Legal Times
WEEK OF FEBRUARY 18, 2008 • VOL. XXXI, NO. 7
ALM

Joint Inspection

Antitrust review of a Microsoft-Yahoo merger might go like this.

BY MATTHEW L. CANTOR AND MITCHELL L. STOLTZ

Whenever two large companies in a market with few players seek to merge, antitrust enforcers sit up and take notice. So when Microsoft Corp. proposed last month to buy Yahoo Inc., observers predicted an in-depth review of this joinder of household names.

Microsoft is offering more than $40 billion in cash and stock for Yahoo so that it can mount a stronger challenge against Google Inc. in the fast-growing field of online search-related advertising. Google is the undisputed market leader in the field, with Yahoo and Microsoft a distant second and third. Conventional wisdom says that, whether approved by Yahoo's board (which initially rejected Microsoft's bid) or its shareholders, the deal will be done.

When that deal is accepted, antitrust enforcers will step in to rigorously analyze whether a Microsoft-Yahoo merger would harm competition. If the deal is likely to reduce competition substantially, allowing the combined company to charge much higher prices and still make a profit, federal and/or state enforcers can sue to block completion of the deal.

Antitrust authorities will consider such key issues as market definition, market concentration, and network effects. Of course, the merging parties will have their own arguments pushing authorities to clear the transaction—or a court to override the regulators' recommendation.

WHY IT MATTERS

Last year, advertising on the Internet grew faster than any other segment of the advertising market, with revenues increasing by 20 percent over 2006. The market still has a lot of room to grow: According to the Yankee Group, the Internet now accounts for 20 percent of U.S. media consumption but only 7.5 percent of advertising dollars. As consumers spend more time online and less with traditional media, advertisers will move their spending to the Internet as well.

Perhaps the most important form of online advertising has been that associated with search engines. The idea began in 2001 with the company GoTo.com (later called Overture), which ranked search results based on an auction, with the highest-bidding advertisers receiving top placement.

Google, the current leader in Internet search technology, took a different tack in 2002 with its AdWords system. Google ranks search results based on "relevance," taking into account many factors, including the number of hits a page receives and how many other Web sites link to that page. Text-based ads are matched with and shown alongside these results. Users proved much more likely to click on such ads, which increased the value of the ads and drew more advertisers into Google's network.

Yahoo, long the most visited destination on the Internet, attempted to build up its own search-ad business by purchasing Overture for $1.4 billion, the search technology company Inktomi for $257 million, and last year the Right Media ad exchange for $680 million. Microsoft, for its part, paid $6 billion for advertising conglomerate aQuantive last year—the software giant's largest acquisition to date.

Notwithstanding both Yahoo's and Microsoft's willingness to spend big money to capture a larger share of the search advertising market, Google continues to dominate. The

© 2008 ALM Properties Inc. All rights reserved. This article is reprinted with permission from Legal Times
(1-800-933-4317 • LTsubscribe@alm.com • www.legaltimes.com).

Internet research service comScore Inc. reports that Google accounted for 58.4 percent of Internet searches in December 2007—some 5.6 billion searches. Yahoo followed with 22.9 percent of all searches, and Microsoft's MSN/Windows Live captured a mere 9.8 percent. Time Warner/AOL and the Ask.com network claimed just under 5 percent each.

LOOK AT THE MARKET

The first step in most merger analyses is defining the relevant market or markets. That is, in order to determine whether a particular merger could harm competition, antitrust enforcers must first identify all of the goods and services that are substitutes for the goods and services supplied by the merging parties. The more narrow the relevant market, i.e., the fewer reasonable substitutes there are for the products supplied by the merging parties, the more the proposed merger will worry antitrust enforcers.

For the Microsoft-Yahoo deal, the most important market is probably Internet search engines. The ability to quickly find information is indispensable to most Internet users—it is hard to imagine the Internet today without fast and accurate search engines. Powerful search tools are what make search-related advertising a lucrative segment of the Internet advertising field.

There do not appear to be any goods or services that could serve as a substitute for online search engines. In addition, as Internet searches permit advertisers to reach consumers in a very targeted fashion, it seems unlikely that other forms of advertising media can constrain the prices charged for search ads. It was for these reasons that the Federal Trade Commission defined a market in search-related advertising in its (ultimately positive) review of the Google-DoubleClick transaction last year. It is likely that the Justice Department's Antitrust Division, which will probably conduct the Microsoft-Yahoo merger review, would also identify this market as relevant.

Having defined the relevant market, enforcers then ask whether a merger has the potential to create anti-competitive effects within that market, such as higher prices, reduced outputs, or declines in quality. To determine whether anti-competitive effects are likely, enforcers consider whether the defined market will become significantly more concentrated among fewer competitors.

According to data from comScore, five search providers—Google, Yahoo, Microsoft, Time Warner/AOL, and Ask.com—together received 94.7 percent of all search queries in December 2007. A combined Microsoft-Yahoo entity would account for about 32.7 percent of the search market while Google would continue to account for 58.4 percent. In other words, just two entities would control more than 90 percent of the market. At that level of concentration, antitrust enforcers are likely to presume anti-competitive effects.

RIVALS TO COME?

Next, enforcers seek to determine whether the presumption of anti-competitive effects can be rebutted. If it can be sufficiently rebutted, the authorities will likely clear the transaction—that is, inform the parties that they will not sue to stop the merger.

To judge those anti-competitive effects, enforcers analyze whether potential competitors are likely to enter the market, thereby offsetting the enhanced market power accrued by the merging parties. If it would be easy for companies that do not currently offer search advertising to start offering it—particularly if Microsoft-Yahoo raised prices—then the loss of Yahoo as an independent competitor is not likely to harm consumers.

In the search advertising market, however, the phenomenon of network effects—where a service becomes more valuable to users, the more users it has—may create high barriers to entry for a start-up search engine. A new company trying to offer Internet search-based advertising could be caught in a bind: It would have to attract a significant number of users running searches before advertisers would want to sign on; at the same time it would have to attract a number of advertisers in order to make its search technology attractive to consumers seeking goods or services on the Internet.

But an existing Internet publisher that already reaches a large group of people might be able to create a search engine and encourage many of its existing customers to use it, quickly generating scale and overcoming the problems of starting from scratch. A popular media property, such as Time Warner/AOL or MySpace, or a major Internet service provider, such as Comcast, might be able to do this.

For the possibility of new entrants to overcome the presumption of anti-competitive effects, that entry must be timely (within two years of consummation of the merger), likely, and sufficient in magnitude. In the Microsoft-Yahoo case, data would be needed to prove that other competitors could easily offer search services and would have the economic wherewithal to do so, particularly if either Google or the merging parties attempted to raise advertising rates.

These two merging parties would also assuredly argue that the proposed combination offers pro-competitive effects to counterbalance any adverse effects from the creation of a highly concentrated market, even if the market is characterized by high barriers to entry. In particular, as Microsoft CEO Steven Ballmer stated in his Jan. 31 letter to Yahoo's board of directors, the parties can argue that the merger helps offset the dominance of Google—in search ads and elsewhere.

This "defense against giants" argument would be even stronger if the merging parties could show that, absent the proposed deal, the power of network effects threatens to "tip" the market toward a single Google standard for Internet search. Therefore, the argument would go, the merger is needed to protect consumers and advertisers against a monopoly being formed through such market tipping. The parties would contend that by increasing their scale through merger, they could offer more robust competition and reduce the possibility of this tipping.

TOUGHER JUDGING

That's how the U.S. review would likely proceed. But scrutiny of a Microsoft-Yahoo merger would not end at the

© 2008 ALM Properties Inc. All rights reserved. This article is reprinted with permission from Legal Times
(1-800-933-4317 • LTsubscribe@alm.com • www.legaltimes.com).

American border. Having a global reach means facing regulators outside the United States as well.

A Microsoft-Yahoo merger would face a serious challenge in Europe. In recent years, the European Commission's competition authorities have proved to be more aggressive than U.S. antitrust enforcers in analyzing transactions and business practices that affect personal computing and the Internet. Indeed, they are still scrutinizing the Google-DoubleClick transaction even though the FTC cleared it several weeks ago.

A Democratic presidential administration in the United States may also bring a mandate for stronger antitrust enforcement and tougher oversight of big mergers. Moreover, Microsoft has a history of violating antitrust precepts and therefore would be held to higher levels of scrutiny than companies that lack such a record.

But Microsoft's reputation among antitrust authorities is not the main reason that its proposed merger with Yahoo would receive very close analysis. The combination of two major Internet players raises serious questions about what is best for consumers. The outcome of antitrust review may very well determine how Internet commerce develops for years to come.

Matthew L. Cantor is a partner and Mitchell L. Stoltz is an associate at Constantine Cannon, practicing in the New York and D.C. offices, respectively. The firm specializes in antitrust litigation and counseling.

© 2008 ALM Properties Inc. All rights reserved. This article is reprinted with permission from Legal Times
(1-800-933-4317 • LTsubscribe@alm.com • www.legaltimes.com).