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# ANTITRUST LITIGATOR



## THE SUPREME COURT'S RENEWED INTEREST IN ANTITRUST AND INTELLECTUAL PROPERTY LAW

BY: JAMES C. HO\*

**M**y first observation is that this is not just a new court – it is also a newly polarized court. It's often said that a new justice means a new court. That is doubly true here. But although our new Chief enjoyed somewhat of a honeymoon period during October Term 2005, that appears to have ended this Term. More than a third of the 67 signed decisions issued this Term were decided by a 5-4 vote – a greater rate of division than in any recent term.

Moreover, the battle lines on the Court have hardened. Of the 23 cases decided by a 5-4 vote, 19 of them fell along traditional coalition lines. Remarkably, Justice Kennedy enjoyed a perfect 23 for 23 record in cases decided on a 5-4 vote.

Even Justice O'Connor never enjoyed such a perfect record during her 24 years on the Court. And of 67 signed opinions this Term, Justice Kennedy was on the winning side in all but 2.

The second observation I would like to make is about our two new justices and how they are relating to their new colleagues. In particular, I want to note their approach to precedent.

On the one hand, the two new justices are generally voting on the same side as Justices Scalia and Thomas. That itself is, of course, a noteworthy development. In particular, the replacement of Justice O'Connor with Justice Alito has already

*(cont'd on p. 25)*

## THE "PASS-ON" DEFENSE IN INDIRECT PURCHASER ACTIONS UNDER STATE ANTITRUST LAWS

BY: DAVID G. MEYER\*



### 1. The Background: The United States Supreme Court Decisions In *Hanover Shoe* and *Illinois Brick*

**S**ection 4 of the Clayton Act permits treble-damages actions by any plaintiff who has been "injured in [their] business or property by reason of anything forbidden in the antitrust laws...." 15 U.S.C. §15(a). One typical category of potential plaintiffs consists of those who claim to have paid higher prices as a result of a defendant's violation. For example, a manufacturer who has paid a higher price for materials purchased from a supplier because of the supplier's participation in a price fixing conspiracy is an injured consumer and a classic antitrust plaintiff.

But what about the manufacturer's customer? If the manufacturer paid more for the materials it purchased from the conspirator/supplier as a result of the conspiracy, the manufacturer may have included those costs in its own pricing and passed on some or all of the conspirator's price increase to its own customers. Depending upon the nature of the industry in which the price-fixing occurred, numerous levels of distribution might be affected by the supracompetitive prices of the antitrust violator, culminating with the ultimate consumer who buys a finished product from a retail store. How many of these potentially injured parties may sue?

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## SECTION 7 OF THE CLAYTON ACT

BY: BRADLEY C. WEBER \*



In the past two issues of *The Antitrust Litigator* we discussed two of the four main pillars of the antitrust laws: Section 1 of the Sherman Act prohibiting agreements in restraint of trade, and Section 2 of the Sherman Act prohibiting unilateral attempts to create or maintain a monopoly. In this issue we continue our examination of the fundamental antitrust laws by focusing on the third major pillar – Section 7 of the Clayton Act.

### 1. Overview

Business transactions involving acquisitions of stock, assets, or partnership interests can have potentially harmful effects on consumers by creating or enhancing market power – i.e., the power to restrain output and raise prices above competitive levels for a significant time, thereby harming consumer welfare.<sup>1</sup> A merger or acquisition can create or enhance market power by increasing concentration in the relevant product and geographic market. This increase in concentration may permit a firm to unilaterally maintain a selling price above the level (or in the case of a purchaser, a buying price below the level) that would prevail in a more competitive market. Consequently, the primary focus in analyzing mergers and acquisitions under the antitrust laws is the creation or enhancement of market power.

The competitive effects of mergers and acquisitions are principally governed by Section 7 of the Clayton Act (“Section 7”), which prohibits such transactions “where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.”<sup>2</sup> Section 7 may be enforced through actions brought by the Federal Trade Commission (“FTC”), the Antitrust Division of the United States Department of Justice (“Antitrust

Division”), state attorneys general, and private plaintiffs.<sup>3</sup> In addition, when the FTC challenges a merger or acquisition, it usually asserts an additional violation of Section 5 of the Federal Trade Commission Act, which prohibits “unfair methods of competition in or affecting commerce.”<sup>4</sup> These types of transactions may likewise be challenged as unreasonable restraints of trade or as monopolization or attempted monopolization under Sections 1 or 2 of the Sherman Act.<sup>5</sup>

Over the years Section 7 has been extended by amendments to cover asset acquisitions, acquisitions by or from individuals and partnerships, and firms engaged “in any activity affecting commerce.”

The vast majority of mergers and acquisitions reviewed by the Antitrust Division and FTC are subject to the reporting requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (“H-S-R Act”).<sup>6</sup> As discussed in more detail below, the H-S-R Act requires certain waiting periods to expire before the parties involved in the transaction may consummate the deal so that the government agencies may examine the implications of those mergers that pose competitive concerns. In addition, the federal agencies are permitted to review transactions outside the H-S-R context and after the transaction has been consummated.

Over the years, the courts and regulatory agencies have developed and refined certain tests and criteria for analyzing the competitive impact of a given transaction. This process involves defining the relevant market, identifying the market participants, determining market concentration resulting from the merger, and predicting the likely competitive effects of the increase in market concentration resulting from the merger. This article also examines some of these tests and criteria for enforcing Section 7’s prohibition of transactions that may substantially lessen competition.

### 2. Scope of Chapter 7

When it was originally enacted in 1914, Section 7 applied only to stock acquisitions by corporations, where both corporations were engaged in interstate commerce. Over the years Section 7 has been extended by amendments to cover (a) asset acquisitions, (b) acquisitions by or from individuals and partnerships, and (c) firms engaged “in any activity affecting commerce.” Courts have also applied Section 7 to transactions involving non-profit entities.<sup>7</sup>

Section 7 applies not only to acquisitions of all voting stock in a corporation, but also to partial stock acquisitions. As a practical matter, however, partial stock acquisitions have generally been found to violate Section 7 only where the acquiring company would have a sufficient percentage of stock to obtain representation on the board of directors of the acquired company,<sup>8</sup> or where it was determined that the purpose of the acquisition was to eventually gain control.<sup>9</sup> Courts have not developed a bright line test regarding the percentage of stock that must be acquired to create a presumption of intent to influence or gain control. Generally, however, partial acquisitions that were found to violate Section 7 have involved acquisitions of at least 15 percent of the stock in the

acquired company.<sup>10</sup>

Stock acquisitions made “solely for investment” are excluded from the scope of Section 7.<sup>11</sup> Courts that have construed this exception generally look at whether the acquisition was part of an effort to obtain control. This issue is typically determined by focusing on the intent or capacity of the “passive investor” to obtain control. Evidence of the investor’s intent can include the commercial circumstances surrounding the transaction and the historical behavior of the investor. In situations where direct influence over the acquired company’s operations is prevented by a consent order<sup>12</sup> or shareholder’s agreement,<sup>13</sup> the “solely for investment” defense is more likely to succeed.

A potential transaction that has received recent attention because of the involvement of a “passive investor” is the acquisition of Midwest Air Group, Inc. (the operator of Midwest Airlines and regional carrier Midwest Connect)

The purpose of the H-S-R Act is to facilitate prompt, thorough investigations of acquisitions and to provide the agencies with the opportunity to seek a preliminary injunction if necessary to block mergers or acquisitions that may tend to substantially lessen competition.

by a private equity firm, TPG Capital. This transaction has been delayed and is under scrutiny by the Antitrust Division because a passive investor, Northwest Airlines Corp., would acquire nearly 47 percent of Midwest’s shares under the deal, while TPG would acquire the remaining 53 percent.

According to Northwest, its investment would not carry with it any right to participate in the management or control of Midwest. That alone, however, may not exempt the transaction from the scope of Section 7. Northwest and Midwest compete against each other at a number of airports. For example, at Milwaukee’s Mitchell International Airport, Midwest is the dominant carrier with a 57 percent market share, while Northwest is the second-largest carrier with a 13 percent market share. Combined, the two rival carriers would have a 70 percent market share at the Milwaukee airport. The commercial circumstances surrounding the transaction could be enough to convince a court that the transaction is not exempt under Section 7 because Northwest’s investment was part of an effort to obtain control of Midwest.

In addition to stock acquisitions, Section 7 applies to acquisitions of many kinds of assets, including patents,<sup>14</sup> trademarks,<sup>15</sup> leases,<sup>16</sup> and licenses.<sup>17</sup> Section 7 can also apply to transactions where a party acquires control of or influence over another party’s decision making powers.<sup>18</sup> Certain types of joint ventures between actual or potential competitors are also subject to Section 7.

Section 7 applies to horizontal and non-horizontal mergers.<sup>19</sup> Some mergers have both horizontal and vertical aspects. Government enforcement efforts during the 1980’s and 1990’s were focused on horizontal transactions. In recent years, however, increased attention has been directed to the competitive effects of vertical transactions and transactions between potential competitors.

By its express terms, Section 7 is applicable only to persons *acquiring* stock or assets from another.<sup>20</sup> Claims brought against only the sellers of stock or assets have consistently been dismissed because they do not fall within the scope of Section 7.<sup>21</sup> Courts have recognized, however, that sellers may be joined in a Section 7 action against a purchaser when the plaintiff, usually the FTC or Antitrust Division, seeks equitable relief and the court needs jurisdiction over both the buying and

selling parties.

### 3. Enforcement Mechanisms

The United States government enforces Section 7 through two federal agencies – the Antitrust Division and the FTC. These agencies’ enforcement powers are aided by the H-S-R Act,<sup>22</sup> which sets forth the rules for reportable transactions (i.e., those rules for which a pre-merger notification must be filed with the FTC and Antitrust Division). The purpose of the H-S-R Act is to facilitate prompt, thorough investigations of acquisitions and to provide the agencies with the opportunity to seek a preliminary injunction if necessary to block mergers or acquisitions that may tend to substantially lessen competition. The FTC is the agency principally responsible for enforcing the H-S-R reporting process.

#### a. H-S-R Reporting Rules

An acquisition or merger is reportable, and a mandatory post-filing waiting period (typically 30 days) must be observed before the transaction may close, if certain jurisdictional criteria are met and no exemptions apply. The three-part preliminary test that a transaction must satisfy to be reportable consists of: (i) the in-commerce test, (ii) the size-of-the-transaction test, and (iii) the size-of-the-parties test.

##### (i) The Preliminary Threshold Tests

The in-commerce test requires that either the acquiring entity or the acquired entity be engaged in interstate or foreign commerce or in an activity that affects interstate or foreign commerce. This test is easily met in most transactions.

The size-of-the-transaction test is met if the acquiring entity will hold voting securities or assets of the acquired entity valued in the aggregate at more than \$50 million, as adjusted annually for changes in the Gross National Product.<sup>23</sup> The size of the transaction is determined based on the value of the total (aggregate) assets or voting securities of the acquired entity that the acquiring entity will hold, rather than just the incremental value of the additional assets

or voting securities if the acquiring entity already owns a part of the acquired entity. The value of the assets is the greater of fair market value or acquisition price, and valuation includes the assumption of liabilities. With regard to publicly-traded voting securities, the value is the greater of the market price or the acquisition price.

Acquisitions of voting securities or assets valued in excess of \$200 million, as adjusted annually,<sup>24</sup> are reportable regardless of the size of the parties involved in the transaction. For those mergers and acquisitions valued up to \$200 million, as adjusted, the size of the involved parties is also considered in determining whether the transaction is reportable. Under the size-of-the-parties test, one of the parties must have at least \$100 million, as adjusted, in total worldwide assets or annual net sales and the other party must have at least \$10 million, as adjusted, in total worldwide assets or annual net sales. The holdings of all entities controlled by the party are included for the purposes of determining whether the size-of-the-parties test has been met. Total worldwide assets are determined by the parties' last regularly prepared balance sheets, and annual net sales are determined by the parties' annual income statements.

### *(ii) Exemptions*

Transactions that meet the in-commerce, size-of-the-transaction, and size-of-the-parties tests must be reported to the FTC and Antitrust Division unless they fall into one of several exempt categories. Exemptions include: (a) acquisitions of goods and realty in the regular course of business; (b) certain acquisitions of real property; (c) acquisitions of voting securities where the acquiring entity already owns at least 50 percent of the voting securities of the acquired entity; (d) passive investments of 10 percent or less of an acquired entity's voting securities; (e) acquisitions of non-voting securities; and (f) acquisitions requiring approval of certain other federal agencies. A full list of the H-S-R exemptions, along with the regulations governing those exemptions, is contained in 16 C.F.R. § 802.

### *(iii) Filing Requirements*

Parties involved with transactions that meet the threshold tests and do not fall under any of the exemptions must file a notification and report form with both antitrust agencies. The form requires detailed information about the merger or acquisition, including a description of the transaction, financial information about the parties, and affidavits certifying the parties' good faith intention to complete the transaction. The form also requires the inclusion of studies, surveys, analyses, reports, and other documents prepared by or for the officers and/or directors of the parties for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, competitors, markets, and potential for sales growth or expansion into product or geographic markets.

The H-S-R Act imposes filing fees that are generally paid by the acquiring company and vary depending on the value of the deal. These filing fees range from \$45,000 for deals valued at less than \$100 million, as adjusted, up to \$280,000 for deals valued at more than \$500 million, as adjusted. Transactions may be reported as soon as the acquiring party can attest to a good faith intention to make the acquisition. After an agreement has been reached, there is no time limit for filing, but if the deal is reportable it cannot close until the waiting period imposed by the H-S-R Act has expired.

### **b. Penalties for Noncompliance with the H-S-R Act**

Parties may be penalized for failing to notify the antitrust agencies of a reportable transaction, as well as for failing to comply with specific reporting requirements of the H-S-R Act. Such failures may result in an extension of the waiting period, civil penalties, and "such other equitable relief as the court in its discretion determines necessary or appropriate."<sup>25</sup> Civil penalties of up to \$11,000 may be assessed for each day during which a person is in violation of the act.

The *Hearst Trust* case<sup>26</sup> provides a good example of the penalties that may be imposed for noncompliance with the

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reporting requirements of the H-S-R Act. This case involved the Hearst Corporation's acquisition of J.B. Laughery, Inc., which included the Medi-Span drug information database business. As alleged by the FTC in its Complaint, Hearst violated Section 7, Section 5 of the FTC Act, and the H-S-R Act when, in its requisite pre-merger filing with the antitrust agencies, it illegally omitted several high-level corporate documents prepared to evaluate the Medi-Span acquisition and its competitive effects. Hearst was required to provide those documents to the antitrust agencies to help them determine whether a full pre-merger antitrust review of the acquisition was necessary. According to the FTC, the failure to submit those documents hindered its ability to analyze the competitive effects of the acquisition prior to consummation.

The FTC eventually reached a settlement with Hearst. Under the terms of the settlement, Hearst was required to divest the former Medi-Span business and pay \$19 million as disgorgement of unlawful profits. In addition, the Antitrust Division brought a complaint against Hearst to obtain civil penalties for its failure to comply with the H-S-R reporting requirements.<sup>27</sup> Hearst agreed to pay an additional \$4 million in civil penalties to the Antitrust Division. The FTC's settlement marked the first time

the FTC sought disgorgement of profits in a federal court action for a consummated merger.

### c. Merger Clearance and FTC-Antitrust Division Coordination

The Antitrust Division and FTC's Bureau of Competition have concurrent statutory authority to enforce Sections 7 and 7A of the Clayton Act.<sup>28</sup> This overlapping antitrust enforcement authority necessitates coordination between the two agencies in order to determine which agency will handle specific matters when they arise.

The FTC and Antitrust Division have established "clearance procedures" to determine which agency is better equipped to handle a specific transaction. The FTC's and Antitrust Division's jointly-issued *Clearance Procedures for Investigations*<sup>29</sup> state, among other things, the criteria for resolving matters on which both agencies have sought clearance. The FTC and Antitrust Division have also jointly announced a commitment by each agency to resolve clearance on matters where an H-S-R filing was made within, at most, nine business days of the filing.

When either the FTC or Antitrust Division wishes to investigate a particular transaction, it can request the other agency's clearance for the proposed investigation. Both the FTC and Antitrust Division will inform the heads of their own sections or divisions most likely to have an interest in the proposed investigation. These persons may "contest" clearance, agree to clear the matter, agree to clear it with a caveat, or seek additional information about the proposed investigation. Clearance requests that generate no objections or conflicts are usually processed within a few days.

Objections to clearance usually arise when both agencies have requested clearance to investigate the same transaction. Once a matter is contested, the staff for each agency prepares a contested matter claim form, which describes the conduct or merger sought to be investigated and describes the agency's relevant expertise with the product in question. Liaison officers of

each agency discuss the merits of each agency's claim. In most cases, the liaison officers are able to resolve the dispute and the matter is either cleared to the Antitrust Division or, after approval by the appropriate Director of Enforcement, cleared to the FTC. If the liaison officers are unable to resolve clearance, it is "escalated" up the chain of command within the two agencies. In rare cases, the Assistant Attorney General for Antitrust will enter into negotiations with the FTC Chairman to resolve the matter.

### d. Waiting Periods and Second Requests

The initial waiting period typically expires 30 days after the filing of a pre-merger notification form. During the waiting period, the agencies will review the filing and determine whether further investigation is warranted. The agencies may ask the parties to voluntarily submit information or make employees or officers available for questioning. After obtaining clearance and authority to initiate an investigation during the initial waiting period, agency staff will contact customers and competitors to conduct third-party interviews.

If, at the end of the initial waiting period, the agency conducting the investigation decides that further examination is warranted, it may seek additional information by issuing to the parties a request for additional information and documentary materials (a "second request"). A second request typically consists of a broad set of interrogatories and a detailed request for additional documents. The FTC and Antitrust Division have developed a uniform model second request,<sup>30</sup> though it is usually modified to require detailed data and information on issues particular to the transaction. Parties typically

negotiate with the agency to narrow the scope of a second request and often obtain significant limitations or modifications.

### e. Merger Challenges

Once the merging parties have "substantially complied" with the agency's second request, an additional 30-day waiting period is triggered.<sup>31</sup> During this period the agency may close the investigation, allow the waiting period to expire without further action, or commence an enforcement action. If the investigation is closed, a press release is issued or a formal letter is sent to the merging parties informing them of the decision.

If the antitrust agency decides to commence an enforcement action, it may seek to obtain a preliminary injunction in federal district court that will prevent the parties from closing their transaction. Unless the merging parties agree not to consummate the transaction prior to a ruling on the preliminary injunction motion, the agency must obtain a temporary restraining order to prevent the closing of the transaction.<sup>32</sup>

Due to the time-sensitive nature of mergers and acquisitions, a preliminary injunction may have the effect of permanently terminating a potential transaction. Therefore, the parties have a limited time to present an entire case in the context of a pretrial motion. If the motion for a preliminary injunction is denied, the merging parties are free to consummate the transaction unless the agency obtains a stay pending appeal from the district court or a temporary restraining order from the appellate court.

## 4. Tests for Determining Competitive Impact

In April 1992, the FTC and Antitrust Division jointly issued the *Horizontal Merger Guidelines* ("1992 Merger Guidelines").<sup>33</sup> This joint statement by the two federal enforcement agencies provides a reasoned analysis of the likely competitive effects of individual transactions based on real-world market circumstances in which those transactions occur. The 1992 *Merger*

"Determination of a relevant market is the necessary predicate" to a Section 7 claim.

*Guidelines* were revised in 1997 to elaborate on the agencies' approach to the evaluation of efficiencies claims.

The 1992 *Merger Guidelines* describe a five-step analytic process by which the FTC and Antitrust Division determine whether to challenge a particular merger or acquisition. These steps consist of (a) defining a relevant market and determining the extent to which the proposed transaction would increase concentration in that market; (b) assessing, in light of both the impact of the proposed transaction on market concentration and other factors, whether the transaction would raise competitive concerns; (c) assessing whether entry by additional firms into the market would counteract these competitive concerns; (d) considering whether the proposed transaction would likely result in merger-specific efficiencies; and (e) determining whether, but for the merger, either firm would be likely to fail, causing its assets to exit the market.<sup>34</sup> Courts generally have followed the same basic approach in analyzing mergers and acquisitions.

#### a. Determining and Assessing the Relevant Market

"Determination of a relevant market is the necessary predicate" to a Section 7 claim.<sup>35</sup> The Supreme Court has held that defining a market

is necessary because the question of whether a merger has a substantial effect on competition can only be determined in terms of the affected market.<sup>36</sup>

In many cases the success or failure of the agency's case will depend on how the court views the evidence when trying to identify the relevant market. An example of this issue can be found in the recent *Whole Foods* case,<sup>37</sup> which involved

a proposed merger between Whole Foods Market, Inc. and Wild Oats Markets, Inc. The critical issue in *Whole Foods* was whether the two companies competed in a narrow market of "premium natural organic supermarkets" ("PNOS"), as argued by the FTC, or a much broader market that included regular supermarkets as competitors. The *Whole Foods* court, in denying the FTC's request for a preliminary injunction blocking the proposed merger, accepted Whole Foods' theory that the two companies competed in a broader market containing all supermarkets, not just other PNOS's.<sup>38</sup>

The 1992 *Merger Guidelines* include a detailed process for identifying participants in the relevant market. This process begins with determining all firms that currently produce or sell the relevant product in the relevant geographic market.<sup>39</sup> Market participants also include so-called uncommitted entrants, defined as firms that would likely commence production of the relevant product "within one year and without the expenditure of significant sunk costs of entry and exit, in response to a 'small but significant and nontransitory price increase.'"<sup>40</sup> To qualify as an uncommitted entrant, it is not sufficient that a firm has the technological capability to produce the product – it is necessary to demonstrate that the firm likely would do so.

A firm's market share reflects the portion of economic activity for which it accounts in the relevant market. The Supreme Court has declared that the "amount of annual sales is relevant as a prediction of future competitive strength"<sup>41</sup> and is "the primary index of

market power."<sup>42</sup> As a result, the courts in many cases have measured market shares with reference to the ratio of a firm's sales in the relevant market to total sales in that market, expressed in either dollar revenues or units. In other cases, the courts have used production or capacity to measure competitive strength. The 1992 *Merger Guidelines* provide that the measure of choice is the one that best measures a firm's future competitive significance.

Market concentration measures the aggregate market shares of firms in the market to reflect the extent to which supply is controlled by the largest firms. There are two major types of concentration measures in use: (1) concentration ratios and (2) the Herfindahl-Hirschman Index ("HHI"). Concentration ratios measure the portion of the market accounted for by a given number of the leading firms, typically the top two, four, or eight firms. The 1992 *Merger Guidelines* adopt the HHI as the principal measure of concentration.<sup>43</sup> This index is calculated by summing the squares of the individual market shares of the firms in the market. It results in a single figure somewhere between a number approaching zero (a market composed of thousands of small sellers) and 10,000 (a market composed of a single monopoly). The process of squaring the shares gives heavier weight to large firms. Many courts have relied on the HHI and most have recognized it to be the preferred method for measuring market concentration.

The Supreme Court has not decided any case since 1974 that elaborates on market concentration standards in the merger context. Decisions by lower courts and by the FTC have applied an initial presumption of illegality based on market concentration data, but this typically occurs when the market shares and the increase in concentration are very high. Courts have been more receptive than in the past to non-market share evidence that bears on competitive harm, such as evidence that firms will not be able to raise prices notwithstanding high market shares.

Reflecting on this trend, the 1992 *Merger Guidelines* do not include specified criteria

In addition to defining and assessing the market, a typical merger analysis also focuses on the competitive effects of the transaction and whether it is likely to substantially lessen competition in that market.

for challenging mergers based on the level of the HHI for the post-merger market and the increase in HHI caused by the merger. Instead, the 1992 *Merger Guidelines* state that (i) mergers that result in a post-merger HHI of less than 1,000 “ordinarily require no further analysis,” (ii) mergers that increase the HHI by 100 points where the post-merger HHI is between 1,000 and 1,800 “raise significant competitive concerns,” and (iii) where the post-merger HHI is greater than 1,800 it will be “presumed that mergers producing an increase in the HHI of more than 100 points are likely to create or enhance market power or facilitate its exercise.”<sup>44</sup> This presumption may be overcome, however, by evidence of ease of market entry by other competitors or other market factors demonstrating that the merger will not create market power or facilitate its exercise.

#### b. Assessing Competitive Harm

In addition to defining and assessing the market, a typical merger analysis also focuses on the competitive effects of the transaction and whether it is likely to substantially lessen competition in that market. The 1992 *Merger Guidelines* identify two broad analytical frameworks for assessing whether a merger substantially lessens competition. These frameworks require a determination of whether the proposed merger may (i) result in a market where “coordinated interaction” among rival firms is likely to be facilitated or (ii) enable the merged firm to unilaterally raise prices or otherwise exercise market power.

##### (i) Coordinated Interaction

Terms such as “conscious parallelism,” “tacit collusion,” and “interdependent behavior” are all related to the concept of coordinated interaction among firms in an oligopolistic industry. Firms that engage in coordinated interaction are able to accurately predict, without an explicit agreement, how their competitors will react to a change in price or product output. Coordinated interaction among rivals is not illegal under Section 1 of the Sherman Act. However, mergers that facilitate coordinated interaction are illegal under

Section 7 of the Clayton Act. Consumers are harmed by coordinated interaction because competitors are collectively able to charge supracompetitive prices, reduce product quality, or slow the rate of innovation. Consequently, a primary goal of Section 7 enforcement is to prevent markets from consolidating sufficiently to create or enhance the conditions that permit competitors to engage in coordinated interaction.

A merger can facilitate coordinated interaction in two ways. The transaction may eliminate a barrier to coordinated interaction. In addition, the merger may increase the likelihood that any pre-existing coordinated interaction will be more successful, more complete, or longer lasting in the post-merger market. Successful coordinated interaction generally requires the firms in the relevant market, without explicit agreement, to: (a) reach an informal consensus on the terms of coordination; (b) detect deviations from such terms; and (c) punish deviations that would undermine the coordinated interaction. Merger analysis involves a determination of the extent to which post-merger market conditions permit the remaining competitors to achieve these objectives. One way in which an acquisition may increase the likelihood of coordinated interaction is the acquisition of a “maverick” firm that is exerting a disruptive and competitive influence on the market.<sup>45</sup>

##### (ii) Unilateral Anticompetitive Activity

In addition to facilitating coordinated interaction, a merger can raise competitive concerns because it increases the ability of the combined firm to unilaterally raise prices following the merger. The primary focus is on markets characterized by differentiated products. In such a market, a firm may

be reluctant to raise prices because customers will switch to products produced by the competitor that makes the closest substitute. If the firm acquires that competitor, however, it may be easier to raise the price for its product. In that case, some of the decrease in sales for its product would be offset by the increase in sales of the product produced by the acquired firm.

Where the likely alternative to a merger is financial failure for one of the merging parties, the merger will not violate Section 7.

##### c. Determining and Assessing Ease of Entry into the Market

The ease with which new firms can enter the relevant market is an important consideration in evaluating the ability of existing firms in a concentrated industry to increase prices above competitive levels. As explained by the D.C. Circuit in the *Baker Hughes* case,<sup>46</sup> “[i]n the absence of significant barriers [to market entry], a company probably cannot maintain supracompetitive pricing for any length of time,” even in a highly concentrated market. Conversely, high entry barriers have been held to increase competitive concerns in highly and even moderately concentrated industries.<sup>47</sup>

Courts have identified a variety of factors that can create barriers to entry. Many of the most important factors tend to make entry expensive, difficult, and time consuming. For example, entry is often viewed as difficult if it requires high capital expenditures, large sunk costs, long lead times, and a large minimum scale of operation for efficient production. The need for specialized knowledge, technology, or resources may also inhibit market entry. In addition, government-imposed entry restrictions and established brand loyalty to incumbent firms have also been cited as barriers to entry.

The 1992 *Merger Guidelines* require a party seeking to assert an ease of entry defense to demonstrate that, if existing firms

were to increase prices following the merger, entry by other firms would be “timely, likely, and sufficient” to counteract the price increase.<sup>48</sup> The focus is on entry that might occur as a result of changes in the market conditions following the merger – as opposed to entry that would occur regardless of the merger. The analysis considers the actions a hypothetical firm would take and does not require the identification of specific firms that are likely to do so.

#### d. Determining and Assessing Efficiencies

Merging firms may create synergies by reducing their costs, combining complimentary assets, eliminating duplicative activities, or achieving scale economies. Mergers may also lead to enhanced product quality or increased innovation that results in lower prices or more rapid product introduction. These pro-competitive benefits – which the courts and antitrust agencies recognize as merger-related efficiencies – are also a relevant factor in analyzing the legality of a transaction under Section 7.

In 1997, the FTC and Antitrust Division revised the 1992 *Merger Guidelines* to clarify how they will analyze merger efficiency claims.<sup>49</sup> These revisions clarify how and to what extent the antitrust enforcement agencies will consider merger-related efficiencies. The revisions make clear that only merger-specific efficiencies will be considered. Efficiency claims will not be considered “if they are vague or speculative or otherwise cannot be verified by reasonable means.”<sup>50</sup> The revisions further elaborate that “[w]hen the potential adverse competitive effect of a merger is likely to be particularly large, extraordinarily great cognizable efficiencies would be necessary to

prevent the merger from being anticompetitive.”<sup>51</sup> Since the revised efficiencies section of the 1992 *Merger Guidelines* was issued, a number of courts have relied on it in analyzing arguments put forth by the merging parties.<sup>52</sup>

#### e. Assessing the Financial Condition of the Merging Firms

Where the likely alternative to a merger is financial failure for one of the merging parties, the merger will not violate Section 7. This “failing firm defense” is based on the belief that “the effect on competition and the ‘loss to [the company’s] stockholders and injury to the communities where its plants were operated’ will be less if a company continues to exist even as a party to a merger than if it disappears entirely from the market.”<sup>53</sup> The defense was first recognized in *International Shoe*, where the Supreme Court held that the acquisition of a failing company did not violate Section 7.<sup>54</sup> The defense was subsequently recognized in the legislative history to the 1950 amendments to Section 7, and has been invoked by courts in numerous decisions after *International Shoe*.<sup>55</sup>

In *Citizen Publishing*,<sup>56</sup> the Supreme Court clarified the failing firm defense in holding that an acquisition may be permitted under the doctrine if three requirements are satisfied: (i) the proponent of the acquisition must demonstrate that the firm to be acquired is in imminent danger of failure; (ii) the failing firm must have no realistic prospect for a successful reorganization; and (iii) the failing firm defense is available only if there is no viable alternative purchaser that poses less anticompetitive risk.<sup>57</sup>

The 1992 *Merger Guidelines* have a slightly different test for the failing firm defense.

Under these guidelines, an anticompetitive proposed merger might be allowed to proceed if one of the parties in the transaction (i) “would be unable to meet its financial obligations in the near future”; (ii) “would not be able to reorganize successfully under Chapter 11” of the Bankruptcy Code; (iii) has made “unsuccessful good faith efforts to elicit reasonable alternative offers of acquisition” that would raise fewer competitive concerns; and (iv) “absent the acquisition, the assets of the failing firm would exit the relevant market.”<sup>58</sup>

#### 5. Conclusion

Section 7 of the Clayton Act is a deceptively simple statute that prohibits any transaction, the effect of which “may be substantially to lessen competition, or to tend to create a monopoly.” The words of the statute seem to pose a simple question. In practice, however, the application of Section 7 to specific transactions has resulted in a complicated, dynamic area of the antitrust laws. Despite all of these complexities, though, the underlying goal of Section 7 is to prevent mergers and acquisitions that are likely to reduce competition and lead to higher prices, lower quality goods or services, or suppress innovation. ■

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#### ENDNOTES

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<sup>1</sup> See, e.g., *Eastman Kodak Co. v. Image Technical Servs.*, 504 U.S. 451, 464 (1992).

<sup>2</sup> 15 U.S.C. § 18.

<sup>3</sup> State attorneys general and private parties may enforce Section 7 through actions brought pursuant to Section 4 or 16 of the Clayton Act.

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<sup>4</sup> 15 U.S.C. § 45.

<sup>5</sup> 15 U.S.C. §§ 1, 2. The Antitrust Division, state attorneys general, and private plaintiffs – but not the FTC – may challenge mergers under the Sherman Act.

<sup>6</sup> 15 U.S.C. § 18a.

<sup>7</sup> See, e.g., *FTC v. Freeman Hosp.*, 69 F.3d 260, 267 (8th Cir. 1995) (holding that the FTC had jurisdiction to challenge a non-profit hospital's asset acquisition transaction).

<sup>8</sup> See, e.g., *American Crystal Sugar Co. v. Cuban-American Sugar Co.*, 152 F. Supp. 387, 392 (S.D.N.Y. 1957).

<sup>9</sup> See, e.g., *Gulf & W. Indus. v. Great Atl. & Pac. Tea Co.*, 476 F.2d 687, 694 (2d Cir. 1973) (finding a substantial likelihood that Gulf & Western would seek to obtain control of A&P and that it had the potential to obtain that goal).

<sup>10</sup> See, e.g., *Denver & Rio Grande Western Railroad v. U.S.*, 387 U.S. 485, 504 (1967) (20%); *Metro-Goldwyn-Mayer, Inc. v. Transamerica Corp.*, 303 F. Supp. 1344, 1354 (S.D.N.Y. 1969) (slightly less than 17%).

<sup>11</sup> Section 7 provides in pertinent part: "This section shall not apply to [corporations] purchasing such stock solely for investment and not using the same by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition." 15 U.S.C. § 18.

<sup>12</sup> See, e.g., *Anaconda Co. v. Crane Co.*, 411 F. Supp. 1210, 1216-19 (S.D.N.Y. 1975).

<sup>13</sup> See, e.g., *U.S. v. Tracinda Inv. Corp.*, 477 F. Supp. 1093, 1100 (C.D. Cal. 1979).

<sup>14</sup> See, e.g., *SCM Corp. v. Xerox Corp.*, 645 F.2d 1195, 1205 (2d Cir. 1981).

<sup>15</sup> See, e.g., *U.S. v. Lever Bros. Co.*, 216 F. Supp. 887, 889 (S.D.N.Y. 1963).

<sup>16</sup> See, e.g., *U.S. v. Archer-Daniels-Midland Co.*, 584 F. Supp. 1134, 1139 (S.D. Iowa 1984) (Section 7 applies to a multi-year operating lease with an option to purchase).

<sup>17</sup> See, e.g., *U.S. v. Columbia Pictures Corp.*, 189 F. Supp. 153, 181-83 (S.D.N.Y. 1960).

<sup>18</sup> See, e.g., *Mr. Frank, Inc. v. Waste Mgmt.*, 591 F. Supp. 859, 864-67 (N.D. Ill. 1984) (Section 7 is applicable where acquisition of debts owed defendant and right of first refusal to purchase may create opportunities to control decision making).

<sup>19</sup> Horizontal transactions involve competitors in the same product and geographic market. Non-horizontal transactions include mergers between (a) potential competitors, (b) firms that have or could have supplier-customer relationships or produce complementary products (vertical acquisitions), and (c)

firms that are not actual or potential competitors and do not have an actual or potential customer-supplier relationship (conglomerate acquisitions).

<sup>20</sup> "No person shall **acquire**, directly or indirectly, the whole or any part of the stock or share capital ...." 15 U.S.C. § 18 (emphasis added).

<sup>21</sup> See, e.g., *Tim W. Koerner & Assocs. v. Aspen Labs*, 492 F. Supp. 294, 300 (S.D. Tex. 1980), *aff'd mem.*, 683 F.2d 416 (5th Cir. 1982).

<sup>22</sup> 15 U.S.C. § 18a.

<sup>23</sup> The current adjusted threshold for the "size-of-the-transaction test" is \$59.8 million. Information on threshold amounts and other H-S-R filing requirements is available on the FTC's H-S-R website at <http://www.ftc.gov/bc/hsr/hsrinfopub.shtml>.

<sup>24</sup> The current adjusted threshold for the "size-of-the-parties test" is \$239.2 million.

<sup>25</sup> 15 U.S.C. § 18a (g)(1)-(2).

<sup>26</sup> *FTC v. Hearst Trust*, Civil Action No. 1:01-CV-0734 (D.D.C. filed April 5, 2001).

<sup>27</sup> *U.S. v. Hearst Trust*, No. 1:01-CV-02119 (D.D.C. filed October 11, 2001).

<sup>28</sup> The Antitrust Division and FTC also have concurrent statutory authority to enforce Sections 2, 3, and 8 of the Clayton Act. Section 2, known as the Robinson-Patman Act, addresses price discrimination; Section 3 addresses exclusive dealing; and Section 8 addresses interlocking directorates.

<sup>29</sup> FEDERAL TRADE COMM'N & U.S. DEP'T. OF JUSTICE, FTC/DOJ CLEARANCE PROCEDURES FOR INVESTIGATIONS (Dec. 1993).

<sup>30</sup> The *Model Request for Additional Information and Documentary Material* is available on the FTC's website at <http://www.ftc.gov/bc/hsr/guide3.pdf>.

<sup>31</sup> 15 U.S.C. § 18a (e). The extension is 10 days in the case of a cash tender offer or acquisition in bankruptcy.

<sup>32</sup> FED. R. CIV. P. 65(b).

<sup>33</sup> The 1992 MERGER GUIDELINES are available at <http://www.ftc.gov/bc/docs/horizmer.shtml>.

<sup>34</sup> 1992 MERGER GUIDELINES, § 0.2.

<sup>35</sup> *U.S. v. E.I. duPont de Nemours & Co.*, 353 U.S. 586, 593 (1957).

<sup>36</sup> *Id.*

<sup>37</sup> *FTC v. Whole Foods Market, Inc.*, 2007 U.S. LEXIS 61331 (D.D.C. Aug. 16, 2007).

<sup>38</sup> For a detailed analysis of the *Whole Foods* case and other recent cases involving

market definition issues, see Heather Mayer, *Whole Foods: Has the District Court Set a New Standard for the FTC?* in this issue.

<sup>39</sup> 1992 MERGER GUIDELINES, § 1.31.

<sup>40</sup> *Id.* § 1.32.

<sup>41</sup> *U.S. v. General Dynamics Corp.*, 415 U.S. 486, 501 (1974).

<sup>42</sup> *Brown Shoe Co. v. U.S.*, 370 U.S. 294, 322 n.38 (1962).

<sup>43</sup> 1992 MERGER GUIDELINES, § 1.5.

<sup>44</sup> 1992 MERGER GUIDELINES, § 1.51.

<sup>45</sup> 1992 MERGER GUIDELINES, § 2.12.

<sup>46</sup> *U.S. v. Baker Hughes Inc.*, 908 F.2d 981, 987 (D.C. Cir. 1990).

<sup>47</sup> See, e.g., *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 717 & n.13 (D.C. Cir. 2001) ("[T]he anticompetitive effect of the merger is further enhanced by high barriers to market entry").

<sup>48</sup> 1992 MERGER GUIDELINES, § 3.0.

<sup>49</sup> See U.S. DEP'T. OF JUSTICE & FEDERAL TRADE COMM'N, REVISION TO SECTION 4 OF HORIZONTAL MERGER GUIDELINES.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> See, e.g., *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1175 (N.D. Cal. 2004); *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1088-89 (D.D.C. 1997).

<sup>53</sup> *U.S. v. General Dynamics Corp.*, 415 U.S. 486, 507 (1974) (quoting *International Shoe Co. v. FTC*, 280 U.S. 291, 302 (1930)).

<sup>54</sup> *International Shoe*, 280 U.S. at 302-03. (where the acquired company's resources were depleted, business failure was a grave probability, and acquisition by a non-competitor was not possible).

<sup>55</sup> See, e.g., *California v. Sutter Health Sys.*, 84 F. Supp. 2d 1057, 1081-85 (N.D. Cal.), *aff'd*, 217 F.3d 846 (9th Cir. 2000).

<sup>56</sup> *Citizen Publishing v. U.S.*, 394 U.S. 131 (1969).

<sup>57</sup> *Id.* at 138-39.

<sup>58</sup> 1992 MERGER GUIDELINES, § 5.1 n.39.