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The Ease of Entry Doctrine in Merger Law: Managing the Waste of *In Re Echlin*

Victor Hsu*

The most significant new issue in merger analysis is ease of entry. Recent cases have enshrined it as an absolute rebuttal against high market concentration figures which would otherwise block a merger. If the present trend continues, antitrust litigation under Section 7 of the Clayton Act[1] will focus not on market definition or efficiencies, but on assessing the height of entry barriers.

This Article surveys the developing case law on ease of entry and points out certain flaws which should be addressed. An extended discussion of the significance of entry barriers follows, and the Article concludes with suggestions for reform.

I. The Developing Case Law

Entry conditions are fundamental to any sophisticated analysis of market power. In the absence of significant barriers, any attempt by existing firms in a market to charge a supra-competitive price generally induces new firms to enter the market. These entrants should dissipate excess profits and bid the price back down to competitive levels. Many early cases did not acknowledge the importance of entry

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1. 15 U.S.C.A. § 18 (West 1988).

in assessing market power.[2] Instead the focus was on market concentration.[3] Entry was only mentioned to reinforce predetermined conclusions that market power existed.[4]

In the late 1970s, courts began to pay more attention to entry issues in merger cases. Unfortunately, they had to labor under a cloud of misguided precedent. As one commentator noted:

> The mistaken notion that every step a new entrant must take to enter a market amounts to a substantial entry barrier pervades many court and FTC opinions. As a consequence, the decisions—while often purporting to apply Bain's basic methodology for assessing entry barriers—actually have distorted it into a "laundry list" approach to barrier analysis.[5]

In 1982, the Department of Justice issued new merger guidelines which gave explicit consideration to market entry. Concentration was still the primary focus, but ease of entry became the most important secondary factor in deciding whether to block a merger. The new guidelines provided the following rule of thumb: "If entry into a market is so easy that existing competitors could not succeed in raising prices for any significant period of time, the Department is unlikely to challenge mergers in that market."[6]

The 1982 Merger Guidelines combined the issue of entry with the issue of market power: "In assessing the ease of entry to a market, the Department will consider the likelihood and probable magnitude of entry in response to a small but significant and nontransitory increase in price."[7] In practice, this usually means a five percent price increase sustained for two years.

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2. The two leading merger cases of the 1960s were the Supreme Court's decisions in Brown Shoe Co. v. United States, 370 U.S. 294 (1962) and United States v. Von's Grocery Co., 384 U.S. 270 (1966). These cases have been roundly criticized for their flawed economic analysis. *See, e.g.*, R. Bork, The Antitrust Paradox 210-18 (1978); R. Posner, Antitrust Law 100-10 (1976). One major error was the lack of adequate consideration given to entry conditions. In *Brown Shoe*, the opinion mentioned entry as a relevant factor but then failed to apply entry analysis to the shoe retailing market. *Von's Grocery* neglected entry entirely.

3. Wentz, *Mobility Factors in Antitrust Cases: Assessing Market Power in Light of Conditions Affecting Entry and Fringe Expansion*, 80 Mich. L. Rev. 1545, 1556 (1982). *See In re* Ecko Products Co., 65 F.T.C. 1163, 1206-09 (1964) ("where the merger's effects on competition are those proscribed by Section 7, its illegality cannot be overcome by a showing of ease of entry"), *aff'd* 347 F.2d 745 (7th Cir. 1965).

4. Wentz, *supra* note 3, at 1556-57. The Supreme Court recognized the importance of ease of entry only in cases involving the potential competition doctrine, which has very limited application. *See* United States v. Marine Bancorp, Inc., 418 U.S. 602 (1974); *In re* B.A.T. Indus., 104 F.T.C. 852 (1984).

5. Wentz, *supra* note 3, at 1558-59 (footnote omitted).

6. United States Department of Justice Merger Guidelines § III B (1982), *reprinted* in 4 Trade Reg. Rep. (CCH) ¶ 13,102 at 20,537 (1988) [hereinafter 1982 Merger Guidelines].

7. *Id.* (footnote omitted).

Though the Federal Trade Commission did not quantitatively mingle ease of entry with concentration, it followed the Justice Department's lead in emphasizing the importance of entry analysis. According to the 1982 FTC Statement Concerning Horizontal Mergers: "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."[8] These policy changes represented a significant step toward an economically correct approach to entry issues in merger cases. Several cases decided after the announcement of the new Justice Department and FTC guidelines explicitly recognized that concentration ratios may not accurately reflect market power if barriers to entry are very low.[9]

In 1984, minor changes were made to the Department of Justice Merger Guidelines.[10] Those revisions did not have any impact on the treatment of entry, but a Second Circuit case decided the same year had a tremendous impact, expanding the significance of entry to new frontiers. In *United States v. Waste Management, Inc.*,[11] the court held that a post-merger market share of nearly fifty percent and 3,040 points on the Herfindahl-Hirschman Index was not illegal since the market was characterized by ease of entry.

The *Waste Management* case involved a merger between two Texas firms in the waste disposal business. The district court found the post-merger market share based on revenue data to reach 48.8 percent and held the merger to be prima facie illegal under the market concentration standard of *United States v. Philadelphia National Bank*.[12] Judge Griesa conceded that "entry into the trash collection business is relatively easy, and the barriers to entry not great."[13] Yet he rejected the contention that this fact had any economic or legal significance:

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8. FTC Statement Concerning Horizontal Mergers § III A(1) (1982), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,200 at 20,902 (1988) [hereinafter FTC Statement].

9. *See, e.g., In re* Grand Union Co., 102 F.T.C. 812 (1983); *In re* Weyerhaeuser Co., 106 F.T.C. 172 (1985); Will v. Comprehensive Accounting Corp., 776 F.2d 665 (7th Cir. 1985); Ball Memorial Hosp., Inc. v. Mutual Hosp. Ins., 784 F.2d 1325 (7th Cir. 1986).

10. *See* United States Department of Justice Merger Guidelines § 3.3 (1984), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,103 at 20,562 (1988).

11. 743 F.2d 976 (2d Cir. 1984).

12. United States v. Waste Management, Inc., 588 F. Supp. 498, 512 (S.D.N.Y. 1983), *rev'd*, 743 F.2d 976 (2d Cir. 1984). *See* United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 364-66 (1963).

13. *Waste Management*, 588 F. Supp. at 513.

> There is no showing of any circumstance, related to ease of entry or the trend of the business, which promises in and of itself to materially erode the competitive strength of [the merged firms]. With regard to the legal effect of low entry barriers and potential competition in a section 7 case, there is no persuasive authority for allowing such factors to overcome a strong prima facie showing of concentration in the *existing* competitive structure.[14]

The appellate court reversed, holding that ease of entry may rebut a showing of prima facie illegality.[15] Judge Winter's reasoning relied heavily on the Supreme Court's decisions in *United States v. General Dynamics Corp.*[16] and the potential competition cases. *General Dynamics* held that market share data may be rebutted by proof that they do not accurately reflect the effect on competition of a proposed merger. The teaching of the potential entrant doctrine is that firms not presently in the market should be considered in calculating market share if they are likely to enter in response to a price increase by market incumbents. The Second Circuit amplified these themes and concluded that ease of entry rendered the government's concentration figures immaterial:

> [W]e believe that entry into the relevant product and geographic market by new firms or by existing firms in the Fort Worth area is so easy that any anti-competitive impact of the merger before us would be eliminated more quickly by such competition than by litigation.[17]

The opinion was obviously informed by Chicago School economics. In response to the argument that entry into the market has been infrequent, Judge Winter explained: "The fact that such entry has not happened more frequently reflects only the existence of competitive, entry-forestalling prices."[18] Judge Winter hoisted the Justice Department with its own petard by raising the Merger Guidelines as a quasi-estoppel argument:

> [T]he *Merger Guidelines* issued by the government itself not only recognize the economic principle that ease of entry is relevant to appraising the impact upon competition of a merger but also state that it may override all other factors. . . . If the Department of Justice routinely considers ease of entry as relevant to determining

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14. *Id.*
15. *Waste Management*, 743 F.2d at 982.
16. 415 U.S. 486 (1974).
17. *Waste Management*, 743 F.2d at 983.
18. *Id.*

the competitive impact of a merger, it may not argue to a court addressing the same issue that ease of entry is irrelevant.[19]

The *Waste Management* opinion has had a dramatic effect. It has transformed ease of entry from merely a factor the government would consider before challenging a merger into a powerful affirmative defense. Since the Reagan Administration challenges relatively few mergers, the presence of such a defense may significantly weaken whatever legal restraints against horizontal mergers which remain.

An important victory for the *Waste Management* approach came less than five months later in *United States v. Calmar Inc.*[20] The district court allowed a merger which gave the merging firms over 50 percent market share in an already concentrated industry, because entry into the market was "relatively easy."[21] With *Waste Management* as his sole authority, Judge Debevoise held: "If ease of entry in the market is such that the producers in the market could not long sustain an unjustified price increase, then in spite of a high degree of concentration there has not been a substantial lessening of competition."[22]

Ease of entry was also dispositive in *In re Echlin Manufacturing Co.*,[23] decided by the Federal Trade Commission. The sole dissenting Commissioner pointed out that the merger would involve "competing firms with 36% and 10% of a small and declining market so highly concentrated that six firms account for 95% of sales. The Herfindahl-Hirschman index as a result of this acquisition rises by over 750 points to just under 3000."[24] Yet the rest of the Commission could abide by such concentration after determining "that there are no barriers to entry into the [market]."[25]

Not only has ease of entry become a powerful defense, it has also been suggested that the obverse, difficulty of entry, may be necessary for a prima facie case. In *Saltz & Sons, Inc. v. Hart Schaffner & Marx*,[26] the district court granted defendant's motion to dismiss,

19. *Id.* at 982-83.
20. 612 F. Supp. 1298 (D.N.J. 1985). Another example of the growing acceptance of the *Waste Management* doctrine is the recent opinion of Judge Williams in McCaw Personal Communications, Inc. v. Pacific Telesis Group, 645 F. Supp. 1166 (N.D.Cal. 1986).
21. *Calmar*, 612 F. Supp. at 1305.
22. *Id.* at 1301.
23. 105 F.T.C. 410 (1985). *Echlin* is the only ease of entry case which devotes a significant part of its opinion to the economics of entry. It will be analyzed in more detail in the next section of this Article.
24. *Echlin*, 105 F.T.C. at 492 (Bailey, Comm'r, dissenting).
25. *Id.* at 480.
26. 1985-2 Trade Cas. (CCH) ¶ 66,768 (S.D.N.Y. 1985).

finding that "the degree of concentration is insufficient to warrant antitrust relief."[27] Continuing the opinion in dictum, Judge Cannella relied on *Waste Management* and stated, "Finally, even had plaintiff shown market concentrations indicative of the anticompetitive impact of the acquisition, the lack of any significant barrier to entry would preclude a finding of an antitrust violation. . . . Plaintiff has pointed to no barriers nor presented evidence of significant difficulty of entry."[28]

It is clear that courts have taken the *Waste Management* doctrine and run with it as far as it will go, perhaps farther than a careful reading of the holding would permit. The holding itself probably goes farther than its factual and analytical basis would permit.[29] The case may have been correctly decided, but it was not correctly reasoned. Judge Winter's opinion lacks detail and rigor, and its cryptic conciseness about a matter as complex as market entry renders it a poor guide for future decisions.

While low entry barriers may indeed prevent a concentrated market from supporting supra-competitive prices, the question which is ignored in all the cases discussed above is how low is "low"? If a finding of "ease of entry" or "low entry barriers" is sufficient to overcome prima facie illegality under Section 7, those terms of art must be given substance and quantitative meaning. Otherwise, merger inquiries will degenerate into a battle of the experts over obscure and subjective evaluations of "low" and "high" barriers. Judges will have the discretion to rewrite the antitrust laws to their liking, and litigants will go on sprees of forum shopping.

Unfortunately, the limited judicial authority on ease of entry after *Waste Management* indicates that this is the direction the law is taking. The cases make no attempt to measure the height of entry

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27. *Id.* at 63,724.

28. *Id. See also* Will v. Comprehensive Accounting Corp., 776 F.2d 665, 672 (7th Cir. 1985) (in order to prove market power "plaintiff must show a barrier to entry that prevents competition"); Schmalensee, *Ease of Entry: Has the Concept Been Applied Too Readily?*, 56 ANTITRUST L.J. 41, 50-51 (1987) (burden of proving entry barriers seems to be shifting to plaintiff). Since *Waste Management* stated that concentration alone could prove prima facie illegality under Section 7, it is unclear why the plaintiff should be required to buttress his case by attacking an affirmative defense not yet raised. Judge Cannella raised no economic or legal justification for shifting the burden to the plaintiff. The Department of Justice, which has ambivalent feelings about ease of entry, has not accepted the *Saltz & Sons* rule. *See* Leddy, *Entry Issues in Merger Analysis*, 54 ANTITRUST L.J. 1257, 1259 (1986) ("The defendant has the burden of proof on entry in Section 7 cases.").

29. *See* Calkins, *Developments in Merger Litigation: The Government Doesn't Always Win*, 56 ANTITRUST L.J. 855, 863, n.45 (1987); Rule, *Merger Enforcement Policy: Protecting the Consumer*, 56 ANTITRUST L.J. 739, 749 (1987).

barriers in order to distinguish high from low.[30] Instead, "low entry barriers" and "ease of entry" have become talismanic incantations which amount to a test of *per se* legality for many mergers.[31]

II. Should Ease of Entry Always Trump Concentration?

A. *The Justice Department View—Ease versus Likelihood*

It was the Reagan Administration Justice Department which brought entry issues to the fore, so it is ironic that their own creation has come back to haunt them. Actually, the entry issues which the Antitrust Division emphasized in 1982 related to proper market definition and did not directly implicate market power. There was a concern that rigid market definition would systematically understate the competitive impact of potential entrants.[32] The 1982 Merger Guidelines took entry barriers into account in order to correct this problem.[33]

The entry analysis discussed in *Waste Management* and its progeny does not concern market definition, but the lack of market power despite concentration. It is common knowledge among economists that entry barriers are a prerequisite for monopoly pricing.[34] What *Waste Management* stands for is the converse: the absence of entry barriers absolutely prevents any supra-competitive pricing. This proposition is much more controversial, depending upon how entry barriers are defined.

The Department of Justice maintains that *Waste Management* and *Calmar* were wrongly decided because the courts misread the Merger Guidelines. As Deputy Assistant Attorney General Mark Leddy explains:

> Section 3.3 [of the 1984 Merger Guidelines] says that if entry is so easy that firms in the market will be deterred from colluding for

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30. Schmalensee, *supra* note 28, at 47. For a survey of the recent cases on ease of entry, *see* Briggs, *An Overview of Current Law and Policy Relating to Mergers and Acquisitions*, 56 Antitrust L.J. 657, 666-67, 679-80 (1987).

31. *In re* Echlin Manufacturing Co., 105 F.T.C. 410, 502 (1985) (Bailey, Comm'r, dissenting).

32. *See, e.g.*, Landes & Posner, *Market Power in Antitrust Cases*, 94 Harv. L. Rev. 937 (1981).

33. *See* 1982 Merger Guidelines § III B, *supra* note 6 (potential entrants "are included in the market and given a market share"). *See also* Leddy, *supra* note 28, at 1257.

34. *See, e.g.*, F. Scherer, Industrial Market Structure and Economic Performance 11 (2d ed. 1980).

> fear that higher prices will bring in more competition, then we won't challenge the merger. This does not mean that if entry is physically easy to accomplish, then any increase in concentration is automatically acceptable. That is how I think the courts in *Waste Management* and *Calmar* characterized the entry questions, and that is where they went wrong. The pertinent question is how *likely* entry is. One must read in Section 3.3—the second paragraph says that it is the "likelihood and probable magnitude" of entry that matter.[35]

Mr. Leddy's statement raises two issues. First, antitrust law is what Congress and the courts say it is, no matter how vigorously the Department of Justice might disagree. The Merger Guidelines may be given the force of law by judicial application and acceptance, but they do not constitute law by themselves.[36] Second, the distinction the Department raises between ease of entry and likelihood of entry is curious. If markets are functioning properly, ease of entry should presuppose likelihood of entry if prices rise.

In a recent interview, former Assistant Attorney General (and now D.C. Circuit Judge) Douglas Ginsburg described one case where there would be no probability of entry despite low barriers: "In an industry where there are no legal or other barriers to entry, but where the short-run marginal cost is below long-run marginal cost—for example, in a declining industry—there isn't going to be any entry in response to a five percent price increase."[37]

Judge Ginsburg incorrectly implies that there should be entry in such a situation, in order to bid down the price increase. A competitive price is one which equals *long-run* marginal cost; forcing firms to price at short-run marginal cost will inevitably lead to bankruptcy. In declining industries, mergers can enhance efficiency by cheaply adjusting supply markets to meet decreased demand. Price increases under these circumstances are not necessarily monopoly rents. They may simply reflect the loss of scale economies and other

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35. Leddy, *supra* note 28, at 1258.

36. United States v. Atlantic Richfield Co., 297 F. Supp. 1061, 1073 (S.D.N.Y. 1969); Allis-Chalmers Mfg. Co. v. White Consol. Ind., Inc., 414 F.2d 506, 524 (3d Cir. 1969), *cert. denied* 396 U.S. 1009 (1970). In fact, the Reagan Administration has proposed a bill which would essentially codify the 1984 Merger Guidelines. *See Reagan Administration Unveils Antitrust Reform Package; Rodino Attacks Proposals*, 50 ANTITRUST & TRADE REG. REP. (BNA) No. 1253, 307-08 (1986); *Baldridge, Ginsberg Defend Antitrust Package; Democrats Try to Unravel It*, 50 ANTITRUST & TRADE REG. REP. (BNA) No. 1260, 627-29 (1986) (discussing H.R. 4247, S. 2160, The Merger Modernization Act of 1986).

37. *60 Minutes with Douglas H. Ginsburg, Assistant Attorney General, Antitrust Division*, 55 ANTITRUST L.J. 255, 272 (1986).

factors which would have permitted lower prices if demand were stronger, or they may represent the end of cutthroat price wars and a return to competitive equilibrium after a market shake-out.

The distinction between ease of entry and likelihood of entry has no economic basis. To the extent that market power is the issue, likelihood of entry is irrelevant.[38] Entry is unlikely in a saturated, fiercely competitive market, as well as a declining, unprofitable market. Entry is also unlikely if barriers are high. Yet it is unclear why firms would not enter a market characterized by low barriers and high profits. Basic microeconomic theory teaches that entry would be quite likely.[39]

Thus, the Department of Justice would not consider ease of entry to be dispositive if there is no corresponding likelihood of entry. This analysis fails to address the complexity of the issue. Perhaps the Justice Department is more sophisticated than it appears, however, and is saying "when we argue that there is no *likelihood* of entry, we really believe that there is no *ease* of entry, despite what the factfinder says." The ease/likelihood distinction may be a way for the government to get a second bite at the apple once it has lost on the facts. This subtle ploy is admirable, since it is likely that the courts have been too quick to find low barriers to entry in the cases discussed above. Unfortunately, the ploy, if that is what it is, has not been successful. It does not appear that the Department has refined its approach since losing the *Calmar* case.[40]

B. The Federal Trade Commission View—Unqualified Endorsement

In contrast to the Department of Justice, the Federal Trade Commission seems to consider ease of entry by itself sufficient to guard

38. Commissioner Douglas implicitly rebuked the Justice Department's ease/likelihood distinction in Echlin Manufacturing Co., 105 F.T.C. at 485:

> Complaint counsel suggests that entry barriers are high whenever it is unlikely that new firms will decide to enter the market. We cannot agree. Although high barriers indicate that entry is unlikely, reversing that statement goes too far. For example, entry would be most unlikely if all the incumbent firms were losing money, yet this is clearly not the kind of barrier that facilitates the extraction of monopoly profits.

39. Of course, to the extent that real world behavior differs from economic abstractions, market entry may not be as extensive as theory would suggest. One commentator has recently argued that because American managers tend to focus on unduly short time horizons and be overly risk averse, they are constrained from entering markets even when it would be economically rational to do so. *See* Gerla, *A Micro-microeconomic Approach to Antitrust Law: Games Managers Play*, 86 MICH. L. REV. 892, 903-10 (1988).

40. *See* Yoerg, Hill & Leddy, *Panel Discussion*, 54 ANTITRUST L.J. 1271, 1273 (1985).

against the anticompetitive effects of any merger. This position has evolved gradually. In 1982, when the Justice Department announced its new enforcement policy, the FTC also promulgated new guidelines for its merger investigations. These guidelines provided: "The issue of entry barriers is perhaps the most important qualitative factor . . . [but] the evidence relating to entry barriers may not always point clearly to the conclusion that a merger should or should not be allowed."[41]

The FTC applied this conservative standard in several cases the following year.[42] The opinion in *In re Grand Union Co.* mentioned in the context of potential competition analysis that "evidence of low entry barriers . . . may assist in rebutting a concentration-based legal presumption,"[43] thus anticipating the landmark *Waste Management* opinion.

In 1985, the Commission decided *In re Echlin Manufacturing Co.*[44] That case marked a departure from the previous view of the FTC that low entry barriers alone would not determine a merger's legality. The *Echlin* opinion makes it clear that ease of entry is indeed dispositive, and it represents the most thorough embrace of the *Waste Management* doctrine to date.

The case involved a merger in the carburetor kit industry. Echlin Manufacturing Company, a major supplier and assembler of kits, intended to acquire the industry leader, Borg-Warner Corporation. The merged firms would have controlled a 46.8 percent market share. The Commission noted nine "non-market share factors" which it deemed "sufficient to overcome the substantial anticompetitive potential of the acquisition inferred from market share evidence alone."[45] Some of those factors implied that the original market definition was misleading, while others related to empirical evidence showing that the market was competitive. The only factor which received any discussion in the Opinion of the Commission, however, was the conclusion that "[e]ntry barriers into the assembly and sale of kits are very low."[46]

After making this factual finding, Commissioner Douglas' opinion went into a detailed discussion on ease of entry. The Commission

41. FTC STATEMENT § III A(1), *supra* note 8.
42. *See In re* Weyerhaeuser Co., No. 9150, slip op. at 94-97 (FTC 1983) (preliminary order); *In re* Beatrice Foods Co., 101 F.T.C. 733 (1983); *In re* Grand Union Co., 102 F.T.C. 812 (1983).
43. *In re* Grand Union Co., 102 F.T.C. at 1063.
44. 105 F.T.C. 410 (1985).
45. *Id.* at 478-79.
46. *Id* at 478, 487-92.

adopted the Stiglerian definition of entry barriers "as additional long run costs that must be incurred by an entrant relative to the long-run costs faced by incumbent firms."[47] In addition to citing *Waste Management*, the opinion relied heavily on contestable markets theory and claimed that "in the absence of barriers to entry, incumbent firms cannot exercise market power, regardless of the concentration in the nominal 'market,' and indeed even if that 'market' has been 'monopolized' by a single firm."[48]

Complaint counsel argued that four barriers to entry existed: sunk costs, economies of scale, the lack of significant entry in the recent past, and predatory practices. Commissioner Douglas rejected each of them for lack of evidence and disposed of them for lack of legal impact as well.[49] He pointed out that sunk costs and economies of scale are not by themselves properly considered barriers to entry since every entrant must face these costs. He admitted that the absence of past entry might reflect the existence of barriers but noted that such a history would also be equally consistent with competitive conditions. Finally, he dealt with the predatory pricing argument by asserting:

> Retaliatory price-cutting and other predatory practices are unlikely to deter entry unless there is a significant barrier to entry in addition to the mere threat of retaliation. If there is not such [an] entry barrier, the incumbent firms will never be able to . . . recoup the losses they suffered by selling their products below cost.[50]

Because of its detail, *Echlin* is a key case. It gives unequivocal endorsement to the *Waste Management* doctrine that ease of entry trumps concentration. The FTC has clearly gone farther than the Justice Department in accepting the significance of low entry barriers in merger cases.

C. Entry and Echlin *Revisited*

Commissioner Bailey dissented from the majority opinion in *Echlin* and presented three basic objections: (1) The factual conclusion that barriers are low was wrong; (2) the Stiglerian definition of entry barriers is too narrow; and (3) the Commission misapplied the law

47. *Id.* at 485-86.
48. *Id.* at 484.
49. *Id.* at 487-91.
50. *Id.* at 490.

in making ease of entry a dispositive issue. Though her criticisms were not always correct, they did highlight weaknesses in the case which the majority did not adequately address.

1. *The Height of Entry Barriers—I Say High, You Say Low*[51]

The dissent disputed the majority's conclusion that entry into Echlin's market is "extraordinarily easy and can be quite rapid."[52] Commissioner Bailey was struck by the poor record of entry into the market over the past decade. She reasoned: "The market is clearly unattractive to the new entrants best poised to make the effort, and some factor must account for this fact."[53] To her, the obvious villain was high entry barriers.

Commissioner Bailey impatiently dismissed the Chicago School response that lack of entry is consistent with competitive pricing: "To suggest that the failure to expand can be based on the invisible evidence of some invisible hand is such a spectral conclusion. . . ."[54] Drawing upon the Justice Department's 1984 Merger Guidelines, the 1982 FTC Statement on Mergers, and "traditional case law," Commissioner Bailey advanced an assessment of the historical record on entry as "the simplest and most practical" test for determining whether barriers are high or low.[55]

The simplicity of Commissioner Bailey's test cannot be doubted, but its practicality is dubious. A lack of entry in the past may suggest high barriers, but it may with equal validity suggest low barriers and a lack of excess profits. Her attack on the Chicago School explanation as "spectral" does not rebut it. The use of historical data as the sole test for ease of entry is unsound.[56]

Simply because the dissent is wrong does not mean the majority is right, however. In addition to labeling the existing barriers "very low," the majority opinion in three places remarked that "there are no barriers to entry into the [market]."[57] This cannot be an accurate

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51. The Beatles, *Hello Good-bye*, MAGICAL MYSTERY TOUR (Capitol Records 1967).
52. *In re* Echlin Mfg. Co., 105 F.T.C. 410, 493 (1985).
53. *Id.* at 500.
54. *Id.*
55. *Id.* at 498. Commissioner Bailey's suggestion has since gained some acceptance. In the recent case of *In re* B.F. Goodrich Co., No. 9159, slip op. at 10-12 (FTC 1988), the Commission noted the lack of past entry as one factor supporting the conclusion that significant barriers existed in the polyvinyl chloride market.
56. *See* Schmalensee, *supra* note 28, at 45-46.
57. *Echlin*, 105 F.T.C. at 480, 487, 491.

observation. Nowhere in the opinion was there any attempt to quantify the level of entry barriers.[58] Instead, the Commission based its finding on the fact that the capital investment required to start a carburetor kit company is not large, the process is simple, the equipment could be used for other purposes, and the industry had some history of new entry and price competition.[59]

The *Echlin* opinion's use of vague phrases like "not large," "very low," "virtually nonexistent," "extraordinarily easy," and "little difficulty" parallels the subjective language found in *Waste Management* and *Calmar.* One commentator criticizing the treatment of entry issues in early cases has written: "Virtually nowhere have the courts or the FTC endeavored to estimate even roughly the extent to which such barriers permit dominant incumbents to hold price above a competitive level."[60] The irony is that this criticism is equally applicable to the modern cases. In the 1960s a reference to "high barriers" simply signalled a pre-determined outcome of illegality, while in the 1980s a finding of "low barriers" or "ease of entry" gives merging firms carte blanche. In both situations the phrases have no strict meaning. *Waste Management* and *Echlin* are simply the mirror images of *Brown Shoe* and *Von's Grocery.*

2. *Defining Barriers—Stigler versus Bain*

Instead of using Professor George Stigler's definition of entry barriers as additional long-run costs which new entrants must face, Commissioner Bailey adopted the definition proposed by Professor Joe Bain. The Bain approach would measure the height of barriers by the "extent to which, in the long run, established firms can elevate their selling prices above the minimal average costs of production and distribution (those costs associated with operation at optimal scales) without inducing potential entrants to enter the industry."[61]

According to Commissioner Bailey, "The defect in the Stiglerian alternative is that it does not account for the time, scale and cost necessary for a successful entry that is a meaningful threat to incumbent firms."[62] Yet the Bain definition has defects of its own. Under

58. Indeed, the Commission maintained that entry barriers "do not lend themselves to precise mathematical expression." *Id.* at 483-84.

59. *Id.* at 482-83.

60. Wentz, *supra* note 3, at 1559.

61. *Echlin*, 105 F.T.C. at 494.

62. *Id.* at 496.

Commissioner Bailey's method, any factor which lets firms price above the costs of production is a barrier. This is certainly too broad, because it confuses post-entry conditions of profitability with pre-entry conditions. For example, if a market is particularly risky, firms must expect a premium above the long-run marginal cost of production in order to induce them to enter. After entry, some firms will be successful while others will fail and exit the market. The fact that an incumbent firm is now earning profits above marginal production costs does not necessarily mean it is garnishing supra-competitive profits. It may simply be capturing its expected risk premium, which should be taken into account in assessing the true marginal cost of an item.[63] The fact that pre-entry firms face uncertainties which incumbents have already overcome does not prove that there are entry barriers.[64]

Commissioner Bailey maintained that the essence of the Bain definition of entry barriers is "whatever allows incumbent firms to charge supra-competitive prices yet not attract new entry."[65] This definition is sound, though it is derivative of both Bainian *and* Stiglerian notions.[66] The debate over the Harvard and Chicago Schools in this regard centers on what is the true competitive price. What adherents of Bain consider supra-competitive may be competitive in the eyes of Stigler's disciples when factors such as pre-entry risk are taken into account. In terms of correctly measuring consumer welfare, Stigler's definition is superior.

Though Commissioner Bailey's arguments in support of the Bain definition are not compelling, they serve to emphasize her third objection over the misuse of ease of entry as a defense to an otherwise illegal merger. This point will be discussed below.

3. *Strategic Barriers*

The weakness in the majority's opinion in *Echlin* was its shallow treatment of predatory pricing. Incumbent firms need not price below cost in order to increase risks to outsiders and deter entry. They need

63. *See* Campbell, *Comments on Presentation of Richard Schmalensee*, 56 ANTITRUST L.J. 53, 54 (1987). *But cf.* P. AREEDA & H. HOVENKAMP, ANTITRUST LAW 669 (Supp. 1987) ("That incumbents once took risks and may be entitled to the fruits of their risk-taking does not justify a merger that is likely to reduce competition among incumbents.").

64. *See Echlin*, 105 F.T.C. at 488-89.

65. *Id.* at 495.

66. Schmalensee, *supra* note 28, at 44 (most economists follow a middle road between the Bain and Stigler definitions).

only make a credible threat. The dissent recognized this and pointed out: "The few incumbent firms may have the scale economy advantages of lower unit costs, which may permit selective retaliatory pricing that is not, strictly speaking, predatory, but is, generally speaking, entry deterring."[67]

Commissioner Bailey glossed over a major oversight in the majority opinion—entry barriers are not always exogenous to firms. Even without conventional, easily identified barriers like government regulation, incumbent firms can still create artificial barriers. Professor Stephen Salop makes a useful distinction: "An *innocent* entry barrier is unintentionally erected as a side effect of innocent profit maximization. In contrast, a *strategic* entry barrier is purposely erected to reduce the possibility of entry."[68] These strategic barriers do not reflect the normal cost of entering the market, and the supra-competitive prices which result represent a real welfare loss. The majority opinion discussed innocent barriers but largely neglected strategic barriers.

The economic literature has recognized the impact of strategic barriers for several years now.[69] One such barrier which has received much scholarly attention is the investment in excess capacity. Such an irretrievable commitment of resources makes credible the threat of price warfare.[70] This threat may deter even firms which can produce at a lower marginal cost, if the sunk cost of excess capacity credibly signals mutually destructive competition for a sufficient period in response to new entry.[71]

In addition to investments which adversely affect the pre-entry outlook for new firms, information signalling through price may also create strategic entry barriers. In the absence of strategic behavior, a new entrant can infer cost differentials from price differentials between it and the incumbents. It is in the incumbents' interest to manipulate price signals, however.[72] Incumbents may temporarily price below cost, not necessarily to predate against existing rivals, but to make long-run marginal cost appear lower than it actually is in order to discourage

67. *Echlin*, 105 F.T.C. at 501.
68. Salop, *Strategic Entry Deterrence*, 69 AM. ECON. REV., May, 1979 at 335.
69. *See, e.g.*, Caves & Porter, *From Entry Barriers to Mobility Barriers: Conjectural Decisions and Contrived Deterrence to New Competition*, 91 Q.J. ECON. 241 (1977); Spence, *Entry, Capacity, Investment and Oligopolistic Pricing*, 8 BELL J. ECON. 534 (1978); Dixit, *A Model of Duopoly Suggesting a Theory of Entry Barriers*, 10 BELL J. ECON. 20 (1979); Demsetz, *Barriers to Entry*, 72 AM. ECON. REV., March 1982, at 47.
70. Caves & Porter, *supra* note 69, at 245.
71. Salop, *supra* note 68.
72. *Id.* at 337.

new rivals. Low pricing and recent exit from a market reinforce the belief that conditions are risky and that entrenched incumbents have an insurmountable advantage.[73]

The majority opinion in *Echlin* is simply incorrect when it concludes that predatory pricing is "unlikely to deter entry."[74] If the threat to predate is backed up by a credible commitment, a formidable entry barrier exists. The majority also uses Stigler's definition of entry barriers too simplistically. For example, the Commission denies that sunk costs can create barriers:

> If sunk costs are considered an entry barrier, it must be because they create a difference in the risk confronting the incumbent firms who have already committed their resources and potential entrants who have yet to make that decision. . . . This, however, is a false comparison, because the returns earned by the incumbent firms reflect in part the risks they faced at the time they made the decision to enter the market.[75]

This explanation completely ignores the possibility that entrants may work to increase barriers once they are in the market. Incumbents have several strategic options which are not available to later arrivals. The majority's analysis is static and does not treat the issue with enough sophistication.[76]

D. Entry and Contestable Markets

One reason for the neglect of dynamic considerations in *Echlin* may be the majority's reliance on a new static model proposed by Professors Baumol, Bailey, Willig, and others, dubbed the theory of contestable markets.[77] A contestable market is one which is characterized by

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73. Joskow & Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213, 230-31 (1979). A host of other strategic barriers are discussed in Krattenmaker & Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209 (1986). *See also* Salop, *New Economic Theories of Anticompetitive Exclusion*, 56 ANTITRUST L.J. 57, 62-63 (1987).

74. *In re* Echlin Mfg. Co., 105 F.T.C. 410, 490 (1985).

75. *Id.* at 488.

76. *Cf.* J. FRIEDMAN, OLIGOPOLY THEORY 205 (1983) ("It cannot be too strongly emphasized that entry and exit are intrinsically dynamic processes; therefore, they must be studied with the aid of dynamic models. To claim to study entry with static models . . . is not the study of entry at all."). The Commission has recently attempted to incorporate market dynamics into its merger analysis. *See In re* B.F. Goodrich Co., No. 9159, slip op. at 9 (FTC 1988) (discussing "impediments to entry" which allow incumbents to exercise market power while new entrants are delayed).

77. *See* W. BAUMOL, E. BAILEY, & R. WILLIG, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE (1982); Baumol, *Contestable Markets: An Uprising in the Theory of Industrial Structure*, 72 AM. ECON. REV. 1 (1982).

perfectly free entry and exit, equal access to technology, and instantaneous price response. Under these circumstances, concentration is irrelevant because any attempt to increase price above marginal cost will be met with the loss of one's entire market share to new entrants. Such market discipline means that even a monopolist will be forced to charge competitive prices.

Since its announcement six years ago, the theory has generated much acclaim and criticism.[78] A major point of controversy centers on the applicability of the theory once its strict requirements are relaxed. An example of this involves sunk costs and time lags. Contestable markets theory requires free exit, which implies no sunk costs. The presence of small sunk costs does not necessarily mean that there would only be a small deviation from perfect efficiency. Depending on the structure of the industry, the presence of any sunk costs at all may be enough to give the first entrants the chance to raise barriers further, thus destroying the conditions for contestability.[79] These objections are applicable to other aspects of the theory as well. Real world refinements such as lags in entry, strategic interaction, and differential access to technology and information may substantially limit the scope of the theory to a few special markets.[80]

As is the case with most new theories, widespread acceptance is contingent on persuasive empirical evidence. Studies are being conducted in the airline, railroad, trucking, and long-distance telephone service industries. Conclusive results have not yet been reported.[81]

Until the *Echlin* case was decided, the theory of contestable markets had not been given judicial recognition.[82] Government antitrust enforcers considered its application at best limited to certain regulated transportation industries.[83] The FTC dramatically changed that state

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78. *See, e.g.*, Brock, *Contestable Markets and the Theory of Industry Structure: A Review Article*, 91 J. POL. ECON. 1055 (1983); Spence, *Contestable Markets and the Theory of Industry Structure: A Review Article*, 21 J. ECON. LIT. 981 (1983); Weitzman, *Contestable Markets: An Uprising in the Theory of Industry Structure: Comment*, 73 AM. ECON. REV. 486 (1983).

79. Shepard, *Illogic and Unreality: The Odd Case of Ultra-Free Entry and Inert Markets*, in ANTITRUST AND REGULATION 231, 236-37 (R. Grieson, ed. 1986).

80. *Id.* at 231-39.

81. *Id.* at 239-47. *But see* Schwartz, *The Nature and Scope of Contestability Theory*, 40 OXFORD ECON. PAPERS 37, 47-50 (Supp. 1986) (recent empirical evidence does not support contestability) (on file at the *Pacific Law Journal*); Tye, *The Contestable Market Defense in Freight Antitrust Cases*, 54 TRANS. PRAC. J. 177, 184-85 (1987) (same).

82. Alpert & Kitt, *Is Structure All?* 53 ANTITRUST L.J. 255, 264 (1984); Shepard, *Economics in Court: An 8-Case Antitrust Summary*, 18 ANTITRUST L. & ECON. REV. 76, 82 (Spring 1986).

83. *See, e.g.*, Schwartz & Reynolds, *On the Limited Relevance of Contestability Theory*, ANTITRUST DIV. ECON. POLICY OFFICE DISCUSSION PAPER, EPO 84-10 (1984) (on file at the *Pacific Law Journal*). The Department of Justice continues to doubt the validity of contestable markets theory. *See* Rule, *supra* note 29, at 745.

of affairs by citing articles relating to contestable markets theory no less than six times in the *Echlin* opinion.[84] This seems to be an overt attempt to give the theory the imprimatur of legal authority. Unfortunately, the Commission's reliance is misguided. The absence of entry barriers is a necessary but not a sufficient condition for contestability. Other requirements include instantaneous market displacement on the part of entrants and sluggish price response on the part of incumbents. There is no evidence that these requirements were met in *Echlin*.

This does not mean that potential entrants cannot discipline the market. They can and do. The Commission should recognize, however, that strategic barriers may shield and sustain the limit price being charged, resulting in excess profits. The Commission's conclusion that there are no entry barriers in the carburetor kit market is too facile, and its reliance on contestability theory is unwarranted.

E. Conclusion—Entry Is Important But Not Always Dispositive

The less than rigorous treatment of entry barriers in *Echlin* sets a poor precedent for scrutinizing the anticompetitive effects of mergers. The opinion states that ease of entry can defeat the presumptive illegality of high concentration, but gives no guide as to what constitutes "ease." Nor does the opinion adequately assess the more subtle strategic barriers which incumbents raise against new entrants. Finally, the Commission's misplaced reliance on contestable markets theory gives the opinion unwarranted confidence regarding the competitive discipline which will be exerted on the market after the merger.

The Justice Department's more cautious policy toward ease of entry is preferable. Though the Department's ease/likelihood distinction has a dubious economic basis, the ultimate result is to view entry as important but not dispositive. This is superior to the FTC's approach, for two reasons. First, as the *Echlin* case shows, entry is a subtle and complex subject. Analyzing the obvious innocent barriers in a market does not settle the issue. Yet strategic barriers may be difficult to identify and measure.[85] Second, recent economic scholarship indicates that markets with no overt entry barriers can still support oligopolies

84. *In re* Echlin Mfg. Co., 105 F.T.C. 410, 484-85, 488-89, 491 (1985).

85. *See, e.g.*, Arvan, *Sunk Capacity Costs, Long-Run Fixed Costs, and Entry Deterrence Under Complete and Incomplete Information*, 17 RAND J. ECON. 105 (1986); Farrell, *Moral Hazard as an Entry Barrier*, 17 RAND J. ECON. 440 (1986).

which have market power.[86] Explanation of these theories is beyond the scope of this Article, but a recurring theme is the dynamic interplay between entrant and incumbent.

It is interesting how entry deterrence shares a certain symmetry with the theory of contestable markets. An incumbent in a contestable market is forced to keep prices low in order to forestall new entry. The existence of time lags in entry characterizes the opposite situation, in which the incumbent is able to use limit pricing and strategic entry deterrence to keep prices high, yet forestall new entry with the threat of retaliation. In the former case, the entrant threatens the incumbent: "If you do not price competitively, then I will enter." In the latter case, the incumbent threatens the entrant: "If you enter, then I will price competitively."

Obviously, the validity of these contrasting models depends on empirical evidence which is not yet available. It may well be that certain markets are prone to fit one of the models over the other. Since the empirical evidence is still inconclusive, however, radical changes in antitrust law are not justified.

In conclusion, until ease of entry is accurately quantified and all strategic barriers are taken into account, a vague finding of low entry barriers should not by itself trump the conclusions inferred from high concentration.

III. SUGGESTIONS FOR REFORM

A. *Introduce Rigor*

One recurring criticism throughout this Article has been the failure to quantify entry barriers. The obvious solution is to define an entry barrier as any factor (including strategic factors) which allows incumbents to price above long-run marginal cost (including a premium for risk) without attracting new entry, and to require courts and litigants to identify and measure the height of these barriers whenever ease of entry is at issue in a merger case.

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86. *See, e.g.*, Radner, *Collusive Behavior in Noncooperative Epsilon-Equilibria of Oligopolies with Long but Finite Lives*, 22 J. ECON. THEORY 136 (1980); Eaton & Wooders, *Sophisticated Entry in a Model of Spatial Competition*, 16 RAND J. ECON. 282 (1985); Mankiw & Whinston, *Free Entry and Social Inefficiency*, 17 RAND J. ECON. 48 (1986).

Such measurement may be exceedingly difficult, but it would prove no worse than defining markets, assessing merger efficiencies, or debating the myriad of other complex issues which already vex antitrust litigation.[87] In any event, it is preferable to giving judges the discretion to rewrite merger law on a case-by-case basis. Recently, there has been serious attention devoted to measuring entry barriers.[88] It is important to keep in mind that the term "barriers to entry" is only a metaphor; there are no physical "barriers" surrounding a market like a castle wall. The "height" of entry barriers is measured in terms of cost. Several factors can account for the cost of entering a market. Professor Salop identifies speed of entry, economies of scale, and sunk costs as particularly important.[89] Each of these factors may be quantified and translated into a per unit cost for new entrants.

The next step is to determine whether these barriers permit the incumbents to exercise market power. A convenient benchmark is the five percent test of the Justice Department Merger Guidelines. If the barriers impose added per unit costs greater than five percent of long-run marginal cost, then entry barriers are "high." Otherwise barriers are low, and the market is characterized by ease of entry.

A finding of ease of entry does not end the inquiry. Before permitting the merger, the court should first regard ease of entry as an indication that the market has been drawn too narrowly.[90] After broadening the market to a point where significant barriers exist, the court can repeat its concentration analysis. If the market does not exhibit high barriers at any level of definition, then the merger may be permitted. The plaintiff should be able to counter the defense of ease of entry by proving that the market in question is capable of maintaining an oligopoly even in the absence of overt entry barriers.

Relating the height of entry barriers to the Merger Guidelines' five percent test sets a clear standard, leading to greater certainty and better enforcement. It also underscores the economic basis which underlies ease of entry as an affirmative defense.

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87. *Cf.* Rowe, *Comment: Market as Mirage*, 75 CAL. L. REV. 991 (1987).

88. *See, e.g.*, Salop, *Measuring Entry Barriers and the Rule of Reason: A Sophisticated Approach to Merger Analysis* (pts. 1 & 2), 15 ANTITRUST L. & ECON. REV. 59 (1983), 16 ANTITRUST L. & ECON. REV. 33 (1984). *But cf.* Yoerg, Hill & Leddy, *supra* note 40, at 1274 (trying to measure entry barriers is an "impossible task for litigators and courts"); Schmalensee, *supra* note 28, at 42 (there is not yet a single, reliable method to measure entry barriers).

89. Salop, *Measuring Ease of Entry*, 31 ANTITRUST BULL. 551, 556-57 (1986).

90. *See* Carter Hawley Hale Stores, Inc. v. The Limited, Inc., 587 F. Supp. 246, 252-53 (C.D. Cal. 1984); Areeda, *Monopolization, Mergers and Markets: A Century Past and the Future*, 75 CAL. L. REV. 959, 978 (1987).

B. Emphasize the Defendant's Burden of Proof

The existence of both innocent and strategic entry barriers complicates the analysis. Often, entry will not be as easy as it appears. It is important to identify and measure *all* strategic barriers to entry. The problem lies in the fact that the defendant has the burden of proving ease of entry, and it will be in the defendant's interest to ignore or mischaracterize strategic barriers of his own making. The testimony of third parties and independent experts will be indispensable to any serious investigation of entry barriers. Moreover, the difficulty of measuring entry barriers should not work to the defendant's advantage. All doubts should be resolved in favor of the plaintiff because of the potential for abusing this defense.[91]

Emphasizing the defendant's burden of proof acknowledges the fact that very few markets are completely devoid of entry barriers.[92] Unless the defendant can present convincing evidence to the contrary, entry barriers should be taken as given in the original market definition.

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91. *See* Schmalensee, *supra* note 28, at 51.

92. *See* Rule, *supra* note 29, at 744; Schmalensee, *supra* note 28, at 42; Shepard, *supra* note 79, at 239-47.