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How Antitrust Agencies Analyze M&A

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This Practice Note from our website provides an overview of how the US federal antitrust agencies analyze mergers, acquisitions and joint ventures. It reflects the release of the revised Horizontal Merger Guidelines, which became effective on August 19, 2010. For the continuously maintained version of this Practice Note, visit practicallaw.com.

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Section 7 of the Clayton Antitrust Act (Clayton Act) prohibits mergers, acquisitions and certain joint ventures which have the effect of substantially lessening competition in any line of commerce or activity affecting commerce in any part of the US.

Details of mergers and acquisitions that meet statutory reporting requirements must be filed, prior to closing, with both the Federal Trade Commission (FTC) and the Antitrust Division of the Department of Justice (DOJ) in accordance with the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR).

>> For a Practice Note on HSR notification requirements and processes, search Hart-Scott-Rodino Act: Overview on practicallaw.com.

After receipt of an HSR filing, either the DOJ or FTC (largely depending on their respective experience) assesses the transaction to determine whether it raises any substantive competition concerns. Where the agency identifies these concerns and they cannot be resolved by agreed settlements with the parties, the government can seek a preliminary injunction in federal district court to block completion of the transaction.

This Note outlines the substantive principles observed by both US antitrust agencies in evaluating whether a transaction is likely to substantially lessen competition. It focuses on the most common type of transaction, horizontal mergers between companies operating at the same level in a line of commerce, taking into account the recently revised Horizontal Merger Guidelines (2010 Guidelines). This Note also briefly considers the agencies' approach to non-horizontal mergers.

The antitrust agencies use their published guidelines as a general framework to evaluate transactions. However, as the 2010 Guidelines specifically note, there

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are nuances to applying these guidelines to the facts in a particular industry and there are continuing developments in antitrust law and economic theory. Therefore, antitrust counsel should always be consulted to obtain a clear understanding of how the agencies may approach a particular transaction.

Horizontal Mergers

In 1992, the FTC and the DOJ jointly issued Horizontal Merger Guidelines (1992 Guidelines) which summarized the analytical framework that the agencies used for their analysis of mergers. They revised the 1992 Guidelines slightly in 1997. On August 19, 2010 the agencies released the 2010 Guidelines, which made substantial changes to the 1992 Guidelines.

In general, the government's investigation seeks to determine whether a proposed merger will result in a substantial lessening of competition in the markets where the merging firms compete. To assess whether anti-competitive effects are likely, the 2010 Guidelines set out some of the principles and tools that the agencies use in analyzing the industry and marketplace conditions.

Compared to the 1992 Guidelines, the 2010 Guidelines de-emphasize the importance of market definition in the agencies' analysis and reject strict adherence to any specific method or process. While the agencies highlight that the merger review process will be flexible and fact specific, generally the 2010 Guidelines:

- Explain the range of analytical tools and methodologies that the agencies will use for merger analysis.
- Identify the categories of evidence that may be considered as part of the analysis.
- Increase the extent to which economic analysis will be used as part of the process for assessing potential competitive effects.

The 2010 Guidelines explain that the agencies are focused on whether the proposed transaction will result in harm to competition, rather than being limited to a specific type of analysis. As a result, compared to the 1992 Guidelines, the 2010 Guidelines offer less predictability regarding which analytical methodology will be applied and the likely outcome of an investigation. Also, the 2010 Guidelines appear to provide the agencies with more tools, especially economic ones, to potentially challenge mergers. Although the 2010 Guidelines are intended to reflect the current state of the agencies' merger review policy and procedures, the language and tone of the 2010 Guidelines suggest that the agencies may challenge a greater number of transactions than in the past.

However, it is not yet clear whether the 2010 Guidelines will have an effect on courts in analyzing mergers. The agencies stated that their intent in issuing the 2010 Guidelines was to capture the analysis already in use.

Market Definition

The 2010 Guidelines state that market definition is no longer the necessary first step of the merger analysis. Instead, the agencies will use market definition principles to:

- Specify the line of commerce and section of the country in which competitive concerns may arise.
- Identify market participants.
- Measure market share to the extent the measurements illuminate the competitive effects of a horizontal merger.
- Analyze the substitutes available to customers.

Although the agencies will normally identify relevant markets, they may conclude that a merger raises competitive concerns without defining a precise relevant market if there is evidence that the merger is likely to result in anti-competitive effects.

Product Market

The primary market definition principle used to assess the parameters of a relevant market will continue to be the hypothetical monopolist test. For each product, the agencies assess the likely customer reaction to a "small but significant and non-transitory increase in price" (SSNIP). Most often, the hypothetical SSNIP used will be a 5% price increase, although it could be higher or lower depending on the industry. If customers are likely to switch to a next best substitute product and defeat the price increase, then that substitute product is included in the market. The 1992 Guidelines sought to define the narrowest possible product market. Similarly, the 2010 Guidelines confirm that the agencies will consider the closeness of competition among potential substitutes as part of the analysis during this stage.

Geographic Market

Similarly, the definition of the relevant geographic market focuses on customers' likely response to a hypothetical 5% price increase. If consumers are likely to switch to suppliers located in other geographic areas, then the market is expanded to include those geographic areas.

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Market Shares and Concentration

Once the agencies have determined the relevant product market and geographic market, they identify all of the participants in the market (including the merging parties) and their market shares. The agencies then use the market shares to assess market concentration before and after the proposed acquisition.

Concentration levels are measured using the Herfindahl-Hirschman Index (HHI), which is calculated by summing the squares of the market shares of each market participant. For example, a market that has four competitors with market shares of 30%, 25%, 25% and 20% would have an HHI of 2,550 (900 plus 625 plus 625 plus 400). Mathematically, the HHI takes into account the number, relative size and distribution of the firms in a market. Accordingly, the HHI is low when the market has many competitors of relatively equal size and reaches the maximum of 10,000 when there is only a single firm in the market.

The 2010 Guidelines increase the HHI thresholds from the 1992 Guidelines (see *Box, HHI Thresholds Comparison Chart*).

The 2010 Guidelines note, however, that the HHI thresholds will not be applied as rigid screens and that other competitive factors will be examined to determine whether increased concentration at any level will lead to adverse competitive effects. In addition, although the HHI thresholds have increased, the revised treatment of market definition principles may result in narrower relevant markets, and therefore, higher concentration levels.

HHI Thresholds Comparison Chart

2010 Guidelines	1992 Guidelines
Post-merger increase in HHI less than 100 points. • Unlikely to have adverse competitive effects and ordinarily requires no further analysis.	No similar standalone presumption.
Post-merger HHI below 1,500. • Unconcentrated market. • Unlikely to have adverse competitive effects and ordinarily requires no further analysis.	Post-merger HHI below 1,000.
Post-merger HHI between 1,500 and 2,500 and increase in HHI over 100 points. • Moderately concentrated market. • Potentially raises significant competitive concerns and often warrants scrutiny.	Post-merger HHI between 1,000 and 1,800 and increase in HHI over 100 points.
Post-merger HHI over 2,500 and increase in HHI between 100 and 200 points. • Highly concentrated market. • Potentially raises significant competitive concerns and often warrants scrutiny.	Post-merger HHI over 1,800 and increase in HHI between 50 and 100 points.
Post-merger HHI over 2,500 and increase in HHI over 200 points. • Rebuttable presumption that the merger likely will enhance market power.	Post-merger HHI over 1,800 and increase in HHI over 100 points.

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Competitive Effects

The central analysis of a merger is to determine whether it will lead to a substantial lessening of competition such that it might result in higher prices, reduced output or other harm to customers. The 2010 Guidelines specify two types of potential competitive effects:

- **Unilateral effects.** The agencies consider whether the merger will allow the merged firm unilaterally to raise prices or reduce output in a way that harms customers. The 2010 Guidelines provide an expanded discussion of the unilateral effects theory, including a discussion of the impact on:
  - pricing of differentiated products;
  - bargaining and auctions;
  - capacity and output for homogeneous products; and
  - innovation and product variety.
- **Coordinated interaction.** The agencies also consider whether the merger will increase opportunities for coordinated interaction or collusion among the merged firm and its competitors that may result in increased prices and/or reduced output to the detriment of customers. In assessing the likelihood of coordinated interaction, the agencies analyze whether the post-transaction market conditions would increase the companies' ability to reach terms of coordination, detect deviations from those terms and punish deviators. Market characteristics such as product or firm homogeneity, transparency of price information, frequent sales and previous collusive behavior are viewed as conducive to coordinated interaction. The 2010 Guidelines note that coordinated effects can include concerns about conduct that is not otherwise in violation of the antitrust laws.

Powerful Buyers

The 2010 Guidelines include a new section on the impact of powerful buyers on merger analysis, including a recognition that these buyers can help constrain competitive effects. This argument is sometimes made by merging parties and the addition of this section marks a recognition of its validity. However, the agencies also note that a merger still may enhance market power to the detriment of powerful buyers or other customers.

Entry Analysis

A proposed merger does not harm competition if other firms can enter the market easily and effectively. Accordingly, the 2010 Guidelines explain that the agencies will evaluate whether other firms would enter the market, either through wholly new entry or product or geographic expansion, in response to a price increase by the merged firm. In order to be credited by the reviewing agency, the entry must be:

- **Timely.** Entry is considered timely if an entrant quickly can achieve a significant impact on price in the relevant market. The 2010 Guidelines do not include reference to a specific time frame. However, in practice to date, the agencies typically consider entry as timely if the entrant takes two years or less to plan entry, enter and achieve significant market impact.
- **Likely.** Entry is considered likely if a potential entrant would be profitable, taking into consideration all costs, the likely output level and the likely price.
- **Sufficient.** Entry is not considered sufficient if it would not replace the competition lost by the merger. For example, the new product may not be a close enough substitute or the new entrant cannot offer the same quality or breadth of product offering as the merged firm.

Efficiencies

The 2010 Guidelines note that the agencies will evaluate the efficiency enhancing potential of the transaction. In those cases where the risk of anti-competitive effects are low or can be difficult for the agency to prove in court, the presence of efficiencies may outweigh any possible harm. However, efficiencies alone cannot save an otherwise anti-competitive transaction. For the agencies to consider efficiencies in their merger analysis, they must be:

- **Merger-specific.** These are likely to be accomplished only through the proposed merger and unlikely to be accomplished by the companies absent the merger.
- **Cognizable.** Cognizable efficiencies are those that can be verified for likelihood and magnitude, and do not result from an anti-competitive reduction of output or service.

Failing Firm Defense

The agencies do not consider a proposed merger to be anti-competitive if the merging parties can show that one of the firms would exit the market absent the merger. Though (and perhaps because) the failing firm defense is absolute, it has a high burden of proof. A company making a failing firm argument to the agencies must have substantial proof that the firm cannot:

- Meet its imminent financial obligations.
- Reorganize under Chapter 11.

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- Find a buyer who will keep the assets productive in the relevant market and poses a less severe threat to competition.

This test is rarely met.

Partial Acquisitions

The 2010 Guidelines include a new section on how the agencies will evaluate acquisitions of partial interests in competing firms. The agencies will focus on whether the acquisition:

- Gives the acquiror the ability to influence the target company's competitive conduct.
- Reduces the acquiring firm's incentives to compete.
- Gives the acquiror access to the target's competitively sensitive information.

Implications of the 2010 Guidelines

The 2010 Guidelines detail the diverse types of evidence (such as the merging parties' documents, data, business conduct, and information from customers and industry participants) that the agencies can use to predict competitive effects, all of which could result in longer investigations and broader requests for documents and information. The 2010 Guidelines list the many and varied tools and methods available to the agencies in conducting merger analysis and provides practitioners with this knowledge.

However, the 2010 Guidelines provide little guidance on what results from the various analyses are likely to be persuasive or dispositive in the agencies' decisions whether to permit or seek to enjoin a transaction. In that sense, the 2010 Guidelines provide few true guidelines to assist parties considering a transaction. To the extent that courts look to the 2010 Guidelines for direction in analyzing mergers, the new structure may make it easier for the FTC and DOJ to make their case given that the 2010 Guidelines provide a significantly expanded exposition of the information and theories that the agencies consider appropriate. However, it is unclear how courts will square the agencies' conclusions based on the 2010 Guidelines' analytical methodologies with the well-developed antitrust merger case law.

Non-Horizontal Mergers

There are two types of non-horizontal mergers that could harm competition:

- Mergers involving potential competitors.
- Mergers involving firms that operate at different levels of an industry.

The Non-Horizontal Merger Guidelines, which are used by the agencies to analyze potential anti-competitive effects from these types of mergers, were originally part of the 1984 Merger Guidelines issued by the DOJ. Although these guidelines are somewhat outdated given the advances in economic analysis, the DOJ has not repealed the Non-Horizontal Merger Guidelines.

Potential Competition

Mergers between potential competitors can have anti-competitive consequences. Where one of the merging companies is developing a product that, absent the merger, would compete with its merger partner's product, the merger could eliminate the potential for future competition. Consequently, assuming there are few (if any) similarly situated potential competitors, the merger could have the anti-competitive effect of precluding competition that may have resulted in lowering prices in the future.

A merger could also be anti-competitive if one of the merging firms was widely perceived in the industry as a potential competitor such that its presence was a constraining factor on prices in the industry.

Vertical Mergers

Mergers that combine companies at different levels in the manufacturing or distribution chain (vertical mergers) can sometimes result in diminished competition. The Non-Horizontal Merger Guidelines discuss three specific dangers that can result from vertical mergers:

- **Increased barriers to entry.** In theory, a vertical merger could elevate barriers to entry if, as a result of the merger, new entrants would have to enter both markets in order to compete with the merged firm. For a cognizable harm to exist, the agency must show that the merger rendered entry at both the upstream and downstream level of the market essential for becoming a viable market participant and that the difficulty of entering at two levels was a significant barrier to new entrants.
- **Facilitating collusion.** Where a market is conducive to collusion, vertical mergers could enable coordinated interaction by giving companies increased opportunities to monitor pricing. For example, if manufacturers are engaged in collusion, acquiring retail outlets could enable manufacturers to better track pricing to detect and punish deviant firms. In addition, when a manufacturer acquires a disruptive buyer (that is, an important buyer that could tempt the manufacturers to deviate from a collusion

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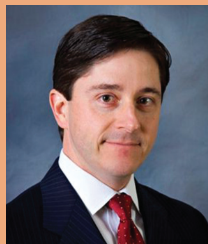
agreement), the transaction may facilitate collusion among manufacturers in the industry.

- **Avoidance of rate regulation.** A price-regulated company's acquisition of an unregulated supplier could allow the regulated company to evade rate regulation by artificially inflating the costs of its internal transactions. Recognizing that a merger between a regulated entity and its unregulated supplier ultimately could give rise to pro-competitive efficiencies, the agencies are not likely to challenge a merger under this theory unless it creates substantial opportunities for abuses.

In addition to the theories outlined in the Non-Horizontal Merger Guidelines, economic literature predicts that vertical mergers can result in market foreclosure. This can arise where, as a result of merging with a supplier or distributor, the merged firm may be able to foreclose its rivals from particular essential inputs or distribution channels, or charge its rivals inflated prices for access to those inputs or channels. The agencies have also challenged vertical mergers based on potential foreclosure.



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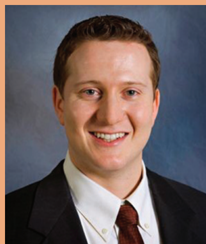

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