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US Merger Review: A ‘Goldilocksian’ Perspective

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Abstract

US merger control rests on four strong cornerstones. The first is section 7 of the Clayton Act, as amended by the Celler-Kefauver Act in 1950, which created the substantial lessening of competition standard as the test for the legality of mergers and acquisitions. The second is the Supreme Court’s 1962 decision in Philadelphia National Bank, which relied on the structure-conduct-performance paradigm from industrial organisation economics to fashion a presumption that mergers that significantly increase concentration in already concentrated industries will lessen competition, imposing on the parties the burden of rebutting the government’s structural case. The third is the Hart-Scott-Rodino Antitrust Improvements Act of 1976, which introduced the concept of pre-merger notification, to give the agencies an opportunity to review major transactions before they are consummated. The fourth, and final, cornerstone was the publication by the Justice Department in 1982 of a completely new set of Merger Guidelines, which have been refined over time and which set forth the basic analytical framework the agencies use to evaluate mergers.

US merger review: a 'Goldilocksian' perspective

WILLIAM KOLASKY, Wilmer Cutler Pickering Hale and Dorr LLP, the former deputy assistant attorney general for international enforcement in the Antitrust Division of the US Department of Justice, says the US merger control regime is getting things 'just about right'.

US merger control rests on four strong cornerstones. The first is section 7 of the Clayton Act, as amended by the Celler-Kefauver Act in 1950, which created the substantial lessening of competition standard as the test for the legality of mergers and acquisitions. The second is the Supreme Court's 1962 decision in *Philadelphia National Bank*, which relied on the structure-conduct-performance paradigm from industrial organisation economics to fashion a presumption that mergers that significantly increase concentration in already concentrated industries will lessen competition, imposing on the parties the burden of rebutting the government's structural case. The third is the Hart-Scott-Rodino Antitrust Improvements Act of 1976, which introduced the concept of pre-merger notification, to give the agencies an opportunity to review major transactions before they are consummated. The fourth, and final, cornerstone was the publication by the Justice Department in 1982 of a completely new set of Merger Guidelines, which have been refined over time and which set forth the basic analytical framework the agencies use to evaluate mergers.

As we approach the 30th anniversary of the Hart-Scott-Rodino Antitrust Improvements Act, now is a good time to evaluate how well the US's current merger control regime is working. As my title suggests, I take the position is that our current system, developed over more than a half century of trial and error, actually works quite well. As Goldilocks might put it, the agencies finally have it "just about right". This view seemed to be shared by most practitioners who participated in a three-day workshop on merger enforcement sponsored by the Department of Justice and the Federal Trade Commission in February 2004. The participating practitioners expressed general satisfaction with the analytical framework set forth in the Merger Guidelines and

with its application. Even those who are critical of antitrust enforcement generally seem to view merger control as a success. For example, in an article in the American Enterprise Institute's *Regulation* magazine, George Bittlingmayer credits the 1982 guidelines and the HSR merger review process with being responsible for "a more efficient corporate sector and quite plausibly for an expanding, dynamic economy and a booming stock market" (25 *Regulation* 46, October 2002).

Inevitably, not everyone will agree with this Goldilocksian view. The agencies continue to be criticised by some for being too lax in permitting mergers and by others for being too restrictive. One example of the latter view is a study by two economists at the Brookings Institution, Robert Crandall and Clifford Winston, published in the *Journal of Economic Perspectives* (17 *J Econ Perspectives* 3, autumn 2003). Crandall and Winston attempted to look at the effect of merger enforcement activity on price-cost margins from 1984 to 1996 in 30 two-digit manufacturing industries. They found that successful merger challenges had a negative effect on those margins, but that the effect was not statistically significant, whereas unsuccessful merger challenges were associated with a decline in margins that was statistically significant and consent decrees were associated with a statistically significant increase in margins. From this, Crandall and Winston concluded that merger enforcement activity has not increased consumer welfare in any systematic way and may even have reduced it. Gregory Werden, a senior economist at the Justice Department, has written an effective critique of the Crandall-Winston study (AEI-Brookings Joint Center for Regulatory Studies, Publication No. 04-09). Werden shows that the data on which Crandall and Winston relied are too highly aggregated to be useful for evaluating the performance of

markets in which mergers occurred. For more than two-thirds of the mergers that were challenged, the volume of commerce in the relevant markets as defined in the government's complaint accounted for less than one per cent of the total volume of commerce in the two-digit industries Crandall and Winston examined. Those mergers, therefore, could not conceivably have had any significant effect on the overall performance of those industries.

Another way to measure the performance of the agencies in reviewing mergers is to look at whether they have been consistent over time. Using this measure, the agencies score quite well. A study undertaken by FTC commissioner Thomas Leary in 2001 examined the rate of merger challenges over a 20-year period, from 1981 to 2000 (70 *Antitrust L J* 105, winter 2002). He found that over the entire 20-year period, with the exception of a brief period during the second Reagan administration, merger challenges as a percentage of total merger filings have fluctuated within a very narrow range—between 1.4 and 3.0 per cent, with no significant variations from administration to administration. The FTC Bureau of Economics has just published a more rigorous statistical study, examining merger enforcement at the FTC during the period from 1996 to 2003 (Malcolm B Coate and Shawn W Ulrick, 'Transparency at the Federal Trade Commission: The Horizontal Merger Review Process 1996–2003', FTC Working Paper, February 2005). That study found that five key variables could explain most enforcement decisions—industry, concentration, entry, customer complaints, and 'hot documents'. It found no statistically significant difference in the merger enforcement decisions of the Pitofsky and Muris commissions.

The FTC Bureau of Economics data also provide interesting insights into when a merger is likely to be challenged. They show that, with the exception of the petroleum and banking sectors, there were no challenges in markets where the post-acquisition HHI was below 1800 and the increase was less than 500. They also show that, with the exception of the petroleum, chemical, pharmaceutical, and grocery industries, transactions which reduce the number of significant competitors from four to three seem to be the tipping point for enforcement action (see William J Baer et al, 'Taking Stock: Recent Trends in US Merger Enforcement', 18 *Antitrust* 15, spring 2004). According to FTC data, such transactions are as likely to be challenged as not. Mergers that leave four or more significant competitors are less likely than not to be challenged, and mergers that leave

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only one or two competitors are more likely than not to be challenged. (The tipping point for petroleum, chemicals, pharmaceuticals, and groceries appears to be five-to-four.) The FTC study also shows that of the other significant factors (ease of entry, customer complaints, and 'hot documents'), customer complaints are the most important; strong, credible customer complaints appear to be the single most decisive factor in predicting enforcement action in highly concentrated markets.

Critics of the agencies' enforcement decisions sometimes point to the agencies' relatively poor track record in winning litigated merger challenges in court as evidence that the agencies are too aggressive in challenging mergers. During the eight years of the Clinton administration, the

agencies prevailed in half of the merger cases they litigated to a decision (eight of 16). In the first four years of the Bush administration, the agencies won only two of six merger challenges litigated to a decision. These statistics, however, may simply reflect that the only cases parties are willing to invest the time and money to litigate are those in which they feel they have a substantial prospect of winning. (It is worth noting in this regard that the parties abandoned several other mergers in the first four years of the Bush administration after the agencies initiated litigation.)

What all of these statistics obscure is that the agencies have become much more sophisticated over the last three decades in evaluating the likely competitive effects of proposed mergers. The final piece of the puzzle was fully integrating efficiencies into the competitive effects analysis. The agencies also now make more effective use of quantitative data and advanced econometric tools in defining markets and evaluating likely competitive effects.

Even if the agencies do a good job in determining which mergers to challenge, the merger review process might still be criticised if it imposes undue costs on companies in securing merger clearance. There is no question that a full-blown second request investigation can be extremely burdensome. With the advent of electronic discovery, full compliance with a second request can often require five or six months of work and cost the parties several million dollars each. These costs put a premium on the agencies finding ways to identify which transactions raise real competitive concerns during the initial 30-day waiting period without the need for a second request, as well to narrow the second request as much as possible while still giving the agency the information it needs to reach a well-informed decision.

Both the anecdotal evidence and the data suggest that the agencies deserve high marks for making effective use of the initial waiting period. The data show that the agencies are becoming much better at winnowing out transactions that do not raise serious competitive issues during the first 30 days. A recent article by William Baer and two co-authors compared the performance of the Clinton administration in this regard during the period from 1994 to 2000 with the performance of the Bush administration in 2002–2003 (18 *Antitrust* 15, spring 2004). The article reports that, during the Clinton administration, 28.8 per cent of all transactions in which the agencies opened a preliminary investigation received second requests, whereas during 2002–2003 the number dropped to 19.1

per cent, a nearly one-third improvement.

Part of the reason for the agencies' improved performance in this area is that lawyers who practise regularly before the agencies understand the importance of avoiding a second request, and have therefore found ways to 'front-load' the review process. Most importantly, these lawyers understand that it is critical to give the agencies, on a voluntary basis, the information they need to reach an informed decision during the initial 30 days. In addition, these lawyers increasingly advise the agencies informally of a proposed transaction in advance of filing the formal notification, giving the agency additional time to review the transaction before it must decide whether to issue a second request.

Because of the importance of the initial 30-day waiting period, there is one nagging problem that still needs to be addressed, and that is the recurring problem of clearance disputes between the two agencies. According to an FTC press release, between 1 October 1999 and February 2002, 24 per cent of all clearance requests were delayed because of clearance issues, with an average delay of 15 days. To their credit, the agencies attempted to remedy this problem in early 2002 by agreeing to a new protocol for resolving clearance issues. During the brief period that the new system was in place, the average time for clearance dropped to 1.5 days. Regrettably, Senator Ernest Hollings forced the agencies to abandon their agreement because he felt the agreement gave the Justice Department too much authority over media and telecommunications mergers. Although there are no more recent statistics, anecdotal evidence suggests that since the agreement was abandoned the former problems have returned and are becoming increasingly serious. Now that Senator Hollings has retired, the agencies should make another effort to fix the clearance process.

With respect to the burden imposed by second requests, the agencies do seem to be making some progress. Both agencies have undertaken merger process reform initiatives designed to reduce the burden and to encourage more cooperation between the parties and the staff in negotiating the scope of the second request. Among these reforms is a more effective internal appeals mechanism. Partly because of these reforms, the staffs of the two agencies now seem more willing to prioritise the second request in order to allow the parties to give the agencies the information they need to reach a decision without full compliance. Lest Goldilocks become Dr Pangloss, it is important to emphasise that still more needs to be done to reduce the cost and burden of

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second requests, but progress is clearly being made.

A final area that warrants mention and to which the agencies have also been devoting increased attention is the subject of merger remedies. Notwithstanding this attention, there continues to be some important differences between the two agencies. One of the most important is with respect to upfront buyers. In 2002 and 2003, 41 per cent of FTC consent orders required an upfront buyer, whereas none of the Justice Department's divestiture consent decrees did (Baer, 18 *Antitrust* 15). The new chair of the FTC has argued that the differences between the two agencies in this regard have more to do with differences in the industries for which they are responsible than with any underlying policy differ-

ence (see remarks of Deborah Platt Majoras, 18 November 2004, at 7–11, available at www.ftc.gov). It is not clear, however, why upfront buyers should be needed for divestitures of supermarkets or retail gasoline stations but not for dairies or radio stations. That being the case, some further convergence between the two agencies in this area would seem desirable.

Overall, then, both the Justice Department and the FTC deserve high, but not perfect, scores for their performance in the area of merger control. There is also good reason to share George Bittlingmayer's view that the agencies' strong performance in this area has contributed positively to the performance of the American economy. As both agencies and most economists recognise, while mergers may be a means to acquire market power, they also serve important, pro-competitive functions. Mergers not only facilitate transfer of intangible capital across firms, but also provide a means of replacing or disciplining inefficient managers. Mergers also facilitate exit, thereby encouraging entry and investment. Horizontal mergers are particularly valuable, both because they are the ones most likely to generate efficiencies and because companies in the same industry are in the best position to identify and run other, less well-managed companies.

While some recent studies have questioned the value of mergers in terms of economic performance, it is important not to over-generalise from these studies. One frequently-cited study by KPMG found that 70 per cent of mergers "failed", in the sense that they did not increase shareholder value for the acquiring company (*Boston Globe*, 6 February 2005, at C1). Another well-known study by three Ohio state economists found that, from 1991 to 2001, acquiring shareholders lost \$216 billion in the three days following American merger announcements (*The Economist*, 5 February 2005, at 58). These losses, however, were concentrated in just 87 big deals in the period 1998–2001. A broader study of all mergers in America from 1962 to 2001 found that mergers created, on average, combined gains to shareholders of 7.3 per cent (*The Economist*, 21 February 2004, at 62). Another study by Bain & Co. found that companies most successful at creating long-term shareholder value tend to be frequent, steady acquirers; frequent acquirers outperformed occasional buyers by a factor of 1.7 and non-buyers by a factor of almost two to one (*Strategy & Leadership*, 9 August 2004, at 518). Overall, therefore, mergers remain an important source of dynamic efficiencies, and merger control ought not to impose an unnecessary tax on them. ■