


Technological Change and Merger Policy's 3rd Era

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Changes in Merger Policy Over the Last Century

- Evolutionary Changes
 - Antimonopoly Era (1904-1973)
 - => **Consumer Welfare Era** (1973-2004)
 - => **Dynamic Efficiency Era** (2004-)
- Cyclical Changes
 - Merger review has varied in the scope of its objectives: from narrow anti-bigness => broader balance of efficiency and small-business protection => narrow consumer welfare focus => broader balance of static efficiency and innovation.



The Antimonopoly Era

- *Northern Securities Co. v. US* (1904)
 - Case initiated the anti-monopoly era of merger review. Established that mergers were within the purview of Section I of the Sherman Act.
 - Coupled with precedent for strict, textual construction of Section 1 (*Trans-Mo.*, 1899), *Northern Securities* swept mergers under the strong statutory prohibition against “every contract combination . . . or conspiracy in restraint of trade.”



Antimonopoly Era, Cont'd

- Subsequent developments led to a less absolute prohibition against mergers, but entrenched an “anti-bigness” approach.
 - Rule-of-reason approach to Section 1 introduced in *Standard Oil* (1911).
 - Passage of the Clayton Act in 1914 reflects the recognition that some mergers are acceptable. The question for merger law was, which ones?



Antimonopoly Era, Cont'd

- Clayton Act Section 7 bars not all mergers, but mergers whose effect “may be substantially to lessen competition, or to tend to create a monopoly in any line of commerce.”
- Merger review after enactment of Section 7 emphasized the “tend to” language of the provision, continuing and entrenching for decades an antimonopoly era that focused on market share and bigness as evils in and of themselves.



Antimonopoly Era, Cont'd

- Examples:
 - In the *Brown Shoe* case (1962), the U.S. Supreme Court blocked a merger that would have given one shoe manufacturer control over 8% of retail shoe outlets.
 - In the *Von's* case (1966), the Supreme Court blocked a merger that would have given one grocery chain a 7.5% market share in Los Angeles.
 - In the *Philadelphia National Bank* case, the Supreme Court ruled that mergers to a 30% market share were virtually illegal *per se*.



Antimonopoly Era, Cont'd

- The emphasis in all the above cases was preventing a tendency toward consolidation. The cases stated clearly that an important objective of merger policy was protecting the place of small businesses in the American economy,
 - Efficiency was a secondary concern, and the cases made clear that increased consolidation was a problem even without evidence of harmful effects on prices for consumers.



The Consumer Welfare Era of U.S. Merger Policy

- Within a decade after *Vons*, the U.S. Supreme Court sharply changed direction in its review of merger cases, triggering a fundamental shift in merger review by the antitrust agencies.
- In *General Dynamics* (1974), the Court said that it was necessary for the government to prove harmful effects from a merger, not mere consolidation.



Consumer Welfare Era, Cont'd

- The change brought by *General Dynamics* was major: no longer could the agencies justify enforcement on grounds of bigness or market share alone.
 - The inherent effect of this ruling was to eliminate protection of small business as the focus of merger policy.



Consumer Welfare Era, Cont'd

- *General Dynamics* shifted the focus onto the *effects* of consolidation rather than the degree or size of consolidation resulting from a merger.
 - What effects? The effects on efficient price and output levels => consumer welfare becomes the focus.



Consumer Welfare Era, cont'd

- The agencies responded to *General Dynamics* with a set of guidelines for predicting how a merger would effect efficiency, defined in terms of short-run price and output levels.
 - Those guidelines evolved into the now-familiar FTC/DOJ Horizontal Merger Guidelines first officially released in 1984 and which, in revised form, remain the basis for merger enforcement today.



Consumer Welfare Era, Cont'd

- Two important features of the *Guidelines* approach to merger review:
 - The facts about market share that used to end the merger inquiry in the antimonopoly era now are just a starting point.
 - Enforcement agencies retain an additional burden to show that the high market share will likely result in the ability to exercise market power.
 - The market power of concern is short-run control over price and output.



Consumer Welfare Era, Cont'd

- Even in new or rapidly changing markets, the agencies have adhered to the *Guidelines*' emphasis on short-run consumer prices:
 - Examples: WorldCom/Sprint, Echostar/DirectTV.
- The agencies did not ignore productive efficiencies or innovation, but those considerations never formed a “but for” basis for merger enforcement unless a merger either did not raise conventional price concerns (e.g. *Boeing/McDonnell Douglas*) or reinforced concerns over price (e.g. *ZF/Allison*).



Signs of Change: Toward a 3rd Era of Merger Policy

- Even while the *Guidelines* remained the unquestioned framework for merger enforcement, things began to change in the 1990's.
 - Productive efficiencies receive more attention, with revisions to the *Guidelines* in 1997 that give greater (or at least more official) recognition to merger-specific efficiencies.
 - Innovation becomes a much greater focus in the agencies than it had been before.



Signs of Change, Cont'd

- Agencies expressed more concern over a merger's effects not just on price of existing products, but on the flow of future products and the pace of innovation.
 - Examples: *Roche/Genentech*, *Lockheed/Northrop*, *Ciba-Geigy/Sandoz*, *ZF/Allison*.
- Innovation concerns did not necessarily drive decisions to block or remedy the above mergers, but they did contribute to the enforcement decision and the form of the remedy.



Signs of Change, Cont'd

- Innovation Markets
 - In the mid-1990's, the volume of merger activity in high-technology markets coupled with antitrust agencies' concern over innovation, led to more systematic thought about analyzing mergers in terms of innovation effects as distinct from consumer price effects. (Gilbert and Sunshine, 1995).



Signs of Change, Cont'd

- There was some dispute over the meaning, need for, and practicability of the innovation markets approach, but its ultimate impact has been important. At very least, it has:
 - made innovation an independent (of price and output) consideration in merger review; and
 - made merger review more dynamic.
- But even by the end of the 1990's innovation was still a secondary concern to static, consumer welfare considerations in merger cases. No case had been decided purely on innovation grounds. (Gilbert and Tom, 2001).



The Third Era: Innovation and Dynamic Efficiency

- If innovation as a basis for merger policy began to develop in the 1990's, it fully arrived in 2004, with the FTC's decision in *Genzyme/Novazyme*.
- Chairman Muris's statement in the case says clearly that traditional price and product market concerns were not at issue and that innovation considerations alone could form the basis for the merger enforcement decision.
 - *Genzyme* was therefore the first case expressly decided solely on grounds of innovation.



3rd Era, Cont'd

- *Genzyme* signaled two key challenges for merger enforcement in technologically dynamic markets:
 - Market definition
 - Translation of presumptions about relationship between competition and price to the relationship between competition and innovation.



Challenges for Merger Policy in the Age of Innovation

- An expansion of objectives
 - Conventional consumer-welfare objectives
 - Innovation incentives and dynamic welfare
 - May involve future products and consumers that do not factor into the conventional framework, complicating the welfare analysis
- Less-reliable presumptions
 - More competitors not necessarily beneficial for innovation (as they can be presumed to be for prices and outputs)
 - More innovation not necessarily welfare enhancing (as more competitive prices can be presumed to be)



Challenges, cont'd

- So, merger policy is in some sense being asked to do more, with less.
 - Expand its scope, with fewer tools.



Possible Policy Responses

- Business as usual: do not change the *Guidelines* and continue to enforce based on static considerations. See, e.g., Commissioner Thompson's *Genzyme* dissent.
- Systematically retreat from merger enforcement in the name of innovation. Strong "Schumpeterian" approach
- Reform merger enforcement to better account for the realities of innovation without systematically retreating. Gilbert & Sunshine (1995), Katz & Shelanski (2007), Baker (2007).



What Merger Policy's 3rd Era Will Look Like

- More fact-intensive, case-by-case analysis.
- Less reliance on the HHI screens from the *Guidelines* and retreat from, if not abandonment of, conventional presumptions about the relationship between post-merger market structure and the welfare effects of mergers.
- A longer view of market structure than the 2 year window of the current *Guidelines*.
- A shift in burdens and presumptions in merger analysis.
- A more sophisticated approach to analyzing uncertainty in merger review.