in the relevant market, such as by preventing price increases. This will not be simply a comparison of the magnitude of the efficiencies versus the harm, but rather the greater the potential adverse competitive effect -- as measured by the HHI increase, the potential adverse competitive effects, and the prospect of timely and sufficient entry by other firms -- the greater the cognizable effects must be. If the adverse competitive effects are “particularly” large, then the cognizable efficiencies must be “extraordinarily” large for the balance to shift.

Certain types of efficiencies are more likely to be cognizable, such as shifting production among facilities formerly owned separately so as to reduce marginal costs; other types of efficiencies, such as R&D savings, are potentially substantial, but generally less susceptible to verification and may result from anti-competitive reductions in output. Others such as purchasing and management savings and capital cost reductions may not be merger-specific or substantial or may not be cognizable for other reasons.

In *U.S. v. Oracle*, efficiencies arguments were made but were found unverifiable. In *Whirlpool/Maytag*, efficiencies arguments were made and they succeeded. In most cases, such as *AmeriSource/Bergen*, efficiencies will make a difference in the analysis when the adverse competitive effects are not great. They certainly will not vindicate an otherwise illegal transaction. In addition, short-term efficiencies will generally carry more weight; long-term efficiencies will be considered as well, although they are less proximate and more difficult to predict, therefore affecting the weight they are given. Efficiencies almost never justify a merger to monopoly or near-monopoly. Grossly exaggerated efficiency claims may have the unintended effect of generating skepticism and undermining credibility. In the *FTC v. Staples* case, for example, claimed efficiencies of billions and sprinkle-up efficiencies as well were found to be unreliable, inconsistent with

internal and SEC-filed documents, unverified, available without the merger in large part, and illogically extrapolated from limited data. Lockheed, Northrop, American Airlines, British Airways, and even Microsoft to an extent, all made very strong efficiencies arguments and were challenged nonetheless; Heinz and Beech-Nut were initially successful with a convincing efficiencies case and an “Against Giants” defense as well, only to be rebuffed on appeal; and Whirlpool made them, convincingly, and won.

F. “Failing Firm” and “Exiting Assets”

The final factor in the Agencies’ analysis is the so-called “failing firm” defense that a party may invoke to persuade an agency to allow a merger that it otherwise might challenge. For purposes of this analysis, a merger is not deemed likely to create, enhance or facilitate market power if imminent failure of one of the merging firms would cause the assets of that firm to exit the relevant market.

The failing firm defense is strenuous. In considering the question of firm failure, the Agencies will ordinarily not challenge a merger if: (i) the failing firm would not be able to meet its financial obligations in the near future; (ii) it would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Code; (iii) it has made unsuccessful good faith efforts to elicit reasonable alternative offers for acquisition of its assets that would pose a less severe threat to competition than if its assets were acquired in the merger;⁷ and (iv) absent the merger, the assets of the failing firm would exit the market.

The failing firm argument may also be applied, with some modification, to a merger involving a failing division of a non-failing parent entity. The Agencies will apply a three-part analysis when considering a failing division argument. First, upon applying appropriate cost allocation rules, the division must have a negative operating cash flow. Second, absent the acquisition, it must be determined that the assets of the division would exit the relevant market in the near future. Third, the owner of the failing division must have solicited and not received a reasonable offer for the assets or stock of the division from a competitively preferable purchaser. In this analysis, the Agencies will attempt to give due consideration to the ability of the parent entity to allocate costs, revenues and intracompany transactions among itself and its subsidiaries and divisions.

Given all this, the doctrine has life. In June, 1997, the FTC announced that it would not oppose the acquisition of McDonnell Douglas by Boeing, even though the combination was of the only two significant commercial aircraft manufacturers in the United States, and two of only three in the world (the other being Europe’s Airbus). The FTC premised its conclusion on the finding that McDonnell Douglas “no longer constitutes a meaningful competitive force in the commercial aircraft market and . . . there is no economically plausible strategy that [it] could follow . . . that would change that grim prospect.” This was not a failing company doctrine decision in the sense that McDonnell was not failing; its commercial aircraft business was making money. Rather, the FTC concluded that, the past notwithstanding, McDonnell was not going to be a

⁷ The Merger Guidelines expressly add the criterion that any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets or an equivalent offer to purchase the stock of the failing firm will be considered a reasonable offer.

competitive factor in the future because it had not made the capital improvements required to compete with Boeing and therefore potential customers would not view it as a competitive alternative. McDonnell had failed in the sense that it did not present a future competitive force, and therefore its acquisition by Boeing was irrelevant from an antitrust perspective. Contrast, however, the unexpected DOJ contest to the proposed *Lockheed/Northrop* combination in March 1998; where there are demonstrable overlaps, such as electronics and radar in the Lockheed case, and vigorous stand-alone competitors, the Agencies will not be dormant even where the industry has had a long and unchallenged history of combination even to sole supplier levels.

* * *

The Merger Guidelines are the joint statement by the FTC and the DOJ on the criteria used to review mergers for antitrust law violations. The Merger Guidelines, as revised, carry on the basic analytical framework employed by the Agencies since 1982, but now incorporate specific “efficiencies” revisions and clarifications arising out of experience and new regulatory and economic thought. Based on the recent cases, however, the efficiencies arguments seem to be carrying little weight with the Agencies or the courts.

Since merger analysis is so fact-intensive, it is also important to follow a few simple strategic guidelines when dealing with the Agencies and their several levels of review -- competition, economics, and compliance, with the DOJ being considered somewhat more user-friendly than the FTC.

First and foremost, respect the Agencies’ staffs and the job they are trying to do. It does no good, and usually does harm, to argue about the size of a transaction if it satisfies the jurisdictional requirements, or to threaten to go to court -- the staff are going through the analysis for the purpose of determining whether *they* want to go to court. Courtesy is key -- it is extremely unwise to threaten, belittle, bully, or otherwise incite the staff to work overtime to try to unseat one transaction when they have so much discretion at the outset.

Second, do not appear to be too weak -- the Agencies have their own statistics in mind, and if they sense an easy victory via an offered partial fix-it-first divestiture or otherwise, they will be inclined to it. There is no statutory right to a consent decree, but if it is offered it is usually accepted, or even worse it can be the minimum plateau for further requirements.

Third, if there is doubt, ask for advice or file the premerger notification. Penalties are extremely severe for not filing, and staff members are very open to discussing the jurisdictional requirements even on a hypothetical basis.

Fourth, be very careful during the waiting period not to take control in fact; competitors may complain, and this could instigate an investigation even if the merger itself would have been cleared.

Finally, don’t ask for Congressional help unless absolutely necessary. This usually results only in an exchange of form letters and wastes the staff’s time, and also draws attention and therefore more interest in the transaction.

The one overriding current running through the Merger Guidelines and their predecessors is that each merger will be analyzed on its facts and that the antitrust analysis of all proposed mergers is exquisitely fact-sensitive. There will always be some exercise of judgment in the evaluation of mergers under the U.S. antitrust laws, and the Agencies' standards will be applied to a broad range of possible, and even unforeseeable, factual circumstances. The Merger Guidelines are intended to be the basic analytical structure for merger analysis, but the facts of each case will always dictate the outcome of the analysis.

If this outline of Hart-Scott-Rodino and the Merger Guidelines prompts any questions, please contact **Robert A. McTamane**y (mctamane@clm.com), **Austin D. Keyes** (keyes@clm.com), or **Peter Flägel** (flagel@clm.com) of our New York Office.

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