THE NATIONAL LAW JOURNAL
NOVEMBER 1, 2010
Daily Updates at NLJ.COM
An ALM Publication
A SPECIAL REPORT
ANTITRUST
THE NATIONAL LAW JOURNAL/**WWW.NLJ.COM**

The perils of proximity in horizontal mergers

Revised guidelines require merging companies to determine if they are particularly close rivals.

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The new U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines attempt to reshape antitrust merger analysis, going beyond the agencies' primary objective of more closely tracking what they actually do in practice. Excised from the 2010 guidelines is the familiar five-step structure that made the predecessor 1992 Horizontal Merger Guidelines so popular with the courts and served as the model for merger guidelines around the world. Flexibility for the agencies has increased while predictability for the merging parties has decreased. At the same time, the agencies have signaled a sharpened focus on issues of proximity. Understanding how the notion of proximity might be applied in different market circumstances is likely to be the key to reducing the uncertainty inherent in any new guidelines, and particularly pronounced in this revision.

The most fundamental change in the 2010 guidelines is the abandonment of the five-step structure. Each step in the 1992 guidelines was necessary to the analysis, and together the five steps were sufficient to establish that a merger might substantially lessen competition.

First the merger needed to significantly increase concentration in an highly concentrated market, properly defined and measured. Second, specific market circumstances had to support likely adverse "competitive effects," enabling the merged firm as a result of the merger, either unilaterally or in coordination with its remaining rivals, to exercise market power, absent new entry or substantial efficiencies from the transaction. Third, new entry was either not timely, likely or sufficient in scope to deter or counteract the competitive effect

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of concern. Fourth, cognizable efficiencies were not of a character and magnitude to make adverse competitive effects unlikely. Fifth, the acquired entity did not meet the rigorous requirements of the failing company/failing division defense.

Inherent in the structured approach of the 1992 guidelines was that failure of proof on any of the five elements was sufficient to allow a merger to proceed. Much to the agencies' frustration, their inability to establish the very first element—market definition—led to litigation defeats in high-profile cases such as *U.S. v. Oracle Corp.*, 331 F. Supp. 2d 1098 (N.D. Calif. 2004), and *FTC v. Whole Foods Market Inc.*, 502 F. Supp. 2d 1 (D.D.C. 2007), rev'd, 548 F.3d 1028 (D.C. Cir. 2008).

Unlike the predecessor guidelines and the case law, the 2010 guidelines assert that "[t]he Agencies' analysis need not start with market definition." 2010 guidelines § 4. Instead, the 2010 guidelines suggest that the agencies could back into market definition, because "[e]vidence of competitive effects [the second element in the old five-step approach] can inform market definition." Id. The principle underlying this approach is stated as an "example" in the 2010 guidelines: "evidence that a reduction in the number of significant rivals offering a group of products causes prices for those products to rise significantly can itself establish that those products are a relevant market. Such evidence also may more directly predict the competitive effects of a merger, reducing the role of inferences from market definition and market shares." Id.

In logical terms, the agencies have shifted from a deductive to an inductive approach to market definition. The 1992 guidelines represented the deductive approach, reasoning from the general principles of the hypothetical monopolist test to define markets in any particular case. The approach quoted above from the 2010 guidelines is inductive, reasoning from what is viewed as specific evidence of price effects to a more general conclusion about market definition.

Reliance on induction is always risky, as a matter of logic, because the conclusion does not necessarily follow from the premises. For this reason, induction is particularly risky in legal matters when burdens of proof come into play. The 2010 guidelines confront the logical risk of induction by trying to identify the particular types of evidence from which it is most probable to properly draw the inference that a merger is likely to have adverse competitive effects, without limiting the ability to rely on other evidence when believed to be warranted. This is where proximity comes into play in the analysis.

How best to assess proximity varies depending on the products' attributes and how they are sold.

PROXIMITY IS THE WATCHWORD

At the risk of oversimplifying, the 2010 guidelines' central tenet is that a merger is most likely to have adverse competitive effects when the merging firms are uniquely proximate or particularly close rivals. How best to assess this proximity varies, according to the guidelines, depending on the characteristics of the products of the merging firms and how they are sold. But before reaching the more rigorous approaches of the guidelines, advisers should ask the merging parties more simple questions: Which firms do they regard as their closest rivals? Why is this so? For which customers is the rivalry closest? Like the most elemental question that should be asked of all merging parties—"Why do you want to do this deal?"—these questions may yield the most useful information in the shortest time, subject to corroboration from the guidelines' more data-driven approaches.

The guidelines devote the greatest attention to proximity issues in the treatment of differentiated product markets where firms compete by choosing the features and prices of their products and customers select from among those alternatives. Most consumer goods fit this setting. Two products are deemed proximate if one is the next best substitute for the other.

Early in any merger analysis involving this differentiated-products setting, evidence of proximity may come from a simple evaluation of product attributes, how the products are sold, to which customers the products are marketed or how rivals segment the market in which they compete. Much of this information may be publicly available through company Web sites and marketing materials, U.S. Securities and Exchange Commission filings and analyst presentations. High-level strategic plans and other ordinary course-of-business documents also may provide summary evidence of proximity. More systematic evidence in differentiated product markets may come from other sources, including studies of customer switching patterns, panel data and customers surveys. See 2010 guidelines § 6.1.

When data are available, the agencies may attempt to quantify proximity using various economic models to analyze substitution patterns, including the upward pricing pressure model popularized by Joe Farrell and Carl Shapiro, respectively, the chief economists at the Federal Trade Commission and the Justice Department Antitrust Division. See Farrell and Shapiro, "Antitrust Evaluation of Horizontal Mergers: An Alternative to Market Definition," 10 The B.E. J. Theoretical Econ., Issue 1, Article 9 (2010), and various merger simulation models. See 2010 guidelines § 6.1. The specification of these models and the data required to accurately apply them are complex and typically require the engagement of expert economists.

Different evidence of proximity comes into play in markets in which buyers and sellers negotiate to determine prices and other terms of trade, perhaps in an iterative mode, through formal auction, or by a combination of auction and negotiation. In these settings, proximity often is inferred from the product of one merging firm being the runner-up to the product of its merger partner. Actual bidding records, win/loss reports, evidence from discount approval processes and similar ordinary course-of-business documents frequently will be evidence of proximity here. See 2010 guidelines § 6.2.

Proximity for homogeneous or relatively undifferentiated products may be based on the merging firms' locations of production or distribution relative to customers, particularly when transportation costs are a substantial portion of the delivered price of the product. The 2010 guidelines are less practical in advising on how to assess these settings, but the use of price zones and direct recognition of the importance of proximity may come into play here. See 2010 guidelines § 6.3.

In all settings, customer preferences, of course, vary. Any two products plausibly included in the same market must be the preferred and next best alternatives for at least one customer. But, for another customer, those same two products might be third and fourth preferences.

Proximity or particular closeness between the merging firms is a function of the frequency with which their respective products are regarded by customers as their preferred and next best alternatives. Unfortunately, the 2010 guidelines offer no insight into what frequency level makes the firms proximate or particularly close competitors such that their merger might be anti-competitive, other than to note that it need not be a majority. This is a critical hole because, as noted above, for any two products arguably in the same market, there is always at least one customer who regards them as preferred and next best alternatives.

The 1992 guidelines offered guideposts based on the combined market share of the merging firms, but the 2010 guidelines eschew those bright-line tests, along with a number of others that had been employed in the predecessor guidelines. As a result, the 2010 guidelines leave open the question of what constitutes a "substantial" lessening of competition, even while suggesting that, in some situations, the relevant market may be limited to a single customer. See 2010 guidelines § 4.1.4 and the pending complaint in *U.S. and Plaintiff States v. Dean Foods Co.*, No. 10-CV-59 (E.D. Wis.)

The widespread acceptance of the 1992 guidelines by the courts became a measure of success for the approach adopted. Although the 2010 guidelines, like the predecessor guidelines, disclaim describing "how the Agencies will conduct the litigation of cases they decide to bring," judicial acceptance of the new approach likely will be an equally important factor in determining the success of the revisions.

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