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THE SOUND OF ONE HAND CLAPPING: THE 2010 MERGER GUIDELINES AND THE CHALLENGE OF JUDICIAL ADOPTION

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The Sound of One Hand Clapping:

The 2010 Merger Guidelines and the Challenge of Judicial Adoption

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Abstract

There is ample justification for the consensus view that the Horizontal Merger Guidelines have proven one of antitrust law's great successes in the grounding of antitrust doctrine within economic learning. The foundation of the Guidelines' success has been its widespread adoption by federal courts, which have embraced its rigorous underlying economic logic and analytical approach to merger analysis under the Clayton Act. While some have suggested that the Guidelines' most recent iteration might jeopardize this record of judicial adoption by downplaying the role of market definition and updating its unilateral effects analysis, we believe these updates are generally beneficial and include long-overdue shifts away from antiquated structural presumptions in favor of analyzing competitive effects directly where possible. However, this article explores a different reason to be concerned that the 2010 Guidelines may not enjoy widespread judicial adoption: the 2010 Guidelines *asymmetrically* update economic insights underlying merger analysis. While the 2010 Guidelines' updated economic thinking on market definition and unilateral effects will likely render the prima facie burden facing plaintiffs easier to satisfy in merger analysis moving forward, and thus have significant practical impact, the Guidelines do not correspondingly update efficiencies analysis, leaving it as largely as it first appeared 13 years earlier. We discuss two well-qualified candidates for "economic updates" of efficiencies analysis under the Guidelines: (1) out-of-market efficiencies and (2) fixed cost savings. We conclude with some thoughts about the implications of the asymmetric updates for judicial adoption of the 2010 Guidelines.

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INTRODUCTION

It is difficult to overstate the intellectual distance traveled by horizontal merger law in the relatively short time horizon between the rudimentary structure-conduct-performance approach embodied in cases like *Brown Shoe*[1] and *Vons Grocery*[2] to the more rigorous and evidence-based approach of modern merger analysis in cases like *FTC v. Staples*.[3] There is ample justification for the consensus view that the Horizontal Merger Guidelines (Guidelines) have proven one of antitrust law's great successes in the grounding of antitrust doctrine within economic learning.[4]

One critical dimension of the Guidelines' success has been its wide adoption by federal courts. Federal courts have been willing to adopt the Guidelines' underlying rigorous economic logic and analytical approach to merger analysis under the Clayton Act; statements of administrative agency policy rarely prove so influential upon the

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[1] *Brown Shoe Co. v. U.S.*, 370 U.S. 294 (1968).

[2] *U.S. v. Von's Grocery*, 380 U.S. 270 (1966).

[3] *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997). Judge Posner described the *Staples* opinion as the "coming of age" for an economic analysis of mergers. RICHARD POSNER, ANTITRUST LAW 158 (2001).

[4] *See, e.g.*, Dennis Carlton, *Revising the Horizontal Merger Guidelines*, 6(4) J. COMP. L. & ECON. 1, 2 (2010) ("The Guidelines have proven to be a valuable and durable guide to antitrust practitioners and the courts"); William E. Kovacic, *The Modern Evolution of Competition Policy Enforcement Norms*, 71 ANTITRUST L.J. 377, 435 ("The Guidelines not only changed the way the U.S. courts and enforcement agencies examine mergers, but they also supplied an influential focal point for foreign competition authorities in the formulation of their own merger control regimes."); Carl Shapiro, *The 2010 Horizontal Merger Guidelines: From Hedgehog to Fox in Forty Years*, 77 ANTITRUST L.J. 701, 703 (2010) ("One cannot help but marvel at how far merger enforcement has moved over the past forty years, with no change in the substantive provisions of the Clayton Act and very little new guidance on horizontal mergers from the Supreme Court").

courts.[5] The success of the Guidelines owes in large part to the Agencies' joint creation of a sound analytical framework for mergers that has proven ripe for judicial adoption. In addition to their primary function of describing "the principal analytical techniques and the main types of evidence on which the Agencies usually rely to predict whether a horizontal merger may substantially lessen competition," the Guidelines are also intended to "assist the courts in developing an appropriate framework for interpreting and applying the antitrust laws."[6] The adoption of any administrative product into the judicial process is necessarily bilateral, with federal courts themselves shaping the Guidelines.[7]

Some have suggested that the Guidelines' most recent iteration might jeopardize this record of judicial adoption by downplaying the role of market definition. For example, Leah Brannon and Kathleen Bradish warn that "the 2010 Guidelines ask more of the courts than previous versions have, and if recent courts are any indication, courts may not be willing to forgo market definitions in Section 7 cases."[8] While the 2010 Guidelines clearly deemphasize the importance of market definition in Clayton Act

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[5] *See* Leah Brannon & Kathleen Bradish, *The Revised Horizontal Merger Guidelines: Can the Courts Be Persuaded*, ANTITRUST SOURCE, Oct. 2010, *available at* http://www.abanet.org/antitrust/at-source/10/10/Oct10-Brannon10-21f.pdf. Indeed, courts have been criticized for the degree to which reliance on the Guidelines amounts to "voluntarily accepting uncompelled guidance from a constructive administrative interpretation." *United States v. Kinder*, 64 F.3d 757, 771-72 (2d Cir. 1995).
[6] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES (2010) [hereinafter 2010 Guidelines], *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf.
[7] *See* Jonathan B. Baker, *Responding to Developments in Economics and the Courts: Entry in the Merger Guidelines*, 71 ANTITRUST L.J. 189 (2003) (explaining influence of the court in shaping 1992 DOJ and FTC Merger Guidelines analysis of supply-side issues).
[8] Brannon & Bradish, *supra* note 5, at 4.

cases, it is equally clear that the Agencies possess neither the inclination nor the incentive to challenge a merger without defining a relevant market. The Agencies wish to win cases; the Clayton Act mandates a relevant market.[9] Current DOJ Chief Economist Carl Shapiro has stated this irreducible requirement plainly: "The Division recognizes the necessity of defining a relevant market as part of any merger challenge we bring."[10]

Compliance with the Clayton Act, however, is only a necessary condition for widespread judicial adoption and endorsement of the Guidelines. It is not sufficient. This article explores a different reason to be concerned that the 2010 Guidelines will not enjoy widespread judicial adoption: the 2010 Guidelines asymmetrically update economic insights underlying merger analysis. Many of these "economic updates" are largely unobjectionable in and of themselves, and some represent significant theoretical improvements over the 1992 Guidelines.[11] These beneficial updates include long-overdue shifts away from antiquated structural presumptions in favor of analyzing competitive effects directly. These updates are an important step towards applying

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[9] *See* Josh Wright, *Will Federal Courts Adopt the 2010 HMGs?*, TRUTH ON THE MARKET (Oct. 26, 2010, 8:59 PM), http://truthonthemarket.com/2010/10/26/will-federal-courts-adopt-the-2010-hmgs/.

[10] Carl Shapiro, Update from the Antitrust Division, Remarks as Prepared for the Antitrust Bar Association Section of Antitrust Law Fall Forum (November 18. 2010), *available at* http://www.justice.gov/atr/public/speeches/264295.pdf.

[11] There are some obvious exceptions. For example, the 2010 Guidelines update the HHI thresholds which identify which mergers "warrant scrutiny" and which presumptively are "likely to enhance market power." *See* 2010 Guidelines, § 5.3. However, there is no theoretical or empirical basis upon which these cutoffs are tried to competitive effects. *See also* Carlton, *supra* note 4, at 3 (noting that "it would be a mistake for courts to infer from the fact that there are new HHI thresholds in the 2010 Guidelines that there has been any new research to justify giving special credence to these new thresholds").

more rigorous and reliable methods of predicting the competitive effects of mergers. However, while the 2010 Guidelines' updated economic thinking on market definition and unilateral effects will likely render the prima facie burden facing plaintiffs easier to satisfy in merger analysis moving forward, the Guidelines do not correspondingly update efficiencies analysis, leaving it as largely as it first appeared 13 years earlier.[12]

We focus on several specific implications of this asymmetrical updating of the 2010 Guidelines. Part I describes the primary change in the 2010 Guidelines -- the downgrading of market definition in favor of the value of diverted sales approach – and explains how that approach is likely to narrow relevant markets. Part II turns to efficiencies, discussing the evolution of the antitrust analysis of efficiencies in the Guidelines from 1968 to present. Part III suggests two well-qualified candidates for "economic updates" of efficiencies analysis under the Guidelines: (1) out-of-market efficiencies and (2) fixed cost savings. Part IV concludes with some thoughts about the implications of the asymmetric updates for judicial adoption of the 2010 Guidelines.

I. The 2010 Horizontal Merger Guidelines' Revisions

The primary theme of the 2010 Guidelines is to adjust the Guidelines' analytical framework to more closely reflect competitive realities and especially to reflect the Agencies' belief that competition between close substitutes is not adequately accounted for by the standard market definition approach.

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[12] Shapiro, *supra* note 4, at 707 ("[t]he 2010 Guidelines make very few changes to the treatment of efficiencies articulated in 1997").

A. Downgrading Market Definition

Perhaps the most discussed change in the 2010 Guidelines has been the reduced role for market definition, and in particular, the reduction in the weight placed on market shares and concentration than in previous Guidelines. The 2010 Guidelines emphasize "competitive effects" and market definition as a useful tool in illuminating those effects. As we will be discussed below, for both legal and practical reasons, there is little reason to believe that the Agencies will avoid market definition altogether. But there is no doubt that the 2010 Guidelines reduce the importance of market definition. For example, the Guidelines observe that the "Agencies' analysis need not start with market definition," and that "the measurement of market shares and concentration is not an end in itself, but is useful to the extent it illuminates the merger's likely competitive effects."[13]

The 2010 Guidelines focus on competitive effects in lieu of beginning merger analysis by defining a relevant market.[14] The Guidelines expressly endorse using

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[13] 2010 Guidelines, § 4. The 2010 Guidelines also indicate that "evaluation of competitive alternatives available to customers is always necessary at some point in the analysis," but do not expressly state that the Agencies must (at some point in the analysis) define markets. As discussed below, the Department of Justice has described market definition as "necessary" in recent policy speeches. *See supra* note 10.

[14] *See generally* U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 1.1 (1992) ("The Agency will first define the relevant product market with respect to each of the products of each of the merging firms").

multiple methods to illuminate the likely competitive effects of a merger.[15] The single biggest example of this shift in principle lies in the analysis of unilateral effects. Unilateral price effects can arise when, pre-merger, one of the merging firms is constrained from price increases because a substantial amount of sales would be lost to, among others, its prospective merger partner. The merger thereby eliminates that competitive constraint creating an incentive for the post-merger firm to increase prices. Shapiro explains the motivation to update the Guidelines' approach to unilateral effects:

> The biggest shift in merger enforcement between 1992 and 2010 has been the ascendency of unilateral effects as the theory of adverse competitive effects most often pursued by the Agencies. Prior to 1992, merger enforcement focused primarily on coordinated effects. In recent years, a sizeable majority of DOJ merger investigations have focused on unilateral effects. Along with this pronounced shift in practice has come considerable new economic learning about unilateral effects. This shift in practice and advance in learning regarding unilateral effects was one of the chief reasons we at the DOJ felt that the time had come to update the Guidelines.[16]

The most significant change associated with the 2010 Guidelines' treatment of unilateral effects is the introduction of the "value of diverted sales" as a measure of "upward pricing pressure." The Agencies define "the value of diverted sales" as "equal to the number of units diverted to that product multiplied by the margin between price and incremental cost on that product." The Guidelines further explain that

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[15] *See* Shapiro, *supra* note 4, at 708 (observing "the 2010 Guidelines embrace multiple methods" of examining competitive effects).

[16] *Id*. at 712. Shapiro also observes that the Antitrust Modernization Committee, among others, shared these views. *Id.* at n.40. He adds the consensus view of economists that reliance upon market shares in the 1992 Guidelines did not promote "transparent and accurate merger enforcement." *Id.* at 716.

> In some cases, where sufficient information is available, the Agencies assess the value of diverted sales, which can serve as an indicator of upward pricing pressure on the first product resulting from the merger. Diagnosing unilateral price effects based on the value of diverted sales need not rely on market definition or the calculation of market shares and concentration. The Agencies rely much more on the value of diverted sales than on the level of the HHI for diagnosing unilateral price effects in markets with differentiated products. If the value of diverted sales is proportionately small, significant unilateral price effects are unlikely.[17]

The value of diverted sales thus provides a measure, ceteris paribus, of the upward pricing pressure from the unilateral effects of the merger. This approach does not consider efficiencies or other factors that would create downward pricing pressure, and thus is frequently described as the "gross upward pricing pressure index," or GUPPI.[18] A central feature of unilateral effects under the new value of diverted sales approach is the use of price/cost margins.[19]

The GUPPI measures only the upward pricing pressure from cannibalization of sales between merging products. It does not directly incorporate efficiencies. On the other hand, while unilateral effects models will generally predict price increases in the absence of efficiencies, one of the purported benefits of the GUPPI approach is that it

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[17] The 2010 Guidelines note that "the value of diverted sales is measured in proportion to the lost revenues attributable to the reduction in unit sales resulting from the price increase."

[18] *See* Steven C. Salop & Serge Moresi, *Updating the Merger Guidelines: Comments*, HORIZONTAL MERGER GUIDELINES REVIEW PROJECT, Nov. 2009 (proposing adoption of the GUPPI), *available at* http://www.ftc.gov/os/comments/horizontal mergerguides/545095-00032.pdf; Joseph Farrell & Carl Shapiro, *Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition*, 10 B.E. J. THEORETICAL ECON. __ (2010), *available at* http://faculty.haas.berkeley.edu/shapiro/alternative.pdf.

[19] On the use of price-cost margins in merger analysis, *see* Michael R. Baye et al., *Proposed Horizontal Merger Guidelines: Economists' Comment* (June 4, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00017.pdf (remarking on proposed guidelines jointly submitted by Michael R. Baye, Aaron S. Edlin, Richard J. Gilbert, Jerry A. Hausman, Daniel L. Rubinfeld, Steven C. Salop, Richard L. Schmalensee, Lawrence J. White, and Joshua D. Wright).

gives some sense of how large efficiencies must be to offset the upward pressure. In other words, as Shapiro observes, the value of diverted sales measure used in the Guidelines, scaled as GUPPI, indicates how large the marginal cost savings must be on Product 1, measured as a fraction of the price of Product 1, for there to be no net upward pricing pressure on Product 1, given the price of Product 2.[20]

B. Unilateral Effects and Generalized Upward Pricing Pressure Index Methodologies Lead to Narrower Markets[21]

Observers generally agree that the 2010 Guidelines' methodological approach will result in narrower relevant markets. The Agencies believe that narrower markets more accurately reflect competitive pressures as "the competitive significance of distant substitutes is unlikely to be commensurate with their shares in a broad market."[22] The market definition analysis endorsed by the new Guidelines correspondingly favors narrower markets. For example, the hypothetical monopolist test adopted by the new Guidelines states that the Agencies require that a critical loss analysis must be consistent with data on profit margins. Likewise, the Guidelines' value of diversion test tends to narrow relevant markets, all else held constant.[23] As Shapiro observes in

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[20] Shapiro, *supra* note 4, at 728.

[21] This section expands upon the analysis in Joshua D. Wright, *Comment on the Proposed Update on the Horizontal Merger Guidelines: Accounting for Out-of-Market Efficiencies* (May 31, 2010), *available at* http://www.ftc.gov/os/comments/hmgrevisedguides/548050-00008.pdf.

[22] 2010 Guidelines, § 4.

[23] Steve Salop & Serge Moresi, *Horizontal Merger Guidelines: Summary of Proposed Revisions* (2010), *available at* http://www.crai.com/uploadedFiles/Publications/horizontal-merger-guidelines-summary-of-proposed-revisions.pdf. Some have expressed concerns that the new Guidelines will define markets excessively

explaining the Guidelines' methodology, "in some cases, the economic models used by the Agencies predict significant price increases only for products with relatively few sales."[24]

II. Efficiencies Analysis under the Horizontal Merger Guidelines

The evolution of the Guidelines and enforcement agencies' shifting attitudes toward efficiencies is inevitably bound in the mooring of merger law to economic analysis. Like other components of merger analysis under the Guidelines, courts and enforcement agencies have benefited from increasing economic sophistication.

One could glibly summarize the pre-Guidelines treatment of efficiencies in mergers as nonexistent. This would prove too sanguine a summary. The Supreme Court's pre-Guidelines case law dismissed efficiency justifications – often tersely – as foreclosed by Congress's passage of the Clayton Act.[25] The federal Courts of Appeals could dismiss efficiencies claims in merger cases as "rejected repeatedly" as recently as 1979.[26] A triad of cases illustrates this point. In both *Brown Shoe* and *FTC v. Procter & Gamble Co.*,[27] defendant firms seeking review of challenged mergers each adamantly

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narrowly, particularly in markets with substantial intellectual property. *See, e.g.*, Daniel M. Wall & Hanno Kaiser, *What the New Merger Guidelines Mean for Technology Companies* (Apr. 24, 2010), *available at* http://www.lw.com/upload/pubContent/_pdf/pub3492_1.pdf.

[24] *See* Shapiro, *supra* note 4, at 720 n.69.

[25] *See, e.g.*, *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962) ("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.")

[26] Joseph Kattan, *Efficiencies and Merger Analysis*, 62 ANTITRUST L.J. 513, 515 (1994) (quoting *RSR Corp. v. FTC*, 602 F.2d 1317, 1325 (9th Cir. 1979)).

[27] 386 U.S. 568 (1967).

denied their representative mergers would lead to efficiencies. The economic logic behind such a denial is unknown; it can be presumed both firms believed efficiencies would be construed as evidence of *anticompetitive* effect. Both firms ultimately lost at the Supreme Court. Worse still, the Supreme Court in *Philadelphia National Bank* categorically denied accounting efficiencies on some "ultimate reckoning of social and economic credits and debits[]."[28] The *Philadelphia National Bank* Court categorically forbade accounting for out-of-market efficiencies in weighing the competitive effects of a merger.[29] This may be fairly described as the high-water mark of the Court's hostility towards economic analysis of efficiencies in mergers.

Against this backdrop, Donald Turner released the 1968 Horizontal Merger Guidelines on the last day of his tenure as Assistant Attorney General for Antitrust.[30] The 1968 Guidelines provided only for the most hesitant and contingent of potential efficiencies defenses.[31] An efficiency could only justify a challenged merger under "exceptional circumstances;" ordinarily, "the Department [would not] accept [efficiencies] as a justification for an acquisition normally subject to challenge[]."[32] The Guidelines remained exceptionally hesitant towards recognizing efficiencies, however, postulating that most economies of scale and scope could be gained through internal

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[28] 374 U.S. 321, 371 (1963).
[29] *Id*.
[30] William J. Kolasky & Andrew R. Dick, *The Merger Guidelines and the Integration of Efficiencies Into Antitrust Review of Horizontal Mergers*, 71 ANTITRUST L.J. 207, 212 (2003).
[31] *Id*. at 213.
[32] *Id*.

expansion rather than acquisitions, and even where mergers could be theoretically justified, they might prove difficult to accurately establish.[33] By implicitly requiring an affirmative demonstration of proof under this seemingly rigorous standard, the 1968 Guidelines made a presumption *against* construing efficiencies in a merger or acquisition, conceding efficiencies' relevance to antitrust analysis only when convincingly demonstrated and even then only under exceptional circumstances.[34] That efficiencies could lead to consumer welfare gains and thereby justify mergers is common wisdom today; at the vanguard of the New Learning, however, the 1968 Guidelines represented one of the first serious attempts at rigorously integrating economic insights into merger analysis.

Further revisions of the Guidelines reflected greater economic understanding, a more thorough integration of economic insights into merger analysis, and a more sophisticated examination of efficiencies in establishing a proposed merger's effects on consumer welfare. While the 1982 Guidelines stated efficiencies would only be considered in "extraordinary cases," the 1984 Guidelines expanded the treatment of efficiencies in merger analysis, including those related to economies from asset-specific investments as well as economies of scale arising from decreased overhead.[35] The 1992 Guidelines, jointly drafted by the FTC and DOJ, made only a single change to the 1984

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[33] *Id*.
[34] The 1982 Guidelines effectively made this heightened standard of proof explicit, requiring "clear and convincing evidence" of efficiencies as a prerequisite to considering efficiencies' beneficial effects upon consumer welfare. *Id.* at 218 (citing U.S. DEP'T OF JUSTICE, MERGER GUIDELINES § 10.A. (1982)).
[35] *Id*. at 221-22.

Guidelines' treatment of efficiencies: the 1992 Guidelines deleted the "clear and convincing evidence" standard imposed by the 1982 Guidelines.[36] This deletion foreshadowed the 1997 Revisions, a comprehensive expansion of merger analysis which remains in effect to this day. The 1997 Revisions codified the full reversal of the hostility to efficiencies paradigmatic of *Brown Shoe* and *Procter & Gamble*: mergers could indeed *promote* competition through efficiencies, and these efficiencies could prove great enough to mitigate or eliminate the anticompetitive effects of an otherwise forbidden merger.[37]

Yet while the 1997 Revisions effectively rebuffed the efficiencies hostility of *Brown Shoe* and *Procter & Gamble*, the shadow of *Philadelphia National Bank* looms large. The Guidelines' collective revisions reflected the widely-accepted economic advances in understanding efficiencies defenses of their respective times; accordingly, each set of revisions has received wide judicial acceptance and appropriately broad deference. Indeed, many commentators regard the Guidelines' credibility arising from this collected institutional wisdom as a foundational principle of any further revisions to the Guidelines. This caution doubtlessly preserves consumer welfare by reducing costs associated with uncertain antitrust enforcement.

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[36] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 4 (1992).
[37] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 4 (as amended Apr. 8, 1997).

Neither the Guidelines, the Revisions, nor the proposed 2010 Guidelines address *Philadelphia National Bank*'s prohibition on considering "out-of-market efficiencies," despite agency pledges to recognize these efficiencies.[38] The 2010 Guidelines – in keeping with the tradition of its forbearers – integrate economic observations on anticompetitive effects vis-à-vis providing a variety of new methods to demonstrate or prove these effects to establish a narrower market definition than possible under the 1997 Revisions. The 2010 Guidelines in no way diminish the 1997 Revisions' treatment of efficiencies; neither, however, do they update the Guidelines' treatment of efficiencies in light of these new tests for anticompetitive effect to dispel the specter of *Philadelphia National Bank*. The 2010 Guidelines thereby appear to implement 2010 economic knowledge on unilateral effects awkwardly paired with 1997 economic knowledge of efficiencies.

III. Missed Opportunities to Update the Merger Guidelines' Efficiencies Analysis

The 2010 Guidelines appropriately add new tools to demonstrate alleged anticompetitive effects flowing from mergers. The latest updates to these Guidelines fail to similarly update new economic observations regarding efficiencies – and fail to dispel the consequences of a particularly old anti-economic precedent. We next propose two ways in which the 1997 Guidelines were, and the 2010 Guidelines remain, ripe for revision to better reflect economic learning on efficiencies in merger analysis.

[38] *See generally* Wright, *supra* note 21.

A. Out-of-Market Efficiencies[39]

One central concern with the new Guidelines' approach to unilateral effects and market definition is that prosecutorial discretion will be the only force constraining the Agencies from successfully enjoining mergers with net consumer welfare gains despite the presence of anticompetitive effects in a narrowly defined market. To the extent that the new Guidelines more accurately capture competitive effects, the above-discussed methodological changes will lead to improved merger policy and increased consumer welfare. A narrower market definition, however, necessarily consigns greater prosecutorial discretion to enforcement agencies by upholding challenges that violate Section 7 in one relevant market while producing net consumer welfare gains in another relevant market. As discussed, holding all else constant, the Guidelines' methodological approach will more frequently lead to circumstances in which the economic models relied upon by the Agencies predict net unilateral price increases for a very small number of customers with significant "out-of-market" efficiencies flowing outside the recursively defined relevant market encompassing those customers. Under the current Guidelines approach, the Agencies have unfettered discretion to bring such cases. While this discretion benefits Agencies, it does not benefit consumers.

Agencies may properly exercise their prosecutorial discretion when consumer benefits in other relevant markets arise from efficiencies that are "inextricably linked" to

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[39] *Id*.

the merger. The Agencies are not required to do so. This unbounded discretion calls for a firmer commitment to forbearing from challenging mergers that net increase consumer welfare across *all* relevant markets.

Narrow markets inevitably lead to the atomization of classes of consumers, whereby a market may be defined by picking a harmed consumer and defining a relevant market around that individual. Skepticism of this approach is broadly animated by fears that narrower markets obscure competitive benefits of the merger that are "outside" the market. Thus, the new approach could lead to Section 7 liability for mergers that result in net increases in consumer welfare.

Consider the merger of Firms A and B who produce and sell widgets at the same price to two equally sized sets of customers, C_1 and C_2. Assume that, under the new Guidelines, there is convincing evidence that the sale of widgets to C_1 is a relevant market separate from the sales of widgets to C_2 and that the post-merger firm will be able to increase the price of widgets to C_1, by 10%. Assume that, under the 2010 Guidelines, there is also convincing evidence that the sale of widgets to C_2 is a relevant market and that post-merger prices of widgets in that market will fall 20%. Thus, the merger produces net benefits for consumers taken as a whole. Suppose that the efficiency benefits that lead to the 20% price decrease in C_2 are inextricably linked to the merger including the market encompassing sales to C_1, so a divestiture in the C_1 market is not feasible.

Despite these overall consumer benefits, the merger could be successfully challenged because of its harms in market C_1. Under current merger law, the merger of A and B will violate Section 7 despite the fact that it increases consumer welfare, because *Philadelphia National Bank* precludes counting efficiencies outside the relevant market.[40] In other words, the merging parties *cannot* rely upon demonstrable consumer gains outside of the narrowly defined product market to defend the merger, even if the increase in consumer welfare is huge and dominates any potential anticompetitive effects.

The cause of the problem is *Philadelphia National Bank*. *Philadelphia National Bank* mandates this inability to balance cross-market effects. Under the 1997 Revisions, this dictate remained a curiosity of antitrust past. The 2010 Guidelines' diversion approach to market definition is likely to dramatically increase *Philadelphia National Bank*'s practical significance. Narrower markets will lead to more cases in which other groups of consumers benefit but those benefits are systematically excluded from merger analysis, even though they would otherwise meet the cognizability and verifiability requirements for efficiencies.

This failure to incorporate "out of market" efficiencies into merger analysis rebuffs the modern trend, and the trend cited by the Agencies in support of the changes to market definition and unilateral effects reflected in the 2010 Guidelines' revisions, in

[40] *U.S. v. Philadelphia Nat'l Bank*, 374 U.S. 321 (1963).

favor of analyzing actual competitive effects rather than adopting simplifying and potentially misleading proxies. The intellectual case in favor of excluding out of market efficiencies is a weak one; it becomes weaker still when the Agencies adopt an approach of ever-narrowing market definitions. The intellectual underpinnings of the new Guidelines, especially with respect to market definition and diagnosing unilateral price effects, are built on the potential to shed imperfect market share proxies in favor of an approach that reflects the competitive realities of competition between close substitutes. The new Guidelines should adopt the same rigorous analytical approach with respect to efficiencies. This change is further needed as a practical matter because the problem is likely to become more common in light of the narrower markets defined under the new Guidelines.[41]

This approach may render hard cases yet more difficult. In light of error-cost considerations, this may counsel additional caution in prosecuting "hard cases" in the first place. For close cases in which anticompetitive effects are robust, additional work would have value – this effort would permit mergers that benefit consumers while correctly preventing net harmful mergers. This type of balancing is not new. Agencies already conduct this analysis within a (broader) relevant market. No merger affects

[41] To be sure, eliminating the *Philadelphia National Bank* limitation on cross-market balancing in the 2010 Guidelines complicate efficiency analysis. As a simplifying procedural rule, the limitation has some benefits. For example, relaxing the rule would result in parties more frequently making efficiencies claims outside the narrowly defined relevant market. As a result, the Agencies may need to define and analyze additional relevant markets to comprehensively assess competitive effects. Further, this approach will more frequently create the need for balancing competitive benefits and harms across multiple markets.

every consumer identically. The proposed approach would not alter the burdens that already exist with respect to efficiencies under the 1997 Revisions or 2010 Guidelines. "Out of market" efficiencies should still have to satisfy the requirements of Section 10 of the 2010 Guidelines; firms will still bear the burden of demonstrating efficiencies.

Additional burdens of this analysis create an additional layer of complexity; this should not get in the way of incorporating cognizable efficiencies associated with the merger. There is certainly wisdom in simplifying assumptions and rules, based on economic theory and evidence, thereby allowing generalist judges to conduct a more tractable form of antitrust analysis rather than delve into the weeds of economic theory in the name of reducing socially costly errors.[42] However, the limitation on out of market efficiencies embodied in *Philadelphia National Bank* originates from an era of antitrust where these formalistic, simplifying assumptions were neither based in economic theory nor on evidence of competitive realities. Although the proposed commitment to exercise prosecutorial discretion to protect consumer welfare would require the Agencies to ignore *Philadelphia National Bank*, the 1997 Guidelines have already opened the door to considering out of market efficiencies without disastrous consequences. No "parade of horribles" has been forthcoming.

B. **Fixed Costs versus variable cost efficiencies**

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[42] Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984). *See also* Michael R. Baye & Joshua D. Wright, *Is Antitrust Too Complicated for Generalist Judges*?, 54 J. L. & ECON. __ (forthcoming 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1319888.

As discussed above, the 1997 Revisions to the 1992 Guidelines introduced efficiencies into merger analysis. Those revisions as well as the 2006 Commentary on the Horizontal Merger Guidelines make clear that the Agencies contemplate accepting fixed-cost savings as cognizable efficiencies under some conditions. Indeed, while the 1997 Revisions strike a more skeptical tone concerning fixed cost savings,[43] the 2006 Commentary notes that the Agencies "consider merger-specific, cognizable reductions in fixed costs, even if they cannot be expected to result in direct, short-term, procompetitive price effects because consumers may benefit from them over the longer term even if not immediately."[44] Indeed, the Commentary goes on to recognize that "under certain market or sales circumstances, fixed-cost savings may result in lower prices in the short term."[45]

The 2010 Guidelines retain the skepticism of the 1997 Revisions to the 1992 Guidelines. While the 2010 Guidelines recognize that fixed cost savings can in principle "benefit customers in the longer run, e.g., if they make new product introduction less expensive," the 2010 Guidelines also plainly state that "efficiencies relating to costs that

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[43] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 4 (as amended Apr. 8, 1997) ("Other efficiencies, such as those relating to research and development, are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions. Yet others, such as those relating to procurement, management, or capital cost are less likely to be merger-specific or substantial, or may not be cognizable for other reasons."), *available at* http://www.ftc.gov/bc/docs/hmg080617.pdf.

[44] U.S DEP'T OF JUSTICE & FED. TRADE COMM'N, COMMENTARY ON THE HORIZONTAL MERGER GUIDELINES (2006), *available at* http://www.justice.gov/atr/public/guidelines/215247.htm.

[45] *Id.*

are fixed in the short term are unlikely to benefit customers in the short term."[46] Because the Agencies "normally give the most weight to the results of this analysis over the short term" and broadly dismiss possibility of long-term competitive benefits from reductions in fixed cost savings, the 2010 Guidelines retain the status quo.

Problematically, this status quo reflects neither current economic thinking nor actual Agency practice concerning fixed cost savings. The economics literature has long recognized the competitive importance of reductions in fixed cost savings. For example, the Antitrust Modernization Committee concluded that "the agencies should account for the value of fixed-cost efficiencies in assessing the likely competitive effects of a merger" and that failure to do so "could deprive consumers and the U.S. economy of significant benefits from a procompetitive merger."[47] In particular, while ignoring the potential short-term price effects attributable to fixed cost efficiencies is a serious problem, there is substantial concern that merger analysis which does not take into account the full impact of fixed cost savings on competition may ignore the impact that such reductions have on incentives to invest in research and development and introduce new products.[48] Further, actual practice at the Agencies with respect to

[46] 2010 Guidelines, n.15.
[47] ANTITRUST MODERNIZATION COMM., REPORT AND RECOMMENDATIONS 58 (2007).
[48] *Id.* at 59 (concluding that "the enforcement policy of the FTC and the DOJ may give insufficient recognition to innovation efficiencies in some mergers in which they believe the anticompetitive effects may result in the short term"). *See, e.g.*, Comment of David T. Scheffman, Director, Bureau of Economics, Fed. Trade Comm'n, Transcript of Roundtable Sponsored by the Bureau of Economics, Understanding Mergers: Strategy & Planning, Implementation and Outcomes at 228 (Dec. 10, 2002), *available at*

treatment of fixed cost savings departs from the 1992 and 2010 Guidelines' descriptions. For example, a recent study of 186 FTC merger investigations found that "staff was as likely to accept fixed-cost savings as they were to accept claims of variable cost savings."[49] Unfortunately, the Agencies failed to update the Guidelines to reflect both current economic thinking and actual agency practice concerning fixed cost savings.

IV. Conclusions: Will Courts Be As Willing to Adopt the 2010 Guidelines?

The Merger Guidelines' integration of economic understanding and empirical analysis into what was once perhaps the most haphazard and inconsistent area of antitrust doctrine stands as one of the great welfare-enhancing development in antitrust law. These subsequent iterations have established the Guidelines themselves as a persuasive collection of economic insights upon which firms and agencies can predictably rely in arranging both acquisitions and enforcement actions. Each revision and updating has included the latest understandings of anticompetitive and procompetitive consequences arising from mergers; the 2010 inclusion of novel metrics such as GUPPI can potentially continue this advance. The 2010 Guidelines integrate several theoretical updates into merger analysis; these new tests should be subjected to the same rigorous empirical analysis that forms the core of modern antitrust law. With

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http://www.ftc.gov/be/rt/xscriptpanel4.pdf ("[E]conomists have known . . . forever . . . that actual business decisions are often made in part based on average costs rather than incremental costs."); for a broader compilation of sources on this topic, *see generally* Timothy J. Muris & Bilal Sayyed, *Three Key Principles for Revising the Horizontal Merger Guidelines*, ANTITRUST SOURCE, Apr. 2010, at n.40, *available at* http://www.abanet.org/antitrust/at-source/10/04/Apr10-Muris4-14f.pdf.

[49] *See* Malcolm B. Coate & Andrew J. Heimert, *Merger Efficiencies at the Federal Trade Commission 1997–2007* vi (Feb. 2009), *available at* http://www.ftc.gov/os/2009/02/0902mergerefficiencies.pdf.

this key caveat, and subject to this testing, we can certainly support the modernization of economic analysis of anticompetitive effects.

Yet the asymmetrical treatment – or non-treatment – of efficiencies within the 2010 Guidelines gives cause for concern. The Guidelines accrued substantial institutional credibility and capital with courts due to their economic sophistication and consistency in application. By updating the Guidelines' treatment of anticompetitive effects with new, more flexible theoretical grounds while ignoring relevant modern economic insights of efficiencies, the 2010 Guidelines threaten to give rise to a period of stilted economic analysis within proposed mergers. In light of dated Supreme Court precedent, this asymmetry could produce problematic results in merger analysis and enforcement policy, thereby undermining the earlier successes associated with the introduction and revision of the Horizontal Merger Guidelines. Few antitrust institutions represent such a clear improvement over pre-economic antitrust law as the Merger Guidelines; both the Guidelines' persuasive force as well as broader consumer welfare concerns require the symmetrical updating of efficiencies as well as anticompetitive effects, which in turn, facilitate economic consensus and judicial adoption. Merger law still reels from the last slew of case law unmoored from economic learning; scholars and practitioners alike should complete the mission of fully retiring the last of these cases before inviting new examples to the fore.