Unit 3E. Introduction to Anticompetitive Defenses

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Topics

- Refresher: Anticompetitive Effect under Section 7
- Defenses
  - Entry/expansion/repositioning
  - Power buyers
  - Efficiencies
  - Failing firm

Refresher:
Anticompetitive Effect under Section 7

Section 7 of the Clayton Act

- Section 7 supplies the antitrust standard to test acquisitions:

> No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, 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.*[1]

- Test of anticompetitive effect under Section 7
  - Whether "the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly" in any relevant market
  - *Incipiency standard*: The Supreme Court has interpreted the "may be" and "tend to" language in the anticompetitive effects test to—
    - Require proof only of a *reasonable probability* that the proscribed anticompetitive effect will occur as a result of the challenged acquisition
    - *Not* require proof that an actual anticompetitive effect will occur

[1] 15 U.S.C. § 18.

"May be to substantially lessen competition"

- No operational content in the statutory language itself
  - What does it mean to "substantially lessen competition"?
  - Judicial interpretation has varied enormously over the years
- *Modern view*:[1] Transaction threatens—with a reasonable probability—to hurt some identifiable set of customers through:
  - Increased prices
  - Reduced market output
  - Reduced product or service quality
  - Reduced rate of technological innovation or product improvement[2]
  - (Maybe) reduced product diversity[3]

These are called *anticompetitive effects*

A firm that has the power to produce or strengthen an anticompetitive effect is said to have *market power*

[1] The modern view dates from the late 1980s or early 1990s, after the agencies and the courts had assimilated the 1982 DOJ Merger Guidelines.
[2] See, e.g., FTC v. Hackensack Meridian Health, Inc., 30 F.4th 160, 172 (3d Cir. 2022); Viamedia, Inc. v. Comcast Corp., 951 F.3d 429, 475 (7th Cir. 2020); United States v. Anthem, Inc., 855 F.3d 345, 475 (D.C. Cir. 2017); United States v. JetBlue Airways Corp., No. CV 23-10511-WGY, 2024 WL 162876, at *28 (D. Mass. Jan. 16, 2024).
[3] The idea that reduced product diversity may be a cognizable customer harm was formally introduced in the 2010 DOJ/FTC Horizontal Merger Guidelines. Courts have recognized that a merger's elimination of a product option that consumers value is a cognizable harm to competition. *See, e.g.*, United States v. Anthem, Inc., 855 F.3d 345, 366 (D.C. Cir. 2017); United States v. JetBlue Airways Corp., No. CV 23-10511-WGY, 2024 WL 162876, at *28 (D. Mass. Jan. 16, 2024).

Clayton Act § 7

- The incipiency standard
  - *The law*: Beginning in 1957 with the Supreme Court's decision in *duPont/GM*, courts consistently have interpreted the "may be" and "tend to" language in the anticompetitive effects test to—
    - Require proof only of a *reasonable probability* that the proscribed anticompetitive effect will occur as a result of the challenged acquisition
    - Not require proof that an actual anticompetitive effect will result from the merger

> Section 7 is designed to arrest in its incipiency not only the substantial lessening of competition from the acquisition by one corporation of the whole or any part of the stock of a competing corporation, but also to arrest in their incipiency restraints or monopolies in a relevant market which, as a reasonable probability, appear at the time of suit likely to result from the acquisition by one corporation of all or any part of the stock of any other corporation. The section is violated whether or not actual restraints or monopolies, or the substantial lessening of competition, have occurred or are intended.[1]

  - Section 7 tests all mergers—horizontal, vertical , and conglomerate—under the same reasonable probability standard[2]

[1] United States v. E.I. duPont de Nemours & Co., 353 U.S. 586, 589 (1957); *accord* Brown Shoe Co. v. United States, 370 U.S. 294, 325 (1962); United States v. Penn-Olin Chem. Co., 378 U.S. 158, 173 (1964); United States v. Cont'l Can Co., 378 U.S. 441, 444 (1964); United States v. Von's Grocery Co., 384 U.S. 270, 272 (1966); FTC v. Procter & Gamble Co., 386 U.S. 568, 576-77 (1967); Ford Motor Co. v. United States, 405 U.S. 562, 567 n.4 (1972); United States v. Falstaff Brewing Corp., 410 U.S. 526, 531 (1973); United States v. Marine Bancorporation, Inc., 418 U.S. 602, 616, 640-41 (1974);

[2] *Procter & Gamble*, 386 U.S. at 577 ("All mergers are within the reach of § 7, and all must be tested by the same standard, whether they are classified as horizontal, vertical, conglomerate.").

Defenses to anticompetitive effect

- Common defenses
  1. Entry/expansion/repositioning
  2. Power buyers
  3. Efficiencies
  4. Failing firm

- Defenses are negative defenses, *not* affirmative defenses
  1. A *negative defense* says that the merger is not anticompetitive in the first instance
  2. An *affirmative defense* says that even if the merger is anticompetitive, it is nonetheless not unlawful

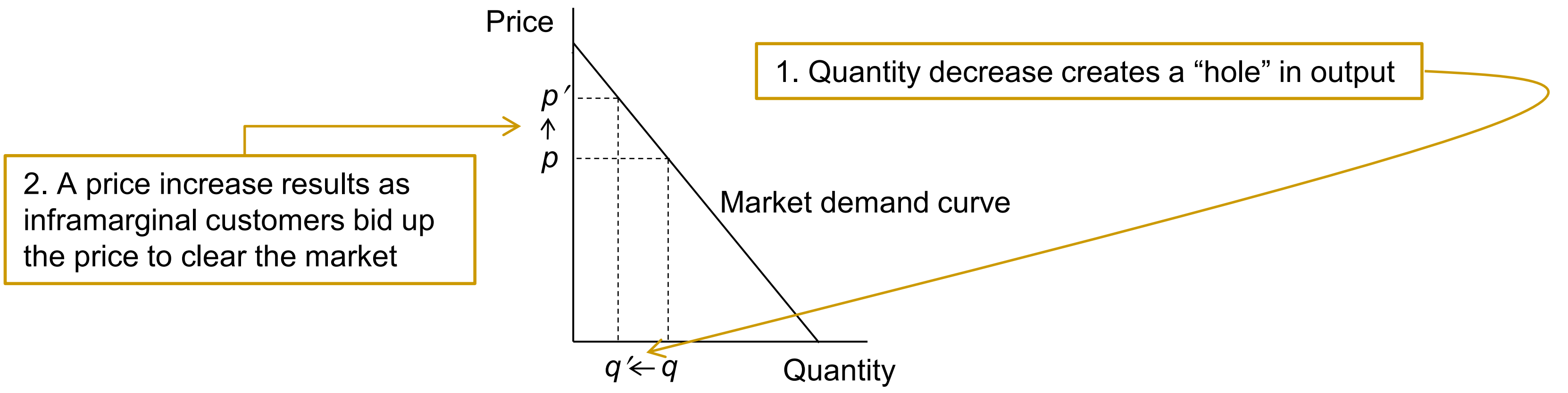
- *Baker Hughes* burden shifting
  1. Formally, the plaintiff can make out its *prima facie case* on the *PNB* presumption without addressing any defense
  2. The defendant has the *burden of production* with evidence predicating the defense (including challenging the *PNB* presumption)
  3. If the defendant adduces sufficient evidence to permit the trier of fact to find for the defendant on the defense, then the plaintiff has the *burden of persuasion* shifts on the ultimate question of whether the merger, with all evidence taken as a whole, is anticompetitive

Entry/Expansion/Repositioning Defenses

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 9 and 2023 DOJ/FTC MERGER GUIDELINES § 3.2

Entry/Expansion/Repositioning

- The story
  - General idea for an anticompetitive increase in price or a reduction in output
    - Think of a merger's anticompetitive effect being achieved by a reduction in market output



    - The defense depends on showing that the "hole" in the output will be filled by—
      - New firms entering the market and adding new output
      - Incumbent firms expanding their output over premerger levels, *or*
      - Incumbent firms extending or repositioning their product lines in product or geographic space to replace output loses resulting from unilateral effects
  - Proof of actual postmerger entry/expansion/repositioning is not necessary
    - The mere *threat* of entry/expansion/repositioning may be enough to deter incumbent firms from acting less competitively for fear of inducing new competition
    - The "threat" variation of the defense is often easier to prove than actual postmerger behavior by third-party firms

Entry/Expansion/Repositioning

- The Merger Guidelines[1]
  - The formalities
    - 1982 and 1992: Depended largely on actual entry having a significant impact within two years of the merger
      - This allows for a short-run anticompetitive effect
    - 2010: Requires entry to “deter or counteract” any anticompetitive effects “so the merger will not substantially harm customers”
      - Does not allow any grace period
    - 2023: Tracks the requirements of the 2010 Guidelines, but with significantly less commentary
  - Guidelines requirements—Entry must be:
    1. Timely
    2. Likely
    3. Sufficient
  - Courts have adopted these requirements

[1] References to “entry” in this section also include expansion and repositioning.

Entry/Expansion/Repositioning

- The Merger Guidelines
  1. Timely
     - 2010 DOJ/FTC Horizontal Guidelines § 9:
       - "In order to deter the competitive effects of concern, entry must be rapid enough to make unprofitable overall the actions causing those effects . . . ."
       - "Even if the prospect of entry does not deter the competitive effects of concern, post-merger entry may counteract them. This requires that the impact of entrants in the relevant market be rapid enough that customers are not significantly harmed by the merger, despite any anticompetitive harm that occurs prior to the entry."
       - "The Agencies will not presume that an entrant can have a significant impact on prices before that entrant is ready to provide the relevant product to customers unless there is reliable evidence that anticipated future entry would have such an effect on prices."
     - 2023 DOJ/FTC Merger Guidelines § 3.2 (entire entry):

       > "To show that no substantial lessening of competition is threatened by a merger, entry must be rapid enough to replace lost competition before any effect from the loss of competition due to the merger may occur. Entry in most industries takes a significant amount of time and is therefore insufficient to counteract any substantial lessening of competition that is threatened by a merger. Moreover, the entry must be durable: an entrant that does not plan to sustain its investment or that may exit the market would not ensure long-term preservation of competition."[2]

Entry/Expansion/Repositioning

- The Merger Guidelines
  2. Likely
     - 2010 DOJ/FTC Horizontal Merger Guidelines § 9:
       - “Entry is likely if it would be profitable, accounting for the assets, capabilities, and capital needed and the risks involved, including the need for the entrant to incur costs that would not be recovered if the entrant later exits.”
       - “Profitability depends upon (a) the output level the entrant is likely to obtain, accounting for the obstacles facing new entrants; (b) the price the entrant would likely obtain in the post-merger market, accounting for the impact of that entry itself on prices; and (c) the cost per unit the entrant would likely incur, which may depend upon the scale at which the entrant would operate.“
     - 2023 DOJ/FTC Merger Guidelines § 3.2 (entire entry):
       - “Entry induced by lost competition must be so likely that no substantial lessening of competition is threatened by the merger. Firms make entry decisions based on the market conditions they expect once they participate in the market. If the new entry is sufficient to counteract the merger’s effect on competition, the Agencies analyze why the merger would induce entry that was not planned in pre-merger competitive conditions.
       - “The Agencies also assess whether the merger may increase entry barriers. For example, the merging firms may have a greater ability to discourage or block new entry when combined than they would have as separate firms. Mergers may enable or incentivize unilateral or coordinated exclusionary strategies that make entry more difficult. Entry can be particularly challenging when a firm must enter at multiple levels of the market at sufficient scale to compete effectively.”

Entry/Expansion/Repositioning

- The Merger Guidelines
  3. Sufficient
     - 2010 DOJ/FTC Horizontal Guidelines § 9:
       - Even where timely and likely, entry must be sufficient to deter or counteract the competitive effects of concern
         - “For example, in a differentiated product industry, entry may be insufficient because the products offered by entrants are not close enough substitutes to the products offered by the merged firm to render a price increase by the merged firm unprofitable.”
         - “Entry may also be insufficient due to constraints that limit entrants’ competitive effectiveness, such as limitations on the capabilities of the firms best placed to enter or reputational barriers to rapid expansion by new entrants.”
       - Sufficient condition for sufficiency
         - “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.”
     - 2023 DOJ/FTC Merger Guidelines § 3.2 (entire entry):
       - “Even where timely and likely, the prospect of entry may not effectively prevent a merger from threatening a substantial lessening of competition. Entry may be insufficient due to a wide variety of constraints that limit an entrant’s effectiveness as a competitor. Entry must at least replicate the scale, strength, and durability of one of the merging parties to be considered sufficient. The Agencies typically do not credit entry that depends on lessening competition in other markets.

         “As part of their analysis, the Agencies will consider the economic realities at play. For example, lack of successful entry in the past will likely suggest that entry may be slow or difficult. Recent examples of entry, whether successful or unsuccessful, provide the starting point for identifying the elements of practical entry barriers and the features of the industry that facilitate or interfere with entry. The Agencies will also consider whether the parties’ entry arguments are consistent with the rationale for the merger or imply that the merger itself would be unprofitable.”

Entry/Expansion/Repositioning

- Likelihood of a successful defense
  - Almost impossible to make out in an agency investigation
    - The agency starts by insisting that the potential entrants be identified by name
    - The staff then calls the identified firms and asks: “Would you enter this market if prices increased by 5% to 10%?”
    - The company almost always answers “no”
      - Can be a kneejerk reaction—Firm has not considered entry and does not know what it would do
      - Can be a “go away staff” reaction—Firm may appreciate that if it answer “yes” the staff will begin a much more detailed investigation to determine whether the firm is in fact likely to enter. This will not be pleasant for the firm.
      - Can be an informed “no”: If the firm has not already entered or is not actively considering entry, the likelihood is that a relatively small increase in margin will not cause it to enter, especially since its entry is likely to increase postmerger competition and decrease postmerger margins below the SSNIP
        - *Note*: As a general rule of business behavior, firms do not enter existing markets just for margin. They almost always require some nonprice competitive advantage against incumbent firms to cause them to entry. The problem is that entry can too easily precipitate a price war and destroy the pre-entry margin that made entry attractive in the first instance.
  - Barriers to entry: Some examples

Capital requirements	Patents/other IP	Skilled employees
Development time	Reputation	Skilled sales reps
Regulatory barriers	Skilled management	

Entry/Expansion/Repositioning

- Burden of proof/likelihood of a successful defense
  - When has the defense been successful?
    - When there has been a significant history of entry and the market has continued to operate competitively even with variations in concentration levels
    - When the market is operating premerger close to competitively and a significant firm is already planning on entering
      - NB: Technically, this should not work as a defense. If the new entrant was already planning on entering absent the challenged merger, then on a going-forward basis the new entrant would be a committed entrant and should already be considered a market participant in the competitive analysis and not a new entrant. Only when the merger precipitates the entry should the entry defense be applied.
      - But if the market was operating premerger close to competitively, then the presence of an additional firm in the postmerger market may be enough to negate any anticompetitive effect of the merger. So there is a defense; it is just not an entry defense.
      - The key here is the market must be close to operating competitively premerger. But in highly concentrated markets this may not make sense
      - Suppose that there are two incumbent firms, which are merging, and a third firm in the process of entering with the prospect of gaining significant market share. The merging parties are likely to argue that, in light of the pending entry, the transaction is a 2-to-2 merger and therefore should not be challenged[1]
      - But if the third firm had already entered some time ago and actually gained significant share, then the transaction would be a 3-to-2 merger, which would likely be challenged. Why then should the pending entry of a new firm serve as a defense to a 2-to-1 merger?

[1] FTC v. Staples, Inc., No. CV 15-2115 (EGS), 2016 WL 2899222, at 22 (D.D.C. May 17, 2016) (making entry defense, which the court considered but rejected for lack of sufficient evidence that Amazon Business would restore lost competition).

Powerful Buyers Defenses

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 8.
NB: THE POWERFUL BUYERS DEFENSE WAS NOT INCLUDED IN THE 2023 MERGER GUIDELINES.

Power buyers defense[1]

- The idea
  - The upward pricing pressure that otherwise would be created by a merger in negated by the ability of buyers to “force” the combined company to charge premerger prices in the postmerger period
- 2023 Merger Guidelines
  - The 2023 Guidelines have dropped the power buyers defense that appeared in the prior guidelines
  - This omission of the power buyers defense appears part of the Biden agencies’ retreat from economic defenses grounded in buyer leverage and competition dynamics
    - It remains to see how the Trump administration treats the defense
  - Regardless, the defense has not been successful in a litigation on the merits

[1] *See* U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines § 8 (rev. 2010).

Power buyers defense

- *Key question #1*: What is the mechanism by which this "forcing" takes place?
  - The agencies will not assume that a buyers can ensure that its suppliers will act competitively postmerger simply because the buyer is large and sophisticated
  - There are three (and perhaps only three) situations when a buyer may be able to protect itself from an anticompetitive merger:
    1. *Share shifting*: Where the purchases of the product by the buyer from the merged firm are sufficiently large that a shift of some or all of these purchases to alternative suppliers would make the price increase to that buyer unprofitable
       - This requires that sufficient alternative suppliers be available to the power buyer
       - The buyer does not have to shift all of its purchases from the merged firm. It only needs to be able to shift enough to make the price increase unprofitable to the merged firm.
    2. *Inducing entry*: Where the purchases of the product by the buyer are sufficiently large that the buyer could sponsor the entry of a minimum efficient scale firm to supply the buyer
    3. *Vertical integration*: A special case of sponsored entry where the buyer itself vertically integrates into production of the input
  - Even when there is an arguable mechanism for a given buyer, the defense is likely to fail for lack of sufficient evidence if—
    1. the putative power buyer does not support the defense, *or*
    2. there is evidence of historical episodes where the putative power buyer (or a similarly situated firm) has not been able to prevent a merged firm from raising prices to it

Power buyers defense

- *Key question #2*: Are all the purchasers in the market able to protect themselves
  - Even if some buyers could protect themselves from a price increase in the wake of an otherwise anticompetitive merger, other buyers may not be able to do so and the merger will be anticompetitive with respect to these other (targeted) buyers

Power buyers defense

- *Key question #3*: Is the only anticompetitive effect threatened by the merger an anticompetitive price increase or output reduction?
  - Power buyer defenses work best, if they work at all, against postmerger price increases or output reductions
  - Other types of anticompetitive effects, especially a reduction in the rate of innovation or product improvement, are much more difficult to negate
    - The buyer may not perceive a reduction postmerger
    - Even if the buyer does perceive a reduction postmerger, it may not be able to trace the reduction to an anticompetitive effect from the merger (as opposed to other causes)
    - *Example*: While it is easy (in principle) to direct a seller to maintain premerger prices and other terms postmerger, it is much more difficult to direct the merged firm "to continue to innovate at premerger rates"

Power buyers defense

- Other observations
  - The parties bear the burden of production of evidence of a mechanism that would be sufficient to negate the upward pricing pressure that the merger otherwise would have
    - Under *Baker-Hughes*, the ultimate burden of persuasion should be on the plaintiffs in Step 3[1]
  - The standard bargaining models used by the agencies predict that buyers, no matter how large or sophisticated they are, will not be able to negate the entirety of a postmerger price increase if the merger increases the combined firm's market power (Nash bargaining models)

[1] *See* FTC v. Sanford Heath, 926 F.3d 959, 965 (8th Cir. 2019).

Efficiencies Defenses

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 10 and 2023 DOJ/FTC MERGER GUIDELINES § 3.3

Efficiencies

- Basic idea
  - “Efficiencies” are loosely defined to be public benefits that result from the deal
  - Contrast this with synergies, which are benefits to the merging parties resulting for the deal
    - Although sometimes the terms are used interchangeably
    - In this case, “cognizable efficiencies” is the term used to denote public benefits

Efficiencies

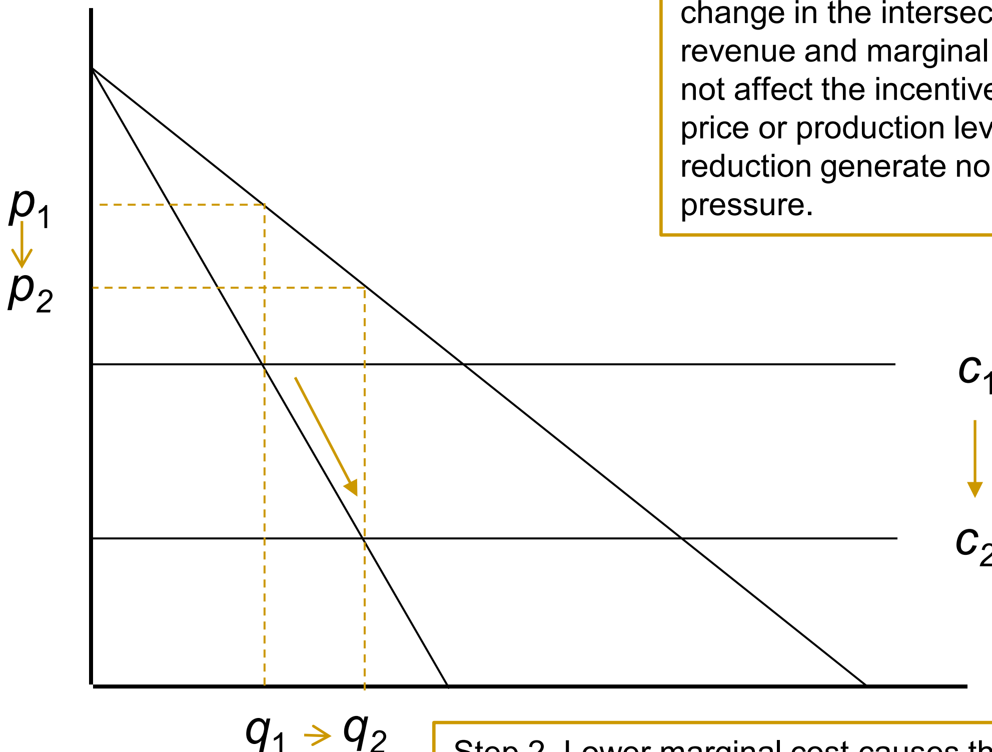
- Types of efficiencies
  - Cost efficiencies
    - Types of cost efficiencies
      - Reductions in fixed costs
        - *Fixed costs* are costs that do not change with the level of production—that is, they are expenses that have to be paid by a company, independent of any business activity
        - Some fixed costs may be incurred only once, such as the building cost for a new facility
        - Other fixed costs may be recurring, such as the compensation for the CEO, the annual maintenance costs for the headquarters building, the annual interest on the company's debt, insurance costs, and property taxes
        - Fixed cost efficiencies usually result from the elimination of duplicative costs: the combined company does not need two CEOs , two headquarters buildings, or two back office accounting systems
      - Reductions in variable costs/marginal costs for a given level of production
        - *Variable costs* are costs that depend on the level of output
        - Economies of scale or scope (one factory or one sales force may be able to handle the production and sales of both companies)
        - The combination of complementary technical assets and skills (the combined company may be able to produce products with lower costs or better products faster).
  - Non-cost efficiencies
    - Increases in production
    - Improvements in product or service quality
    - Increase in the rate of R&D

Efficiencies and downward pricing pressure

- A reduction in marginal cost will cause even a profit-maximizing monopolist to lower price

BUT NOTE: Reductions in fixed costs do *not* change in the intersection of the marginal revenue and marginal cost curves and hence do not affect the incentives of the firm to change its price or production level. Therefore, fixed cost reduction generate no downward pricing pressure.

Step 3. Increased output requires a reduction in the price to clear the market



Step 1. Firm obtains a lower marginal cost due to a production efficiency

Step 2. Lower marginal cost causes the intersection with marginal revenue curve to move to the right, thus increasing output

Efficiencies and downward pricing pressure

- Caution
  - The prior diagram assumes that the residual demand and marginal revenue curves of the firm remain the same before and after the efficiency
  - BUT a prima facie anticompetitive merger is anticompetitive precisely because it makes the firm’s residual demand curve more inelastic, which in turn makes the marginal revenue curve fall faster and creates the upward pricing pressure
  - It is an empirical question whether the downward pricing pressure resulting from an efficiency is sufficient to offset the upward pricing pressure resulting from the reduction in competition
    - This is reflected in the requirements of an efficiency defense in the Merger Guidelines

Efficiencies under the Merger Guidelines

- Recognized under the 2010 Guidelines

> [A] primary benefit of mergers to the economy is their potential to generate significant efficiencies and thus 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, merger-generated efficiencies may enhance competition by permitting two ineffective competitors to form a more effective competitor, e.g., by combining complementary assets. In a unilateral effects context, incremental cost reductions may reduce or reverse any increases in the merged firm's incentive to elevate price. Efficiencies also may lead to new or improved products, even if they do not immediately and directly affect price. In a coordinated effects context, incremental 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. Even when efficiencies generated through a merger enhance a firm's ability to compete, however, a merger may have other effects that may lessen competition and make the merger anticompetitive.[1]

- Examples of how efficiencies can offset the anticompetitive effects a merger would otherwise have:
  - Offset the unilateral anticompetitive effect by sufficiently reducing marginal costs
  - Create a new or better product that consumers prefer
  - Create a more effective competitor by combining complementary assets (e.g., IP rights)
  - Diminish incentives for coordinated interaction by creating a firm with the cost structure to engage in disruptive conduct

[1] 2010 DOJ/FTC Horizontal Merger Guidelines § 10.

Efficiencies under the Merger Guidelines

- Skepticism under the 2023 Guidelines
  - Consistent with its return to 1960s case law, the 2023 Guidelines preserve the position that there is no efficiencies defenses. The efficiencies section of the Guidelines open with the following sentence:

    > The Supreme Court has held that "possible economies [from a merger] cannot be used as a defense to illegality."[1]

  - That said, the 2023 Guidelines recognized in a footnote that some courts have held that efficiencies that negate the merger's likely anticompetitive effect can be used to rebut the prima facie case
    - This makes sense. The Supreme Court (although perhaps not the Biden administration) saw efficiencies as an *affirmative defense*, that is, a justification for a merger that would be anticompetitive with the efficiencies in place.
      - No one today argues this as a legal defense (although they argue it as counselling prosecution discretion not to sue).
    - The modern cases examining efficiencies see it as a *negative defense*, that is, a defense that negates the merger's likely anticompetitive effects.
    - The distinction is obvious, but I have been to see it made in case opinions

[1] 2023 DOJ/FTC Merger Guidelines § 3.3 (quoting United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 371 (1963), and citing United States v. Procter & Gamble Co., 356 U.S. 677 (1958) ("("Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition.")).

Efficiencies

- Examples of how efficiencies can offset the anticompetitive effects a merger would otherwise have:
  - Offset the unilateral anticompetitive effect by sufficiently reducing marginal costs
  - Create a new or better product that consumers prefer
  - Create a more effective competitor by combining complementary assets (e.g., IP rights)
  - Diminish incentives for coordinated interaction by creating a firm with the cost structure to engage in disruptive conduct

[1] 2010 DOJ/FTC Horizontal Merger Guidelines § 10.

Efficiencies

- Efficiencies as a merger defense under the Merger Guidelines[1]
  - Four requirements
    1. Merger specificity
    2. Verifiability
    3. Sufficiency
    4. Not anticompetitive

[1] Notwithstanding its reservation that efficiencies may not constitute a defense at all, the Biden agencies wisely continue to include the four requirements for evaluating efficiencies that prior guidelines had contained.

Merger specificity

1. Are the alleged efficiencies merger specific?
   - 2010 DOJ/FTC Horizontal Merger Guidelines § 10:

     “The Agencies credit only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies.[13] Only alternatives that are practical in the business situation faced by the merging firms are considered in making this determination. The Agencies do not insist upon a less restrictive alternative that is merely theoretical.

     ____

     “[13] The Agencies will not deem efficiencies to be merger-specific if they could be attained by practical alternatives that mitigate competitive concerns, such as divestiture or licensing. If a merger affects not whether but only when an efficiency would be achieved, only the timing advantage is a merger-specific efficiency.”
   - 2023 DOJ/FTC Merger Guidelines § 3.3 (entire entry):
     - “The merger will produce substantial competitive benefits that could not be achieved without the merger under review.70 Alternative ways of achieving the claimed benefits are considered in making this determination. Alternative arrangements could include organic growth of one of the merging firms, contracts between them, mergers with others, or a partial merger involving only those assets that give rise to the procompetitive efficiencies.” [footnote omitted]

Merger specificity

1. Are the alleged efficiencies *merger specific*?
   - The “would”/”could” debate
     - *Could* the efficiencies be achieved in the absence of the transaction? Or is the right question “*Would* they be achieved in the absence of the transaction”?
     - Although the Merger Guidelines ask the second question, in practice the agencies (and to an extent the courts) ask only the first question
       - WDC: Even apart from the language of the Guidelines, this is analytically a mistake. The antitrust laws are concerned with competition as it occurs in the marketplace. If a firm “could” theoretically achieve the efficiency in question absent the merger but has indicated no interest or intent to do so, but the efficiency would occur if the merger takes place, why regard this efficiency as not cognizable? If the efficiencies were large enough to offset the gross anticompetitive effect, then rejecting the defense under the “could” standard only deprives consumers of the benefits of efficiencies that they would otherwise receive if the defense was permitted and the merger was allowed to take place.
       - *Example*: Firm 1 I may be able to develop a better formula for baby food if it makes a large investment, but it would rather use the funds for another investment. Firm 2 has a better formula that could easily be transfer to Firm 1. The transfer would be consider a cognizable efficiency under the “would” standard but not under the agencies’ “could” standard.

Verifiability

2. Are the alleged efficiencies *verifiable*?
   - 2010 DOJ/FTC Horizontal Merger Guidelines § 10:
     - "[I]t is incumbent upon the merging firms to substantiate efficiency claims so that the Agencies can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific."
   - 2023 DOJ/FTC Merger Guidelines § 3.3 (entire entry):
     - "These benefits are verifiable, and have been verified, using reliable methodology and evidence not dependent on the subjective predictions of the merging parties or their agents. Procompetitive efficiencies are often speculative and difficult to verify and quantify, and efficiencies projected by the merging firms often are not realized. If reliable methodology for verifying efficiencies does not exist or is otherwise not presented by the merging parties, the Agencies are unable to credit those efficiencies."

Verifiability

2. Are the alleged efficiencies *verifiable (cont.)*?
   - Agency questions
     - Have the efficiencies been rigorously demonstrated by the parties?
     - Can they be objectively ascertained by a third party?
       - The agencies usually regard this "third party" as an accountant or an economist, who typically lack experience and expertise in the industry in question
         - The agencies' use of "experts" who lack knowledge or judgment about the business operations in question can often lead them to reject of a legitimate efficiency simply because the agency's expert does not understand it
       - Courts are trending toward requiring rigorous third-party confirmation of efficiencies as well
       - Going forward, if the merging parties have a serious efficiencies argument, they should consider retaining an industry expert to present an efficiencies to the investigating agency or court
         - Someone with significant experience and expertise in the industry is likely to be more persuasive than an industrial organization economist or a management consultant

Timeliness/sufficiency

3. Are the alleged efficiencies *timely and sufficient*?
   - 2010 DOJ/FTC Horizontal Merger Guidelines § 10:
     - "[I]t is incumbent upon the merging firms to substantiate efficiency claims so that the Agencies can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific."
   - 2023 DOJ/FTC Merger Guidelines § 3.3 (entire entry):
     - "*Prevents a Reduction in Competition*. To the extent efficiencies merely benefit the merging firms, they are not cognizable. The merging parties must demonstrate through credible evidence that, within a short period of time, the benefits will prevent the risk of a substantial lessening of competition in the relevant market."
   - Observations
     - Will the claimed efficiency occur in time and with sufficient magnitude to offset the anticompetitive effects of the merger that would be likely to occur in the absence of the efficiencies?
     - NB: Inherent in sufficiency is the requirement that to be cognizable the efficiencies *must be passed to consumers* and not retained by the merged firm[1]

[1] *See, e.g.*, FTC v. Univ. Health, Inc., 938 F.2d 1206, 1223 (11th Cir. 1991); New York v. Deutsche Telekom AG, 439 F. Supp.3d 179, 208-10 (S.D.N.Y. 2020); United States v. Aetna Inc., 240 F. Supp. 3d 1, 9 (D.D.C. 2017); United States v. H & R Block, Inc., 833 F. Supp. 2d 36, 87 (D.D.C. 2011); FTC v. Swedish Match, 131 F. Supp. 2d 151, 172 (D.D.C. 2000); FTC v. Cardinal Health, Inc., 12 F. Supp. 2d 34, 62 (D.D.C. 1998); United States v. Long Island Jewish Med. Ctr., 983 F. Supp. 121, 149 (E.D.N.Y. 1997).

Do not arise from an anticompetitive effect

4. Do the efficiencies arise from an anticompetitive effect of the transaction?
   - 2010 DOJ/FTC Horizontal Merger Guidelines § 10:
     - "Cognizable efficiencies are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service."
   - 2023 DOJ/FTC Merger Guidelines § 3.3 (entire entry):
     - "*Not Anticompetitive.* Any benefits claimed by the merging parties are cognizable only if they do not result from the anticompetitive worsening of terms for the merged firm's trading partners.[71]

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       [71] The Agencies will not credit efficiencies if they reflect or require a decrease in competition in a separate market. For example, if input costs are expected to decrease, the cost savings will not be treated as an efficiency if they reflect an increase in monopsony power."
   - Observations
     - The idea here is that cost savings from a reduction in output or service are not cognizable efficiencies
       - This is uncontroversial
     - Footnote 71 in the 2023 Guidelines, however, is controversial
       - It suggests that a cost reduction in the input market, even if it did not reduce output and was passed on to customers, does not qualify as an efficiency.
     - Rarely analyzed by courts

Efficiencies in court

- Judicial skepticism
  - The Supreme Court has cast doubt on an efficiencies defense in three cases
    1. In *Brown Shoe*, the Supreme Court, though acknowledging that mergers may sometimes produce benefits that flow to consumers, stated:

> "Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization."[1]

    2. In *Philadelphia National Bank*, the Court observed:

> [A] merger the effect of which "may be substantially to lessen competition" is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial.... Congress determined to preserve our traditionally competitive economy. It therefore proscribed anticompetitive mergers, the benign and the malignant alike, fully aware, we must assume, that some price might have to be paid.[2]

[1] Brown Shoe Co. v. United States, 370 U.S. 294, 344 (1962).
[2] United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 371 (1963).

Efficiencies in court

- Judicial skepticism (con't)
  - The Supreme Court has cast doubt on an efficiencies defense in three cases
    3. In *Procter & Gamble*, the Supreme Court enjoined a merger without any consideration of evidence that the combined company could purchase advertising at a lower rate:

> "Possible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition."[1]

  - Significantly, in these older cases an accepted goal of antitrust law was the protection of small business
  - In light of these Supreme Court statements, lower courts have expressed skepticism that an efficiencies defense exists[2]

[1] FTC v. Procter & Gamble Co., 386 U.S. 568, 580 (1967) (citing Brown Shoe Co. v. United States, 370 U.S. 294, 344 (1962).
[2] *See* United States v. Anthem, Inc., 855 F.3d 345, 353-54 (D.C. Cir. 2017) (expressing doubts about an efficiency defense in light of *Procter & Gamble*, which has never been overruled); FTC v. Penn State Hershey Med. Ctr., 838 F.3d 327, 348-49 (3d Cir. 2016).

Efficiencies in court

- Modern practice
  - Notwithstanding the Supreme Court precedent, modern lower courts recognize that efficiencies resulting from the merger may be considered in rebutting the government's prima facie case
  - *Advocate Health Care*:

> Although the defense has never been sanctioned by the Supreme Court, the Horizontal Merger Guidelines and some lower courts recognize that defendants in a horizontal merger case may rebut the government's *prima facie* case by presenting evidence of efficiencies offsetting the anticompetitive effects.[1]

[1] FTC v. Advocate Health Care, No. 15 C 11473, 2017 WL 1022015, at *12 (N.D. Ill. Mar. 16, 2017) (entering preliminary injunction on remand).

Efficiencies in court

- Modern practice
  - *Penn State Hershey Medical Center*:

> Remaining cognizant that the "language of the Clayton Act must be the linchpin of any efficiencies defense," and that the Clayton Act speaks in terms of "competition," we must emphasize that "a successful efficiencies defense requires proof that a merger is not, despite the existence of a prima facie case, anticompetitive."[1]

> The efficiencies defense, on the other hand, is a means to show that any anticompetitive effects of the merger will be offset by efficiencies that will ultimately benefit consumers.[2]

[1] FTC v. Penn State Hershey Med. Ctr., 838 F.3d 327, 349 (3d Cir. 2016).
[2] *Id*.

Efficiencies in court

- Modern practice
  1. Interpretation
     - The most sensible way to read the modern approach is that efficiencies can be used as a *negative* defense to disprove the anticompetitive effect element of the prima facie case

       > It is clear that whether an acquisition would yield significant efficiencies in the relevant market is an important consideration in predicting whether the acquisition would substantially lessen competition.[1]

     - But they cannot be used to as an *affirmative* defense to permit a merger that has the requisite anticompetitive effect in the relevant market

       > Of course, once it is determined that a merger would substantially lessen competition, expected economies, however great, will not insulate the merger from a section 7 challenge.[2]

     - This distinction essentially reflects a consumer welfare standard over a total welfare standard

[1] *See, e.g.*, FTC v. Univ. Health, Inc., 938 F.2d 1206, 1222 (11th Cir. 1991).
[2] *See, e.g.*, Univ. Health, 938 F.3d at 1222 n. 29.

Efficiencies in court

- Modern practice
  2. Difficulty in application
     - Plaintiffs establish their prima facie case through the *PNB* presumption and additional supporting evidence of unilateral and/or coordinated effects, which collectively gives a qualitative result that the merger is presumptively likely to substantially lessen competition and harm consumers
     - But how is the qualitative result to be negated by a showing of efficiencies, even if the efficiencies are in some way quantified?
     - Practical solution
       - Defendants must find customer-witnesses that would be harmed if the transaction was in fact anticompetitive who will testify that they believe that the balance of the merger's harmful and beneficial effects will be procompetitive (i.e., beneficial to customers), or, more precisely, not anticompetitive
       - Since the defendants must at least make a prima facie case that the efficiencies will offset any of the merger's anticompetitive tendencies, the defendants' failure to adduce such evidence is likely to result in a rejection of their efficiencies defense

Efficiencies in court

- Modern practice
  3. "Pass on"
     - In any event, claimed efficiencies can offset an anticompetitive effect on consumers only to the extent that the efficiencies are "passed on" by the merged company to the consumers that otherwise would be competitively harmed.
     - *Anthem* court:

> [T]the claimed medical cost savings only improve consumer welfare to the extent that they are actually passed through to consumers, rather than simply bolstering Anthem's profit margin. After all, the merger potentially harms consumers by creating upward pricing pressure due to the loss of a competitor, and so only efficiencies that create an equivalent downward pricing pressure can be viewed as "sufficient to reverse the merger's potential to harm consumers . . . , e.g., by preventing price increases."[1]

- In *Anthem*, the court appears to have rejected the idea that an aggregate dollar savings greater than the aggregate dollar value of an anticompetitive price increase would make out an efficiencies defense
  - That is, it is not sufficient that the gross consumer surplus from efficiencies outweigh the gross wealth transfer resulting from an anticompetitive price increase
- Rather, the court appeared to require that the downward pressure on prices from efficiencies at least offset the upward pressure on prices from the anticompetitive effect, so that there would be no net price increase to customers

[1] United States v. Anthem, Inc., 855 F.3d 345, 362 (D.C. Cir. 2017) (internal citations omitted); *see* FTC v. Penn State Hershey Med. Ctr., 838 F.3d 327, 348 (3d Cir. 2016) ("In order to be cognizable, the efficiencies must, first, offset the anticompetitive concerns in highly concentrated markets.").

Efficiencies in court

- Modern practice
  4. Rent shifting
     - *Query*: Is a lowering of input prices due to greater bargaining power gained by the merger a cognizable efficiency when—
       - the lower prices do not reflect any production efficiency
       - even if the cost savings in procurement is passed on to the downstream customers?
     - *Anthem* court:

> The district court also expressed doubt as to whether the type of efficiencies claimed by Anthem, which merely redistribute wealth from providers to Anthem and its customers rather than creating new value, are even cognizable under Section 7.[1]

       - The court of appeals also expressed skepticism, but found it was unnecessary to answer the question given the facts in the case
       - Other courts have not opined on this

[1] United States v. Anthem, Inc., 855 F.3d 345, 352 (D.C. Cir. 2017) (internal citations omitted).

Efficiencies

- Efficiencies in court (con't)
  - Judicial practice
    - Courts essentially have adopted the requirements of the Merger Guidelines[1]
      - "Projections of efficiencies may be viewed with skepticism, particularly if they are generated outside of the usual business planning process."[2]
      - "The difficulty in substantiating efficiency claims in a verifiable way is one reason why courts generally have found inadequate proof of efficiencies to sustain a rebuttal of the government's case."[3]
    - No court has yet held that the merging parties have successfully defended a merger through a showing of efficiencies

[1] *See, e.g.*, FTC v. Penn State Hershey Med. Ctr., 838 F.3d 327 (3d Cir. 2016) (reversing question of whether an efficiencies defense exists, but assuming it does applying the Merger Guidelines standard and finding that claimed efficiencies cannot offset the merger's likely anticompetitive effects).
[2] FTC v. ProMedica Health Sys., Inc., No. 3:11 CV 47, 2011 WL 1219281, at *40 (N.D. Ohio Mar. 29, 2011) .
[3] United States v. H & R Block, Inc., 833 F. Supp. 2d 36, 91 (D.D.C. 2011) .

Failing Firm Defense

REVIEW 2010 DOJ/FTC HORIZONTAL MERGER GUIDELINES § 11 and 2023 DOJ/FTC MERGER GUIDELINES § 3.1

Failing firm defense

- Theory
  - A "failing firm" is a firm that will exit the market *with its assets* in the absence of an acquisition
  - The original idea behind a failing firm defense is that it is better to permit an "anticompetitive" acquisition than to allow the failing firms assets—and therefore productive capacity—to exit the market
    - While this may sound like an affirmative defense, it is actually a negative defense.
    - If the firm's productive capacity would exit the market in the acquisition, then it has no competitive significance going forward and its acquisition by a competitor cannot reduce competition
    - The key here is whether the firm's productive assets would in fact exit the market in the absence of the challenged acquisition—if, in the "but for" world, the failing firm's assets would be acquired by another firm in a transaction that would make consumers better off than with the challenged acquisition, then the challenged acquisition is anticompetitive

Failing firm defense

- Requirements: The allegedly failing firm—
  1. would be unable to meet its financial obligations in the near future,
  2. would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act, *and*
  3. has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger[1]
     - NB: The alternative buyer need not match the purchase price of the original buyer—as long as the alternative buyer is willing to pay a price above liquidation value the alternative buyer qualifies[2]

[1] 2010 DOJ/FTC Horizontal Merger Guidelines § 11; *accord* 2023 DOJ/FTC Merger Guidelines.
[2] *Id*. at § 11 n. 6 (stating that a reasonable alternative offer is "[a]ny offer to purchase the assets of the failing firm for a price above the liquidation value of those assets"); *see* United States v. Energy Sols., Inc., 265 F. Supp. 3d 415, 446 (D. Del. 2017) (quoting Horizonal Merger Guidelines).

Failing firm defense

- Observations
  - The failing firm defense works in principle for a failing division or subsidiary
  - The failing firm defense has had essentially no success since the Supreme Court recognized it in 1930 by the Supreme Court in *International Shoe*[1]
    - Even if the firm is failing in the sense that it cannot meet its financial obligations, there defense is likely to fail before the agencies and the courts because either—
      - The firm can be reorganized in bankruptcy and continue to operate without its assets existing the market, OR
      - The firm has failed to conduct the requisite search to the satisfaction of the agencies or the court for an alternative, less anticompetitive buyer
  - The defense is rarely raised in modern antitrust cases[2]

[1] International Shoe Co. v. FTC, 280 U.S. 291, 302 (1930); *see* Citizen Publ'g Co. v. United States, 394 U.S. 131, 138 (1969).
[2] For recent cases in which the defense was raised, always unsuccessfully, see, for example, United States v. JetBlue Airways Corp., 712 F. Supp. 3d 109, 160 (D. Mass. 2024); United States v. Energy Sols., Inc., 265 F. Supp. 3d 415, 444-46 (D. Del. 2017); FTC v. ProMedica Health Sys., Inc., No. 3:11 CV 47, 2011 WL 1219281, at *42-*43 (N.D. Ohio Mar. 29, 2011); FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109, 153-57 (D.D.C. 2004).

Weakened Competitor Defense

Weakened competitor defense

- The idea
  - Applies when—
    1. One of the merging firms would remain in the market absent the merger, *but* financial, structural, or other constraints would cause it to compete materially less effectively in the future than its current market share or historical performance implies, *and*
    2. When properly adjusted, the firm's future competitive significance is so diminished that the acquisition would not present a reasonable probability of substantially lessening competition
  - Analytically, think of this as a variant of *General Dynamics*[1]
    - Current market shares and historical performance may overstate a firm's future competitive significance
    - The relevant question under Section 7 is the firm's likely competitive force going forward absent the merger
  - Mechanics
    - Discount the competitive significance indicated by the firm's current market share and other historical evidence to reflect its expected future competitive force
    - Reassess whether the merger, measured against that but-for competitive position, is likely substantially to lessen competition
  - A negative defense
    - Does not justify a merger that otherwise would be anticompetitive
    - Argues instead that the plaintiff's prima facie case overstates the competition the merger would actually eliminate

[1] United States v. General Dynamics Corp., 415 U.S. 486, 503-08 (1974).

Weakened competitor defense

- Contrast with the failing firm defense
  - Failing firm
    - Absent the merger, the firm would fail and its productive assets would leave the relevant market
    - The merger may therefore preserve productive assets and competitive capacity that otherwise would disappear
    - Analytical comparison: acquisition versus exit
    - Requires satisfaction of the strict failing-firm requirements[1]
  - Weakened competitor
    - Absent the merger, the firm remains in the market, but with materially diminished competitive force
    - The defense does not depend on preserving assets that otherwise would leave the market
    - Analytical comparison: acquisition versus continued but weakened competition
    - The issue is how much the firm's expected future competitive significance should be discounted in assessing the merger's likely effect
  - Bottom line
    - *Failing firm*: Will the assets remain in the market?
    - *Weakened competitor*: How much competitive force will the firm exert going forward?

[1] *See* Citizen Publ'g Co. v. United States, 394 U.S. 131, 136-39 (1969); United States v. Gen. Dynamics Corp., 415 U.S. 486, 506-08 (1974) (distinguishing the failing company doctrine from evidence bearing on the acquired firm's future competitive significance).

Weakened competitor defense

- Judicial treatment
  - Courts treat the defense skeptically
    - Financial weakness alone does not justify an otherwise anticompetitive merger
    - The defense is credited only in rare cases[1]
  - *FTC v. University Health* formulation
    - Defendants must make a substantial showing that—
      1. the acquired firm is materially weakened,
      2. the weakness cannot be resolved by competitive means, *and*
      3. the weakness would reduce the firm's future competitive significance enough to undermine the plaintiff's prima facie case[2]
    - "Cannot be resolved by competitive means"
      - Means more than poor financial performance
      - The firm must face constraints that materially impair its ability to obtain the resources necessary to compete going forward[3]
  - *Baker Hughes* sliding scale
    - The stronger the plaintiff's prima facie case, the more substantial the defendants' evidence of weakened future competitive significance must be to rebut it[4]

[1] Kaiser Aluminum & Chem. Corp. v. FTC, 652 F.2d 1324, 1339-40 (7th Cir. 1981) (financial weakness is "probably the weakest ground of all for justifying a merger"); FTC v. Univ. Health, Inc., 938 F.2d 1206, 1221 (11th Cir. 1991).
[2] FTC v. Univ. Health, Inc., 938 F.2d 1206, 1221 (11th Cir. 1991).
[3] United States v. JetBlue Airways Corp., 712 F. Supp. 3d 109, 162-63 (D. Mass. 2024).
[4] United States v. Baker Hughes Inc., 908 F.2d 981, 991 (D.C. Cir. 1990); *see* United States v. Aetna Inc., 240 F. Supp. 3d 1, 93-94 (D.D.C. 2017).

Weakened competitor defense

- Application in *Sanford Health*
  - Merging parties' argument
    - MDC had only "dim long-term prospects"
    - Its future competitive significance would therefore be materially less than its current market shares and historical performance suggested
    - Properly discounting MDC's future competitive force, the acquisition would not substantially lessen competition
  - District court findings
    - MDC was financially healthy
    - Revenues had increased during the three years preceding the FTC action
    - Physician compensation was approximately 32% above the national average
    - 2015 MDC shareholder minutes indicated that the motivation to sell was the attractive price offered by Sanford, not concern about MDC's long-term financial viability
  - Eighth Circuit
    - No clear error in the district court's finding that MDC was not a weakened competitor
    - Accordingly, there was no basis to discount MDC's future competitive significance