

May 24, 2010

Revised Horizontal Merger Guidelines Issued By FTC, DOJ

The U.S. Federal Trade Commission and the Antitrust Division of the Department of Justice have issued proposed revisions to their existing Horizontal Merger Guidelines,¹ the first such change since 1997. The Revised Guidelines will replace those adopted in 1992. These guidelines describe the principal analytical techniques and the main types of evidence upon which the agencies typically rely in determining whether a horizontal merger will substantially lessen competition.

The Revised Guidelines are designed to reflect actual practice at the agencies. As such, they are a welcome revision. While the Revised Guidelines are quite similar to the old guidelines, and have been described as "evolutionary" and not "revolutionary" by the agencies, they do contain certain changes that may in fact represent a significant departure from past practice.

- Deals between close competitors in unconcentrated markets stand a higher probability of being investigated and challenged. Low market shares aren't necessarily dispositive any longer. (Although they, and a properly defined market, will affect the ability of the agencies to win in court.)
- Companies should expect to be asked for win/loss and profit margin data as part of an upfront request for documents and information. If that data shows significant diversion between the parties, or high gross margins, the parties should expect heightened scrutiny. Acquisitive companies should consider analyzing their win/loss databases now. As reliance on these databases grows at the agencies, slipshod data can prolong or even derail transactions. Acquisitive companies in high margin industries should also consider a review of their costs and be prepared to address high margins.
- Companies should generally expect more investigations in the near term, particularly in high margin industries, as the agencies look for an ideal case to test and to establish the new guidelines. Companies in these areas should build in longer drop dead dates, consider upfront margin and diversion analyses (engaging economists early), and generally be prepared for longer, more thorough and thoughtful investigations. And, as always, companies should beware injudicious puffery.

¹ Horizontal Merger Guidelines For Public Comment: Released on April 20, 2010, Section 4. (hereinafter "Revised Guidelines"). The relevant statutory provisions include Section 7 of the Clayton Act, 15 U.S.C. § 18, Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§ 1, 2 and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. Most particularly, Section 7 of the Clayton Act prohibits mergers if "in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be to substantially lessen competition, or to tend to create a monopoly."

1. Reduced emphasis on "market" definition

One of the most noticeable changes in the Revised Guidelines is that market definition no longer plays a central role in merger analysis. It may become "useful"² insofar as it shows a merger's likely effects on competition. Companies with large "market shares" will therefore not face the same up-hill battles they once did with the staff. Companies with relatively small market shares may face increased scrutiny if they are very close substitutes for each other.

The Revised Guidelines are not law, however. They merely reflect the agencies' current thinking on how a merger may substantially lessen competition. Ultimately, the agencies must still go to court to enjoin transactions. Courts are not obliged to follow the revised guidelines; they are obliged to follow precedent.³ While some courts have adopted the language of the old guidelines, others have not. Product and geographic market definition will continue to play a critical role in evaluating a deal's chance of success in court, and so ultimately will play a role in how the agencies evaluate whether a particular transaction is worth litigating.

2. New emphasis on gross margins and diversion ratios

The most significant departure from earlier guidelines is the reliance on high gross margins and diversion ratios. The agencies appear to assume that high gross margins in an industry means that a firm is coordinating with its rivals or that the customers are price insensitive. A diversion ratio is a measure of how close the products of two rivals are. The higher the ratio, the more likely the products are close substitutes. If margins and the diversion ratio are high, the agencies will tend to conclude that the transaction will result in an upward price pressure and will likely harm competition. The agencies may come to this conclusion notwithstanding the parties' low "market share."

The Revised Guidelines ask whether the merged parties can impose a 5 to 10 percent price increase on "targeted customers."⁴ A market may be "as narrow as individual customers," and a "significant fraction need not approach a majority."⁵ Sec. 6.1. Generally, almost any horizontal merger lessens competition somewhere, but Section 7 of the Clayton Act prohibits only those mergers that substantially lessen competition. While courts have not addressed how many customers must potentially be harmed in order to constitute a substantial lessening of competition, the number almost always has been more than one. (Query whether the agencies will adopt this definition for purposes of assessing whether two companies are capable of conspiring under Section 1 of the Sherman Act.)

The most severe repercussions of the new emphasis on diversion ratios and high gross margins will be high tech and pharmaceuticals. Marginal cost in these industries approaches zero, so margins necessarily will be high. Fixed costs, however, are astronomical. Frequently, products in these industries are protected by copyright or patent, but may have many economic substitutes.

² Revised Guidelines § 4.

³ For example, a federal district court recently refused to unwind the merger of two health insurance companies on the grounds of deficient market definition and denied the plaintiff's request to revise its complaint to include the "upward pricing pressure" test, finding no precedent exists to allow the court to consider the test. *City of New York v. Group Health Inc.* No. 06-CV-13122 (S.D.N.Y. May 11, 2010).

⁴ Revised Guidelines § 4.1.4.

⁵ Revised Guidelines § 6.1.

To use margins in those situations as a proxy for the competitiveness of a market is no better than using market shares. For these products, "cost" should be based on something more akin to total cost and not just marginal cost. Failing to take fixed costs into account ultimately will impose an unjust burden on highly innovative, competitive companies.

The reality of the shift toward upward pricing pressure is that more mergers will trigger a second request, even though the courts have not been expanding Section 7 law but rather contracting it. The most significant consequence of these Revised Guidelines will be to chill those mergers where the parties cannot afford to go through elaborate second requests, let alone litigation. Moreover, the Revised Guidelines likely will have no consequential effect on the better-funded transactions where litigation, while costly, is not a meaningful impediment. Indeed, by placing so much emphasis on what is fundamentally a highly fact-intensive inquiry, the agencies may be deterring parties from cooperating during the first 30 days following a premerger filing and encouraging them to deploy aggressive and expensive action to get into substantial compliance quickly, particularly in high margin markets.

3. Updated "hypothetical monopolist" test⁶

The "hypothetical monopolist" test, the starting point for defining a market, focuses on likely price increases resulting from a merger. The agencies use the "SSNIP" test to define a market as the smallest product and geographic space within which the hypothetical monopolist "likely would impose at least a small but significant and non-transitory increase in price (SSNIP) on at least one product in the market."⁷

The agencies will continue to use this test, but as it "does not lead to a single relevant market,"⁸ it is only one of several tools used for evaluating a merger. The revised guidelines contain a detailed explanation of how the agencies implement that test in practice.

4. Updated concentration levels⁹

Concentration levels that are likely to warrant either further scrutiny, or challenge from the agencies, have been modified slightly. The traditional HHI test¹⁰ has considered an HHI of less than 1000 to be a competitive marketplace; a result of 1000-1800 to be a moderately concentrated marketplace; and a result of 1800 or greater to be a highly concentrated marketplace. As a general rule, mergers that increase the HHI by more than 100 points in concentrated markets raise antitrust concerns.

The Revised Guidelines change 1000 to 1500 and 1800 to 2500, reflecting a more realistic application of the HHI. They also emphasize that the HHI is not the only tool for identifying potentially anticompetitive mergers and note that it is not a decision tool but rather just an initial indication that a merger may merit further examination.

⁶ Revised Guidelines Section 4.1.1.

⁷ *Id.*

⁸ *Id.*

⁹ Revised Guidelines § 5.3.

¹⁰ The Herfindahl-Hirschman Index ("HHI") is used as an index of market concentration. It is calculated by squaring the market share of each firm competing in a market, and then summing the resulting numbers. The HHI number can range from close to zero to 10,000.

5. Unilateral vs. coordinated effects¹¹

The Revised Guidelines provide an expanded discussion of how the agencies evaluate unilateral competitive effects, including effects on innovation. This is a significant shift in emphasis from the previous versions of the guidelines, which focused on coordinated effects. But, it is consistent with the de-emphasis of market definition and concentration; these inquiries may not even be necessary if there is strong evidence on unilateral effects.

The Revised Guidelines address unilateral effects – the elimination of competition between two firms that results from their merger itself – with a significantly expanded discussion of factors considered in unilateral effects analysis. Again, however, the emphasis on high margins means that the merger of two firms that are not one another's closest competitor could still be viewed as anticompetitive. Existing case law does not go this far, so we can expect to see this issue litigated eventually.

The Revised Guidelines also contain an updated section on coordinated effects. They clarify that coordinated effects, like unilateral effects, include conduct not otherwise condemned by the antitrust laws.

This section notes that the agencies may use economic models, but that they "do not treat merger simulation evidence as conclusive in itself, and they place more weight on whether their merger simulations consistently predict substantial price increases than on the precise prediction of any single simulation."¹²

6. Ease of entry into market

The Revised Guidelines provide a simplified discussion of how the agencies evaluate whether entry into the relevant market is so easy that a merger is not likely to enhance market power. Significantly, the agencies give substantial weight to "actual history of entry,"¹³ placing less emphasis on the predictive value of what potential entrants might do in certain hypothetical circumstances.

7. Evidence of adverse competitive effects

The Revised Guidelines introduce a new section on "Evidence of Adverse Competitive Effects." This section discusses several categories and sources of evidence that the agencies, in their experience, have found informative in predicting the likely competitive effects of mergers, providing a degree of clarity that will be welcomed by practitioners.

¹¹ Revised Guidelines §§ 6, 7.

¹² Revised Guidelines § 6.1.

¹³ Revised Guidelines Section § 9.

Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:

New York

Carlos T. Albarracín
+1 (212) 408-1081
calbarracin@chadbourne.com

Marc A. Alpert
+1 (212) 408-5491
malpert@chadbourne.com

A. Robert Colby
+1 (212) 408-5571
rcolby@chadbourne.com

William Greason
+1 (212) 408-5527
wgreason@chadbourne.com

Morton E. Grosz
+1 (212) 408-5592
mgrosz@chadbourne.com

Charles E. Hord, III
+1 (212) 408-5353
chord@chadbourne.com

Peter K. Ingerman
+1 (212) 408-5422
pingerman@chadbourne.com

Peter R. Kolyer
+1 (212) 408-5564
pkolyer@chadbourne.com

Sey-Hyo Lee
+1 (212) 408-5122
shlee@chadbourne.com

Jonathan M.A. Melmed
+1 (212) 408-1002
jmelmed@chadbourne.com

J. Allen Miller
+1 (212) 408-5454
amiller@chadbourne.com

Marc M. Rossell
+1 (212) 408-1057
mrossell@chadbourne.com

Robert A. Schwinger
+1 (212) 408-5346
rschwinger@chadbourne.com

Edward P. Smith
+1 (212) 408-5371
esmith@chadbourne.com

Kevin C. Smith
+1 (212) 408-1092
ksmith@chadbourne.com

London
Claude S. Serfilippi
+44 (20) 7337-8030
cserfilippi@chadbourne.com

Washington

David H. Evans
+1 (202) 974-5620
devans@chadbourne.com

Sean P. McGuinness
+1 (202) 974-5680
smcguinness@chadbourne.com

Karen T. Zachary
+1 (202) 974-5785
kzachary@chadbourne.com