Will Your Merger Pass Regulatory Muster?

by Gordon Schnell

As the merger and acquisition market regains some heat, boards will have to consider how a potential deal will look to federal regulators. Though there are often surprises in store, Gordon Schnell notes that the FTC and DOJ have left a clear paper trail on what they like (and dislike) in a proposed merger. The wise board will examine these clues in advance.

The question of whether a proposed merger of two competitors is vulnerable to regulatory challenge can be quite a mystery. Even antitrust lawyers who are specially trained in the niceties of merger review law are routinely befuddled by the decisions of the agencies to attack (or not attack) certain mergers. Further, there is often disagreement within the agencies themselves as to whether a particular merger should be blocked. Three-to-two votes among the five commissioners of the Federal Trade Commission (FTC) on whether to challenge a merger are commonplace. Likewise, recommendations by Department of Justice (DOJ) staff attorneys tasked with reviewing proposed mergers are routinely rejected by their superiors.

So what is a company to do when evaluating whether, from an antitrust perspective, a proposed merger is going to fly? Avoiding regulatory scrutiny is not an option. Under the Hart-Scott-Rodino (HSR) Act, the FTC or DOJ will review in advance of closing virtually all mergers and acquisitions involving at least $50 million worth of assets or voting securities. A transaction that is reportable under the HSR Act may not close until the merging parties have satisfied all of their HSR reporting obligations and the applicable waiting periods have expired. This gives the government plenty of time to probe the competitive implications of your merger.

Even those transactions that escape HSR review will not necessarily elude the watchful eye of the agencies. The government has made it clear that it has the power (and in several instances has actually used that power) to go after mergers too small to qualify for HSR coverage. In addition to their own due diligence, the reviewing agencies can count on a steady stream of complaints from customers and competitors of the merging parties to alert them to potential problems with the deal.

If your proposed merger has an antitrust risk, prepare to deal with it early on, before spending time, money, and public goodwill. The deal may not be worth the trouble.

Thus, if your proposed merger has an antitrust risk, accept that you are going to have to deal with it. And, it is better to deal with it early on—before the company spends a huge amount of time, money, resources, and public goodwill on a transaction heading for a regulatory showdown. The deal just might not be worth all that trouble.

Fortunately, predicting the likelihood of a regulatory challenge, though full of uncertainty, is not completely futile. This is due in large part to the government's own efforts to make its merger review policy more transparent to the outside world. Through its publication of the *Merger Guidelines,* the government has attempted to highlight the principal concerns it has and issues it considers when evaluating mergers between competitors.

The government has also just released historical data from merger investigations it has conducted over the years. These provide some additional insight into the types of mergers it finds most problematic. While the guidelines and merger data fall far short of

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completely solving the great merger review mystery, they do shed some much needed light on the process. Here is what you need to consider.

☐ *Market power.* In reviewing mergers, the ultimate concern of the regulators is market power, the great bogeyman of competition. Market power is the ability to raise price, lower output, or restrict product quality or innovation, without harming profitability. If a merger will enable a company to obtain market power, enhance the market power it already has, or help it exercise market power (either alone or with its remaining competitors), the government is going to have a problem with it.

Not that there is anything inherently illegal about having market power, or even monopoly power for that matter. On the contrary, the potential for obtaining such power (with its ability to charge higher prices) is what drives healthy competition. The courts have been clear that efforts to attain or maintain market power based on superior skill, foresight, and legitimate competition are to be rewarded, not chastened. It is the efforts that involve illegitimate means—such as group boycotts, market allocations, exclusive dealings, tying arrangements, and the like—which the antitrust laws were designed to curb.

Securing market power through a merger falls into this latter category of proscribed conduct. This is not because it guarantees an anticompetitive result, but because it makes such a result more likely. Section 7 of the Clayton Act, the antitrust statute that governs merger review, is an incipiency statute. It deals with preventing *future* competitive harm, not remedying that which has already occurred. It deals with probabilities, not certainties. With respect to mergers that lead to or further entrench market power, there is an increased probability that competition will be lessened and anticompetitive harm will follow.

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So, the ultimate test for the merging parties is to convince the government that their merger will not lead to market power. One way to do this is to show that remaining market forces will constrain any ability of the merged entity to control price or output. Even better would be to show that the merger will actually increase competition by enabling the merged entity to lower prices and increase output, or otherwise better compete against more dominant competitors.

☐ *Relevant market.* The first question in the government's analysis is: What relevant market or markets are affected by the merger? This can be the most important question in the government's inquiry. It ultimately sets the boundaries of its review. Countless merger challenges have been won or lost based solely on the issue of market definition.

Undoubtedly, the merging parties want to define the relevant markets in which they both compete as broadly as possible. The broader the market, the more choices there are for consumers, the less impact a merger will have on those choices, and the less likely the merger will lead to market power. On the other hand, the government will take a more narrow view of the relevant market so that any possibility of anticompetitive harm can be fully explored.

The measure for evaluating the contours of a relevant market is so-called "demand substitution"—what consumers view as reasonable product substitutes. The test for determining whether two products are in the same market is whether they can be used for the same purpose, and if so, the extent to which purchasers are willing to substitute one for the other.

The surest way to answer this question is to look at how consumers respond to price increases. If a price increase in one product results in significant consumer substitution to a different product, then the two products will likely be part of the same market. While the specifics of this price increase test will vary from industry to industry, as a general rule, the government will consider a five percent price increase lasting about a year.

There are *product* and *geographic* dimensions to this analysis. The product dimension considers the actual products that consumers view as reasonably interchangeable. The geographic dimension considers the geographic area to which consumers can practically turn for alternative sources. The relevant market question can only be answered when both of these dimensions are considered together.

It is important to recognize in all of this that no market is too small, obscure, or seemingly insignificant for the government to care about. Whether it is a market for jarred baby food; office product superstores; rum; premium ice-cream; nitrous oxide; dry cat food or even (one of my favorites) the retail sale of food and grocery items in supermarkets in or near the towns of Milledgeville and Sandersville, Georgia—to name just a few recent agency challenges—the government is going to go after proposed mergers that it believes will ultimately lead to market power and thus likely result in anticompetitive harm.

☐ *Market concentration.* Once the relevant market is determined, the threshold inquiry in the government's market power evaluation is market concentration. Who are the principal players in the market, what are their shares, and how will it all change if the merger proceeds? Market concentration is a useful surrogate for predicting market power and something on which the government heavily relies. For most mergers, this measure alone will dictate how the government will likely proceed.

The government uses the Herfindahl-Hirschman Index (HHI) to measure market concentration. The HHI is calculated by totaling the squares of the market shares of every company in the relevant market. For example, a market consisting of four companies with market shares of 30 percent, 30 percent, 20 percent, and 20 percent has an HHI of 2600 (900 + 900 + 400 + 400). The HHI ranges from 10,000 (in the case of a pure monopoly) to a number in the low hundreds for the most competitively crowded markets.

By giving greater weight to companies with the largest market shares, the HHI attempts to spotlight those markets with the greatest likelihood for competitive mischief.

The HHI is particularly useful in predicting the likelihood of a regulatory challenge because the government has established a number of HHI "safe harbors" which effectively immunize many proposed mergers from agency attack. For example, the government has declared that mergers that would result in post-merger HHIs below 1000 (called "unconcentrated" markets) are unlikely to have adverse competitive effects and typically require no further analysis.

The government has created similar safe harbors for mergers resulting in post-merger HHIs between 1000 and 1800 ("moderately" concentrated markets) if the merger would result in an HHI increase of less than 100; and over 1800 ("highly" concentrated markets) if the HHI increase would be less than 50.

In practice, these safe harbors are typically even broader. The government's data reveals that the vast majority of mergers it challenges involve post-merger HHIs of over 2400, HHI increases of over 300, or markets which will be left with four or fewer competitors.

The government will never challenge a merger based on numbers alone. These are only the starting point for a broader inquiry.

Keep in mind, however, that the government's calculation of HHIs is by no means rigid. Nor is its application of any regulatory safe harbors. The government will treat very differently (and more carefully) proposed mergers with a *potential* impact not reflected in HHI calculations. Mergers leading to vertical (as opposed to horizontal) consolidation, buyer (as opposed to seller) power, the elimination of potential competition, and partial ownership or control of key assets or businesses, all fall into this special category.

For most mergers, however, the straight HHI calculation can separate those mergers in which the government will have little or no interest from those which will draw a closer look. For those that cross this HHI threshold of concern, the government will launch a *comprehensive* review of the likely competitive effects of the proposed merger. This is because the government will never challenge a merger based on HHI numbers alone. As the Supreme Court has repeatedly cautioned, statistics reflecting market shares and concentration levels, while of great significance, are not conclusive indicators of anticompetitive effects. They are only a starting point for a broader inquiry into future competitiveness.

☐ *Competitive effects.* The "competitive effects" inquiry goes well beyond market shares and HHIs, which only provide indirect evidence of market power. The government will also consider the structure, history, and probable future of the relevant markets at issue. All of these provide more direct evidence of the likely competitive outcome of a proposed merger.

For example, the government will consider flaws in the industry's reporting structure and changing market conditions that might undercut the competitive reality of the calculated market shares. Market share information is not always a reliable indicator of market power, or may be based on inaccurate underlying data. It may also be misleading because of volatile or shifting market conditions. Straight HHIs, which are a snapshot of present shares based on industry reported data, cannot account for these variables. The government will therefore want to look behind the data to test its reliability as an effective measure of market power.

The government will also want to take a close look at the level of existing competition between the merging parties. Evidence that the two companies compete for the same customers, are constrained by each other's pricing practices, and are the object of each other's business strategies will weigh heavily in whether to challenge the proposed merger. So will the make-up of the parties' customers, their level of strength and sophistication, and their relative power to insist on competitive terms and pricing.

Another factor the government may look to is the market's historic concentration levels and whether there has been any trend towards consolidation. The government will pay particularly close attention to previous acquisitions in the same market made by either of the merging parties and how the parties behaved post-acquisition. The government will similarly probe any evidence of high pricing, excess profit, poor quality, or hampered innovation in the industry as a gauge of the industry's competitive health and its ability to withstand or constrain anticompetitive conduct within.

The government will also consider the likelihood of collusion among the remaining competitors in the post-merger world. The government's concern with market power is not limited to a single company asserting such power unilaterally. It applies with equal measure to a group of companies asserting such power collectively through coordinated action.

If a merger will significantly increase the likelihood that remaining companies in the market will coordinate their behavior, either by overt or tacit understanding, the government will try to block it. The principal elements that make a market conducive to coordination include product and firm homogeneity, standardized or publicly disclosed pricing, open information about rivals' businesses, a general stability in demand and costs, small and unsophisticated purchasers, and a history of collusion in the market.

The threat of potential competition from new entrants into the market operates as a significant check on a company's exercise of market power. Therefore, the government will also evaluate the ease with which a new company could enter the market in response to increased prices or reduced output. If such entry would be timely (within two years), likely (profitability could be reached at premerger prices), and sufficient to counteract any anticompetitive effects about which the government is concerned, the deal will in almost all cases get the government's blessing. If, on the other hand, there are significant entry barriers rendering such entry improbable, the government will take a strict and cautious approach in its competitive effects analysis.

The government has made clear that increased efficiency will count in favor of a merger. However, these efficiencies are very hard to prove, and regulators are wary of them.

☐ *Efficiencies.* The only possible escape hatch for a merger that otherwise fails the government's competitive effects test is the efficiencies defense. That is, the synergies resulting from the combination will actually increase competition—lowering prices, raising output, and increasing quality and innovation.

While efficiencies may not fully outweigh a finding of anticompetitive effects (and no court has ever found that it has), the government has made it clear that efficiencies do count. The only catch is that they must be merger-specific. This means that only the merger (and nothing less restrictive of competition such as a joint venture or co-marketing arrangement) can accomplish the claimed efficiencies.

The problem with this defense (and the reason why it has not met with much success) is that efficiencies are extremely difficult to verify or quantify in any meaningful way. What sounds good on paper may never actually materialize. Even if there is a good chance that they will, there is no guarantee that the resulting benefits and cost savings will be passed on to consumers. The government is particularly wary of efficiency arguments because the information needed to substantiate them is uniquely in the hands of the merging parties. There is little room for an independent check by the government.

Still, efficiencies will be part of the government's analysis. The agencies are going to want to know about them, and the merging parties are going to want to disclose them. Some claimed efficiencies (like cost savings from consolidation of production and distribution; or better ability to compete against the dominant player) are going to carry more weight than others (like elimination of duplicate management functions; or shared research and development). While it is unlikely that efficiencies by themselves will ever carry the day, they may turn out to be very useful in tipping the balance for the close calls.

☐ *The X-factors: hot documents and customer complaints.* Two final factors the government will consider in all of this (and which by themselves are often the driving force behind the government's decision to take action against a merger), are the existence of any "hot documents" or customer complaints.

A hot document is one from a party to the merger (typically the buyer) that predicts, or more likely boasts about, some adverse effect on competition resulting from the merger. It most often comes in the form of an analysis prepared for the board or senior management explaining how the merger will enable the buyer to raise price, control output, squelch innovation, skimp on quality, or gain some form of market leverage. Once created, there is nothing a company can (or should) do to bury it, and the agencies have seriously punished those that have tried.

Customer complaints can be even more damaging to your chances of avoiding a regulatory rumble. The government relies heavily on how customers view the deal. This is not surprising given the proposed merger's impact on consumers is the ultimate concern of the government's review. Moreover, the views of customers (unlike competitors) are inherently reliable as a measure of likely anticompetitive effects. The government not only welcomes input from customers, it actively solicits it. Following the initial HSR filing, the agencies routinely request a list of the parties' top ten customers and call them directly for their views on the proposed deal.

The significance of these two X-factors was underscored in the government's recently released merger data. Hot documents and customer complaints (in addition to market concentration and number of post-merger players) were the only criteria the agency used in tabulating its recent enforcement decisions.

Not surprisingly, the agency's findings reveal that the presence of hot documents or customer complaints markedly increases the chances of a regulatory challenge. That is why it is so important for the merging parties to be extremely careful in the premerger analyses they prepare (perhaps using antitrust counsel as a screen before final dissemination of the documents), and to reach out to their customers before the government does to secure their support for the deal.

At the end of the day, predicting whether or not your merger will ultimately pass regulatory muster may still come down to a coin toss. Thanks to the efforts of the agencies in making their review process a little more open, the odds of getting it right have become a lot higher. So, if you think your proposed deal might have an antitrust problem, give it the proper regulatory check-up. It may just save you a whole lot of trouble for which you never bargained. ■