FEDERAL TRADE COMMISSION

STATEMENT OF FEDERAL TRADE COMMISSION

CONCERNING HORIZONTAL MERGERS

JUNE 14, 1982

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I. Background

The Federal Trade Commission ("Commission") and the Antitrust Division of the Department of Justice ("Antitrust Division") have been reexamining the legal and economic basis for horizontal merger policy. In light of enforcement experience and more recent economic research, the two agencies have both concluded that continued reliance on the Department of Justice's Merger Guidelines, promulgated in 1968 ("1968 Guidelines"), is no longer appropriate. In order to revise the 1968 Guidelines and incorporate new factors that are relevant to current horizontal merger analysis, the Commission and the Antitrust Division formed working groups of lawyers and economists to evaluate past experience under the 1968 Guidelines and to recommend specific modifications. The staffs of both agencies have worked closely in this endeavor. In addition to their research and analytical work, they have also solicited and carefully examined the views of the private bar, the academic and business communities, as well as the public at large.

The Commission is issuing this Statement to express its collective judgment of the reasons why it supports changes in the 1968 Guidelines and to highlight the principal considerations that will guide its horizontal merger enforcement. However, the Department of Justice's 1982 revisions to the 1968 Guidelines will be given considerable weight by the Commission and its staff in their evaluation of horizontal mergers and in the development of the Commission's overall approach to horizontal mergers. 1/

II. Market Share Considerations

Congress enacted section 7 of the Clayton Act to prevent the corporate accumulation of market power through mergers. 2/

1/ While the Commission supports the Department of Justice's decision to revise the 1968 Guidelines, individual Commissioners, however, may not endorse each specific revision that has been proposed.

2/ Clayton Act, Pub. L. No. 63-212, 38 Stat. 730 (1914) (codified at 15 U.S.C. § 18 (1976)).

The subsequent amendment to the Clayton Act, 3/ while primarily focusing on competitive considerations, 4/ also reflected Congress' concern about the overall social and political ramifications of economic concentration attributable to merger activity. 5/ Legal analysis of horizontal mergers, however, has focused on the extent to which these mergers confer market power on the acquiring firm or enhance the ability of firms to collude, either expressly or tacitly.

In measuring these market power effects, the courts, the Commission and the Antitrust Division have traditionally looked to market share data and derivative concentration ratios as the principal indicators of market power. Their reliance on such evidence was founded on early empirical economic literature indicating a significant positive relationship between concentration levels, industry performance and profits. 6/ In addition, market share data provided an easily ascertainable and relatively objective benchmark to evaluate the potential effects of horizontal mergers.

More recent empirical economic research 7/ and well over a decade of practical experience in analyzing and evaluating horizontal mergers, however, have led the Commission to conclude that proper consideration of market realities justifies some revision of market share benchmarks and greater consideration

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3/ Celler-Kefauver Act, Pub. L. No. 81-899, 64 Stat. 1125 (1950) (codified at 15 U.S.C. §§ 18, 21 (1976)).

4/ *See* IV P. Areeda & D. Turner, *Antitrust Law* 8-14 (1980).

5/ For a discussion of Congress' interest in the non-economic aspects of mergers, see Bok, "Section 7 of the Clayton Act and the Merging of Law and Economics," 74 *Harv. L. Rev.* 226, 233-49, 306-07 (1960). *See also* Pitofsky, "The Political Content of Antitrust," 127 *U. Pa. L. Rev.* 1051 (1979).

6/ *See* IV P. Areeda & D. Turner, *supra* note 4, at 52-54. For a discussion of the relevant literature, see generally Pautler, "A Review of the Economic Basis for Broad-Based Horizontal Merger Policy," Federal Trade Commission Staff Working Draft 18-27 (October 1981).

7/ *See* literature survey contained in Pautler, *supra* note 6, at 28-30, 61-74.

of evidence beyond mere market shares when such evidence is available and in a reliable form. Whether utilizing the Herfindahl-Hirschman index or other concentration measures, the Commission believes that an increase in the threshold market shares is clearly justified on at least three bases. First, current economic analysis suggests that the low combined market share thresholds contained in the 1968 Guidelines, e.g., 8 percent and 10 percent, are unlikely to contribute to oligopolistic behavior or market dominance. 8/ Second, the threshold levels in the 1968 Guidelines do not capture as fully as possible economies of scale achieved through merger. 9/ Third, the relationship between the number and relative size of firms in the relevant market was not taken into account in the 1968 Guidelines. Recent studies also suggest that poor market performance may be partly a function of firm size disparity. Thus, although far from definitive, this research suggests that particular attention should be given to disparity in market shares between the top one or two firms and the remaining firms in an industry. 10/

For these reasons, while the Commission will continue to look to market share data as an important indicium of the likely competitive effects of a merger, a more refined treatment of that data is in order.

III. Non-Market Share Considerations

Current statistical information helps to provide a good snapshot of an industry, but consideration of additional market characteristics, entry barriers being the major example, may provide a clearer and more accurate picture of the competitive dynamics of that industry. Such an inquiry may reveal whether any market power conferred by the merger is likely to persist

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8/ Id.

9/ See II P. Areeda & D. Turner, supra note 4, at 291-98; R. Posner, Antitrust Law 112-13 (1976); Fisher & Lande, "Efficiency Considerations in Merger Enforcement," 91 Yale L.J. _____, at Section III (1982)(forthcoming). In certain circumstances, an increase in threshold levels will enhance the ability of smaller firms to exit from the market, thereby facilitating entry. See Pillsbury Co., 93 F.T.C. 966, 1041-42 (1979).

10/ For a detailed discussion of this research, see Pautler, supra note 6, at 78-85.

over time and whether market conditions are conducive either to the exercise of individual firm market power or to collusive-type behavior.

The Commission recognizes, of course, that any type of market analysis, including reliance on market shares, inevitably carries with it an element of imprecision. For example, relevant evidence may be difficult to obtain or, where it is available, may be fragmentary and inconsistent. Further, evidence peculiarly within the control of the parties to the proceeding may be subject to bias and be difficult to verify. Nevertheless, the Commission believes that consideration of factors other than market shares, including qualitative factors, can be useful and desirable. If proper allowance is given to the evidentiary limitations, a balance can be struck that achieves the twin objectives of maintaining reasonable predictability in merger policy while enhancing the quality of the analysis and the correctness of the ultimate outcome.

The following discussion of non-market share factors will serve to define the scope of the merger inquiry and to prevent the analysis from becoming a limitless search for any evidence of possible relevance, since an open-ended examination may prevent the Commission and the courts from providing meaningful and timely guidance to business.

A. Market Power/Duration Factors

As we have noted, market share data can serve as an important preliminary surrogate measure of market power. For a variety of reasons, however, that indicator may not always accurately measure the market power of merging firms. The critical task, then, is to isolate and evaluate those additional factors that are also relevant to the assessment of market power effects.

(1) Marketwide Conditions

Ideally, if we could measure all relevant demand and supply elasticities, we could arrive at relatively precise estimates of market power. 11/ Such evidence, however, is rarely, if ever, available and is not readily susceptible to direct measurement. Therefore, other criteria must be utilized to determine the probable impact of a merger. The most probative criteria include: entry barriers; concentration trends (including the volatility of market shares); technological change; demand trends; and market definition. These factors are interrelated and primarily address industrywide conditions rather than firm-specific characteristics.

11/ Landes & Posner, "Market Power in Antitrust Cases," 94 Harv. L. Rev. 937, 939-43 (1981).

The issue of entry barriers is perhaps the most important qualitative factor, for if entry barriers are very low it is unlikely that market power, whether individually or collectively exercised, will persist for long. 12/ Conversely, if entry barriers are quite high, the effect may be to exacerbate any market power conferred by the merger. Of course, the evidence relating to entry barriers may not always point clearly to the conclusion that a merger should or should not be allowed. On the other hand, evidence of actual entry, especially recent and frequent new entry, is highly probative, as is evidence of failed entry or the absence of entry over long periods of time. Besides mere entry, effective competition might also depend upon a firm's achieving a certain scale of operation. Evidence of substantial expansion by firms already in an industry, especially non-dominant firms, may persuasively indicate that barriers to larger scale are not high. Conversely, evidence of frequent entry by fringe firms on a small scale, without significant expansion, may also suggest the existence of barriers to larger scale.

Market power also may be harder to exercise or less likely to endure in the face of rapid technological change or significant upward shifts in demand. Moreover, this kind of evidence may shed light on questions of market definition and the market's propensity towards collusive interdependence. New technology, for example, may signal that the market is being transformed and that traditional boundaries do not accurately measure the degree of product substitutability which actually exists. If these trends are strong, they are likely to result in new entry, declining concentration or unstable market shares. These issues are closely intertwined. Market share fluctuations may represent overt manifestations of underlying market forces and, as such, provide a very useful picture of market dynamics. Of course, like other evidence, the value of such data depends upon the magnitude and likely duration of the shifts that are occurring. Small deviations in market shares, even if they recur on a frequent basis, may be of little significance.

Additionally, the issue of market definition is relevant in determining whether market power exists and can be exercised successfully. The more carefully the lines are drawn, the more confidence can be placed in the predictive value of market share data; but market boundaries cannot always be drawn with

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12/ See F. Scherer, Industrial Market Structure and Economic Performance 5, 11, 236 (2d ed. 1980); G. Stigler, The Theory of Price 220-27 (3d ed. 1966); Demsetz, "Barriers to Entry," 72 Am. Econ. Rev. 47 (1982).

fine precision. Where the boundaries are highly blurred, it may be appropriate to take that fact into account, especially at the margin where the market shares are not particularly high. 13/

These factors are important in revealing whether the market shares overstate or understate the competitive impact of a merger. The weight to be assigned this evidence is a critical issue since, as noted above, it will often be impossible to make fine distinctions based on the quantity and quality of the non-statistical information. For instance, the fact that demand is increasing or new products are being introduced does not necessarily mean that the market share data should automatically be discounted by some factor. Rather, it is important to look at overall trends to see where the market is heading and at what rate.

Where all of the non-market share evidence consistently points in the same direction, its value will be high. Such evidence will be of even greater significance where the market shares are in the low to moderate range. On the other hand, if the anticompetitive potential of a merger is large, as predicted by the combined market shares of the merging parties, other non-market share factors may appropriately be given less weight, even if the adverse effects are relatively shortlived. To be sure, merger analysis properly focuses primarily on long-term competitive implications, but short-term effects should not be ignored, particularly if they are substantial.

(2) Firm-Specific Characteristics

So far, we have focused on marketwide conditions that may bear on the competitive effects of a merger. Factors peculiar to the merging parties can also be of relevance, although some caution should be exercised since this kind of evidence is harder to verify. 14/ The most important type of evidence relates to the failing company doctrine. However, it is frequently

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13/ See Coca-Cola Bottling Co., 93 F.T.C. 110 (1979); SKF Industries, Inc., 94 F.T.C. 6, 86-87 (1979).

14/ See United States v. General Dynamics Corp., 415 U.S. 486, 506-08 (1974); Kaiser Aluminum & Chem. Corp. v. F.T.C., 652 F.2d 1324, 1338-39 (7th Cir. 1981); Pillsbury Co., 93 F.T.C. 966, 1038-39 (1979).

argued by parties to a merger that financial weakness should be considered as a defense by the enforcement agencies. While not endorsing this approach in all its dimensions, 15/ the Commission does believe that evidence of individual firm performance can be of use in evaluating the probable effects of a merger, primarily if it indicates that a firm's market share overstates its competitive significance. For example, poor financial performance may accompany new entry or technological change, which itself may be evidence of the firm's declining competitive significance and its lack of prospects for future success or it may be indicative of other changes taking place in the market. 16/

Another issue related to individual company performance concerns the acquisition of firms with small market shares whose competitive potential is unique. 17/ Like the previous discussion, the issue here is not so much whether the firm is performing well *per se*, but whether its presence in the market is having some discernible impact on competition. For example, is the firm a disruptive force in an industry that is otherwise susceptible to oligopolistic behavior? Does it have a unique technological capability that can be capitalized to advantage? Obviously, these considerations have more force in markets that are highly concentrated and where the acquiring firm is one of the industry leaders. Thus, there may be situations where the market shares of acquired firms clearly understate their competitive significance. This kind of inquiry most likely will involve combined market shares above the Guidelines, but it could, on occasion, involve acquisitions where the combined market shares fall slightly below the triggering threshold levels.

15/ The courts and the Commission have held that evidence of poor financial performance alone is insufficient, as a matter of law, to sanction a merger. *See* United States v. General Dynamics Corp., 415 U.S. 486 (1974); Kaiser Aluminum & Chem. Corp. v. FTC, 652 F.2d 1324, 1338-39 (7th Cir. 1981); Pillsbury Co., 93 F.T.C. 966, 1036-39 (1979).

16/ *See* Pillsbury Co., 93 F.T.C. 966 (1979).

17/ *See* United States v. Aluminum Co. of America, 377 U.S. 271, 280-81 (1964); Stanley Works v. FTC, 469 F.2d 498 (2d Cir. 1972), *cert. denied*, 412 U.S. 928 (1973).

B. Factors Facilitating Collusion

In the preceding section, market conditions that may facilitate or hinder the exercise of market power were discussed. This section focuses on market characteristics that may enhance or detract from the ability of firms to collude or to raise prices and restrict output by interdependent behavior. Oligopolistic markets, or at least markets with few substantial firms, are more conducive to interdependent behavior than a market without such characteristics. However, the number and size of the firms may not reveal the full picture. Other factors may affect the relative ease or difficulty of achieving or maintaining interfirm coordination. Thus, the Commission believes that it is appropriate to take some account of these considerations, particularly at the pre-complaint stage. The most relevant factors appear to be: the homogeneity (or fungibility) of products in the market; the number of buyers (as well as sellers); the similarity of producers' costs; the history of interfirm behavior, including any evidence of previous price-fixing by the firms at issue; and the stability of market shares over time.

The Commission recognizes, of course, that knowledge of the dynamics of collusion or price coordination is far from complete. Moreover, in mergers where individual market power concerns predominate, issues of collusion will be of less importance. Nevertheless, some consideration of these issues should, at the very least, help the courts and enforcement agencies to sort out those cases where there appears to be little, if any, likelihood that an acquisition will contribute significantly to oligopolistic interdependence. Conversely, where the evidence of these factors points strongly in the opposite direction, we will want to examine a merger more closely, even if the market shares are relatively low.

IV. Efficiency Considerations

Mergers may enhance the efficiency of the combining firms in such diverse areas as management, distribution and production. The difficult issue is whether such efficiency gains should be considered, at least as a partial offset to the potential anti-competitive effects of a merger, given the inherent difficulty of accurately predicting and measuring certain efficiencies. 18/ Unlike the issues discussed previously, the question here is not whether efficiency considerations reduce or enhance the market power effects of a merger, but whether efficiencies should be treated as an independent countervailing factor in merger analysis.

18/ *See* IV P. Areeda & D. Turner, *supra* note 4, at 146-99; Fisher & Lande, *supra* note 9.

There are two ways in which merger guidelines might take efficiencies into account. One way is by raising the market share thresholds so that economies of scale generally can be realized to the fullest extent possible. The Commission supports an adjustment in the numerical criteria, in part, for this reason. Such an approach, however, may not account for all possible efficiencies. To accomplish the latter objective, an efficiencies defense could be allowed in individual cases. Of necessity, such a defense would require an assessment of both the magnitude of the efficiencies anticipated from the merger and the relative weight to accord this evidence vis-a-vis the potential market power effects of the merger.

To minimize measurement difficulties, it has been suggested that an efficiencies defense could be limited to measurable operating efficiencies, such as production or plant economies of scale. 19/ These efficiencies are also more likely to be of the kind that may eventually represent an improved state of the art available to all producers. 20/ While such evidence is appropriate for consideration by the agency in the exercise of its prosecutorial discretion at the pre-complaint stage, 21/ the Commission believes that there are too many analytical ambiguities associated with the issue of efficiencies to treat it as a legally cognizable defense. 22/ To the extent that efficiencies are considered by the Commission as a policy matter, the party or parties raising this issue must provide the Commission with substantial evidence that the resulting cost savings could not have been obtained without the merger and clearly outweigh any increase in market power.

19/ *See* IV Areeda & Turner, *supra* note 4, at 175-96. For a discussion of operating efficiencies and methods of proof, see Fisher & Lande, *supra* note 9, at Sections III(A), V(A); Muris, "The Efficiency Defense Under Section 7 of the Clayton Act," 30 *Case W. Res. L. Rev.* 381 (1980).

20/ Where efficiencies flow from factors peculiar to the merged firms, such as improved quality of management, their contribution to the economy as a whole is more problematic.

21/ This procedural approach has been suggested by Williamson, "Economies As An Antitrust Defense Revisited," 125 *U. Pa. L. Rev.* 699, 734-35 (1977), and by the Section 7 Clayton Act Committee Task Force of the American Bar Association Antitrust Section, "Proposed Revision to the Justice Department's Merger Guidelines" at 41 (1982).

22/ Chairman Miller disagrees with this conclusion and believes that scale-type efficiencies should be considered as part of the legal analysis, consistent with the statutory scheme underlying § 7 of the Clayton Act, see Muris, *supra* note 19.

V. Failing Company Defense and Related Arguments

The failing company defense recognizes a general preference for having assets productively utilized rather than withdrawn from a market. Whether assets will in fact be withdrawn is a difficult question and depends heavily on evidence under the control of the affected firm. For this reason, the failing company doctrine imposes rigorous requirements on firms seeking to invoke it. 23/ In addition, the restrictions contained in the doctrine reflect the fact that the defense is absolute, regardless of any increased market power accruing to the acquiring firm by virtue of its purchase of the failing company's assets.

Because of proof burdens and general competitive considerations, the suggestion has been made that the doctrine should be relaxed to allow greater latitude for a troubled company to sell its assets to the highest bidder. For example, the doctrine could be liberalized to allow for a failing division defense or to permit a sale to the least objectionable purchaser available, where the technical requirements relating to business failure are otherwise not met, but a substantial risk exists that operations will cease if a merger is not consummated.

An increasing number of mergers evaluated by the Commission involve diversified firms seeking to divest a division or subsidiary. To require subsidization of a division or continuation of unprofitable operations carries its own costs to competition, including diminished efficiency and innovation. Such a result encourages firms to make unsound investments and leads to the inefficient use of capital. 24/ The Commission's past reluctance to give legal status to a less-than-failing company defense stems from the difficulty of determining whether the costs of continued operation (until another acceptable purchaser, if any, is found) outweigh the market effects of the proposed merger.

23/ *See, e.g.*, United States v. General Dynamics Corp., 415 U.S. 486 (1974); United States v. Greater Buffalo Press, Inc., 402 U.S. 549, 555-56 (1971); Citizens Publishing Co. v. United States, 394 U.S. 131, 136-39 (1969); Pillsbury Co., 93 F.T.C. 966, 1031-33, 1036-39 (1979); Reichhold Chems., Inc., 91 F.T.C. 246, 288-91 (1978), *aff'd*, 598 F.2d 616 (4th Cir. 1979).

24/ Refusal to consider evidence of a failing division has been characterized as unfair in that it requires diversified firms "to absorb losses that independent companies can avoid, or to take risks which independent lenders would deem improvident." IV P. Areeda & D. Turner, *supra* note 4, at 112.

For example, with respect to the failing division argument, because of the potential facility to shift overhead and losses among divisions, an individual unit can be made to appear in worse fiscal condition by its parent than in fact is the case. 25/

In light of these considerations, the Commission will take into account evidence of a failing division or other similar evidence that falls short of the technical requirements of the failing company defense. However, due to the difficulties of proof, consideration of this evidence will be limited to the Commission's exercise of its prosecutorial discretion. 26/ With respect to any such analysis, the Commission will look closely at the following factors: the extent and history of a firm's financial difficulties; whether established accounting procedures have been followed; whether a good faith effort to find another purchaser for the firm or division has been made; and whether the proposed purchaser is the least anti-competitive purchaser willing to acquire the firm or division.

25/ *See* Dean Foods Co., 70 F.T.C. 1146, 1285 (1966); Farm Journal, Inc., 53 F.T.C. 26, 47-48 (1956). The lower courts, however, are clearly divided on the issue of the failing division. *Compare* FTC v. Great Lakes Chem. Corp., 1981-2 Trade Cas. (CCH) ¶ 64,175 at 73,592 (N.D. Ill., July 23, 1981); United States v. Reed Roller Bit Co., 274 F. Supp. 573, 584 n.1 (W.D. Okla. 1967); *and* United States v. Lever Bros. Co., 216 F. Supp. 887 (S.D.N.Y. 1963) *with* United States v. Blue Bell, Inc., 395 F. Supp. 538, 550 (M.D. Tenn. 1975) *and* United States v. Phillips Petroleum Co., 367 F. Supp. 1226, 1259-1260 (C.D. Cal. 1973), *aff'd per curiam*, 418 U.S. 906 (1974). For a discussion of the problems associated with accurately assessing failing division evidence, see generally *Conglomerate Mergers - Their Effects on Small Business and Local Communities: Hearings Before the Subcommittee on Antitrust and Restraint of Trade Activities Affecting Small Business of the House Committee on Small Business*, 96th Cong., 2d Sess. 49-57, 91-130, 368-435 (1980).

26/ Chairman Miller would permit evidence of a failing division to be raised as a legal defense in a merger proceeding.

VI. Market Definition

The predictive value of evidence concerning competitive effects is directly affected by the manner in which the relevant product and geographic markets are defined. Thus, issues of market definition are critically important to sound merger analysis.

A. Product Market

The purpose of product market analysis is to ascertain what grouping of products or services should be included in a single relevant market. Where the cross-elasticity of demand for separate products or services is high, they normally will be within the same product market. Similarly, a high cross-elasticity of supply tends to suggest the existence of a common product market. Therefore, the issue of whether related products or services place a significant constraint on the ability of merging firms to raise prices, limit supply or lower quality is central to evaluating the competitive effects of a horizontal merger.

Cross-elasticity of demand (or supply) is best measured by the change in the quantity of another product induced by a price rise in the merged firm's product, either over time or in different geographic markets. Since direct evidence of cross-elasticities is generally unavailable, the courts and enforcement agencies look to other, less direct market indicia. For example, the existence of separate product markets may be evidenced by: the persistence of sizeable price disparities for equivalent amounts of different products; the presence of sufficiently distinctive characteristics which render a product suitable only for a specialized use; the preference of a number of purchasers who traditionally use only a particular kind of product for a distinct use; or the judgment of purchasers or sellers as to whether products are in fact competitive. In addition, where firms routinely study the business decisions of other firms, including their pricing decisions, such evidence may reflect a single product market. These secondary indicia, however, will be closely scrutinized because of the inherently imprecise and sometimes self-serving nature of this type of evidence. Finally, investment, marketing and production plans may also evidence whether a firm may competitively enter into the production and sale of another good. Particularly where such information is detailed and provides the basis for a firm's decision, it will be considered in the product market analysis.

B. Geographic Market

This component of market definition focuses on the extent to which different geographic areas should be combined into a single relevant market. The issue is whether producers of the merged firm's product in other geographic areas place a significant constraint on the ability of the merged firm to raise price or restrict output. As a general proposition, an area is a separate geographic market if a change in the price of the product in that area does not, within a relevant period of time, induce substantial changes in the quantity of the product sold in other areas.

The Commission will consider the following factors relevant to this determination: the relationship between price and quantity (or, if evidence of such relationship is shown not to be available, evidence of independent price movement, collusive pricing or price discrimination within a single area); barriers to trade flows, e.g., high transportation costs, time required to make deliveries or municipal, state or federal regulation; and shipping patterns (absence of shipments, however, does not necessarily indicate separate geographic markets because, in some circumstances, a slight price rise in one area could precipitate shipments from other areas). Evidence of shipments may be particularly probative when it reflects long-held patterns of trade and industry perceptions.

An additional consideration relevant to geographic market definition concerns the extent to which foreign markets should be included in the analysis. There is increasing evidence that national boundaries may not fully reflect trade patterns or competitive realities in certain instances. At the same time, evidence relating to foreign markets may be very difficult to obtain. Nevertheless, while these limitations may preclude the delineation of larger-than-domestic markets, some consideration should be given to this issue in determining the competitive significance of domestic market share data.