

## Horizontal Merger Analysis Grows Up: A Review of Chapter 5 of Richard Posner's *Antitrust Law* (2d ed. 2001)

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Richard Posner is a central figure in the generation of brilliant lawyers and economists who created the Chicago school of antitrust.<sup>1</sup> Since the first edition of Posner's *Antitrust Law* was published in 1976, most of the field has been transformed, in many respects along the very lines he proposed, and at times with a helpful decision from now—Judge Posner pushing that movement along.<sup>2</sup> But horizontal merger law, while revolutionized by the Chicago school's signature economic approach, has not changed in the precise manner Posner advocated a quarter century ago. Now, with the publication of the second edition of *Antitrust Law*,<sup>3</sup> Posner finds himself in the position of a parent dispensing fatherly advice to an adult child who has assimilated the lessons of her upbringing but also has developed distinctive views of her own.<sup>4</sup>

On the whole, Posner greatly approves of his offspring. He welcomes the way that antitrust has discarded the “social objection to concentration”—the conception of antitrust law as protecting small business—underlying the Supreme Court's 1966 decision in *Von's Grocery* (128).<sup>5</sup> He endorses the Justice Department's 1982 Merger Guidelines and their subsequent revisions: these “represent the triumph of the economic approach; and the courts have fallen into line with them quite readily” (132). Posner singles out the 1997 *Staples* decision for applause, calling it “the most recent example of the increased economic sophistication with which the antimerger law is being applied” (157).<sup>6</sup> As Judge Posner recognizes, economics has become the essence of antitrust, horizontal

merger analysis included, in significant part because he advocated that outcome decades ago.

But in reviewing the last quarter century of antitrust merger law, Posner does not claim more than “modest vindication” of his earlier views (132). Indeed, in important respects, the courts and federal enforcement agencies have found a better path for horizontal merger analysis than the one Judge Posner advocated in 1975 and, with minor modifications, continues to defend today.

### Factors Beyond Market Concentration

In the updated edition of his book, Judge Posner recollects his previous call for a greater role for market concentration and a narrower look at factors facilitating or frustrating collusion than has evolved in the courts and federal enforcement agencies. His original position can best be understood as a preference for bright line rules over unstructured standards in this doctrinal area, not an argument questioning the central role of economics in antitrust today. Yet, as Posner recognizes, the courts and agencies today are more willing than he was “to peek behind market share and examine the range of factors . . . besides concentration that may predispose a market to or against the forms of collusion that are difficult to detect, including tacit collusion” (133).

The courts and agencies have found a better role for factors beyond market concentration in horizontal merger analysis than was suggested by Judge Posner's original view. Economic theory and the empirical evidence both suggest that price rises as market con-

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centration increases, but they equally suggest the importance of other industry-specific and market-specific factors beyond concentration in determining price and the competitive effects of mergers. Moreover, the empirical research does not reliably identify any particular concentration level common across industries at which price increases begin. Although Posner does not question his original position in the updated edition of his book, he no longer wishes to debate the point. “For the time being,” he now writes, “the history of merger doctrine is at an end” (132).

Having lost the battle against truncating the economic analysis of factors that might influence whether a merger is likely harm to competition, Posner now recognizes that he must fight again to preserve a bright line rule against consideration of efficiencies. The modern trend in the lower courts is to recognize efficiencies as a defense, although efficiencies have never been the primary reason for the failure of a government challenge to a horizontal merger in court. *Heinz* would have been a counter-example, but the district court was overruled on appeal by a panel unwilling to accept the efficiencies credited below.<sup>7</sup> Efficiencies played only a supporting role in government losses in *Butterworth* and *Long Island Jewish Medical Center*.<sup>8</sup>

Posner argues against the efficiency defense mainly on the grounds that cost savings are hard to assess in prospect (“a matter of speculation flavored by hope” (133)), particularly relative to what would have occurred in the merger’s absence. He also contends that it is a practical impossibility to determine whether the benefits of merger-related efficiencies would outweigh the harm to competition from the transaction, regardless of whether the goal is merely to determine price effects or, more broadly, an effort to identify the full social efficiency costs. These complex economic questions, he writes, are better left to the discretion of the federal enforcement agencies, with their

more flexible procedures and greater staff resources. Although the lower courts are now willing to consider an efficiency defense, “they have been understandably, and I think correctly, reluctant to accept the defense in actual cases” (136).

Posner offers a serious argument. But here, as elsewhere in horizontal merger law, the courts may continue to go their own way. It is hard to see why predictions about the cost savings from merger are inherently more speculative and difficult to prove than the predictions of competitive harm. Posner concedes as much when he notes how little we still know “about the effect of marginal increases in concentration under different market conditions” (133). If the merging firms can show that their combination will reduce marginal costs by 15 percent leading to a reduction in quality-adjusted prices by the same amount (as defendants claimed in *Heinz*), why shouldn’t that information be considered in evaluating whether the transaction would likely harm competition? Posner would presumably answer that occasional errors in the application of bright line rules are more than compensated for by the reduction in administrative costs and benefits of clear guidance, and, perhaps also, that he would accept judicial consideration of an efficiency defense in an unusual case where the efficiency evidence is strong and compelling. But the same considerations could have been offered in the mid-1980s, in opposition to what the lower courts then did in accepting a wide-ranging merger defense based on ease of entry<sup>9</sup>—a defense Posner does not discuss in detail but to which he appears to have much more sympathy. Moreover, Posner’s recommendation would place antitrust in the awkward position of allowing proof of efficiencies to count in analyzing joint ventures among rivals,<sup>10</sup> but not to count in defense of a challenged horizontal merger—a setting in which the extent of integration, and concomitant efficiencies, are on average likely to be greater.

### Unilateral Competitive Effects

In revising his antitrust book, Judge Posner updated his 1976 discussion selectively, and chose not to grapple, for example, with what Professor Herbert Hovenkamp has termed “[t]he most significant post-Chicago development in the field of horizontal mergers,” the rise of unilateral theories of anticompetitive effect.<sup>11</sup> For Posner, horizontal merger law is concerned exclusively with the possibility that greater concentration “facilitates collusion, explicit or tacit, among the firms in the market by reducing the costs of collusion and of detecting cheating,” (124) the theory the current Merger Guidelines term coordinated competitive effects. But, as economists have long known and the Merger Guidelines have recognized since 1992, mergers among sellers in differentiated-product industries can also lead to higher prices through the loss of localized competition, even if the other firms in the market do not change their behavior. This theory became highly influential at the antitrust enforcement agencies with the development of econometric methods of quantifying the magnitude of the possible anticompetitive effects,<sup>12</sup> and with the availability of point-of-sale scanner data from supermarkets.

Posner’s neglect of unilateral competitive effects analysis is apparent in his discussion of the FTC’s successful challenge to the Staples-Office Depot merger, one of only two court decisions handed down since the first edition of the book to which he devotes significant textual discussion. *Staples* involved an FTC challenge to a proposed merger of two of the three leading office supply superstore chains, Staples and Office Depot. The district court judge treated the case primarily as a question of market definition. The court defined a submarket consisting of the sale of consumable office supplies through superstores within a broader product market involving all retail sales of such products, relying on the *Brown Shoe* practical indicia as legal authority to do so.<sup>13</sup> Within this market, the merger would have reduced the number of sellers from three to two in some metropolitan

areas, and from two to one in others.

The most important evidence in the case involved pricing, as Judge Posner observes with approval. The FTC showed that Staples charged significantly higher prices, on the order of 7 percent or more, in geographic markets where it had no office superstore competition than in markets where it competed with Office Depot or a third office superstore chain. Posner finds compelling the FTC’s systematic (econometric) analysis of pricing data in reaching this conclusion (as do I)<sup>14</sup>; in contrast, the district court judge relied mainly on evidence from party documents to the same effect.

Judge Posner likes this evidence for the right reason: it is direct evidence that the merger would harm competition. He explains that “the courts and the enforcement agencies bother with market definition only because they cannot make a direct assessment of the likely effect of a merger on price” (158). However, he does not take the next step, debated in recent commentary, to consider whether market definition can or should be dispensed with entirely under such circumstances.<sup>15</sup>

Judge Posner also does not address the *Staples* court’s use of *Brown Shoe* to define a submarket. Elsewhere in the chapter he terms submarkets “unsound” (152) if they fail to include close substitutes. The district court’s submarket definition in *Staples* does not make that mistake, however, as Posner implicitly recognizes by describing what the *Staples* court did as defining a market (rather than a submarket). Posner does not consider the possibility that the submarket label could serve a useful purpose in that case (although one not mentioned by the district court judge): as an expositional tool for highlighting the potential loss of localized competition within a broader market.

This issue of how antitrust law should address unilateral competitive effects of merger within the framework of market definition and market shares goes beyond *Staples*. There are two alternatives, assuming that market definition is actually necessary (notwithstanding the

debate mentioned above). First, if the loss of head-to-head competition among merger partners would permit the firms to raise price regardless of the response by other sellers in the market, the competitive concern can be described as a unilateral competitive effect within a broad market. This frame allows the court to consider the competitive significance of all possible influences on post-merger competition, however distant, but does so at the risk of appearing to minimize a potentially serious competitive problem by reducing measured market concentration. Second, the transaction equally could be described as a merger to near monopoly within a narrow submarket, as is arguably suggested by *Staples*.<sup>16</sup> This alternative frame heightens concentration levels, and may therefore make the case more attractive in court—at least if the submarket definition can be simply stated with practical appeal, and not appear to reflect result-driven gerrymandering. Given the prominence of unilateral competitive effects analysis in merger reviews at the federal enforcement agencies during the past decade, it is disappointing that Judge Posner, in updating his book, chose not to share his views on this interpretation of *Staples* or on the role of unilateral competitive effects analysis generally.

### Empirical Evidence

Judge Posner commendably encourages reliance on empirical evidence like the pricing data in *Staples*. But he highlights two specific econometric techniques for evaluating aspects of mergers without taking on criticisms that have encouraged empirically-oriented economists to prefer alternative approaches. First, Posner writes approvingly of defining markets based on high positive price correlations, a methodology that would include products in the same market if their prices tend to rise and fall simultaneously. This approach is suspect as a market definition tool, and not just for the reason Posner points out: that it is prey to the *Cellophane* fallacy when market power has already been exercised. More fundamentally, high price correla-

tions can be poor indicators of demand substitution, the economic force at issue in market definition. After all, closely correlated price movements may merely represent the result of similar forces, such as common changes in input costs or demand, affecting price in different markets.

Second, Posner writes approvingly of the use of stock market evidence to determine whether a merger harms competition on balance, accounting for the efficiencies. The theory is simple: If the stock market price of rival firms rises upon the announcement of the merger (or falls when the investment community learns that antitrust enforcers have launched an investigation), then Posner would infer that the transaction is likely to harm competition; if the stock market price of rival firms falls on the merger announcement (or rises in response to information about increased enforcer concern), he would infer that the transaction is likely to promote competition. Posner correctly notes that a study along these lines was relied upon by the FTC's economic expert in *Staples*, although the main focus of the Commission's other economic expert, an econometrician, was on the previously-mentioned studies relating price to variations in market structure.

Posner does not, however, address three basic problems with relying on the stock market "event study" methodology to decide merger cases, which go beyond technical implementation difficulties (such as determining when the merger news gets out or controlling for other events affecting share prices). First, the key inference—interpreting lower stock market prices for rival shares to suggest that the merger creates efficiencies rather than anticompetitive harm—is correct on its own terms only if the anticompetitive theory involves collusive rather than exclusionary effects. After all, a merger that harms competition by excluding rivals would also lower the price of rival shares. Second, it is inappropriate for antitrust enforcers to delegate their decisions to the stock market. Wall Street analysts often do not take a sophis-

ticated approach to competition analysis, and even when they do, they rarely know what the antitrust agencies can find out about the industry. Only the enforcement agency staff can subpoena and read the marketing documents of all the firms.

Third, there is a fundamental difficulty with a government policy of drawing inferences about the competitive effects of particular mergers from the stock market response to their announcement—once Wall Street learns that this information matters in agency decision-making. When investors forecast the likely financial consequences of a merger proposal, they must consider not only the competitive effects of the deal but also the likelihood that the transaction will be challenged by antitrust enforcers. If investors believe that the merger would likely harm competition by facilitating tacit collusion, for example, they should bid up the stock market price of rival shares. But if the resulting

increase in the stock market price would make a successful government challenge to the deal likely, investors would not choose to increase the stock price after all. Under such circumstances, it is far from clear what, if anything, the antitrust agencies could reliably infer by analyzing the stock market response to merger announcements.

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Judge Posner concludes his discussion of horizontal merger analysis in the voice of a proud parent. With *Staples*, he writes, “[e]conomic analysis of mergers had come of age” (158). Posner is surely entitled to look upon contemporary horizontal merger analysis with satisfaction, a quarter-century after his work helped revolutionize the field. Antitrust law may no longer reflexively follow his advice, but Judge Posner as much as anyone should be allowed to take a front row seat at antitrust’s graduation. ●

<sup>1</sup>In academic writings published during the 1960s and 1970s, including the essays collected in the first edition of *Antitrust Law*, Posner, along with Robert Bork, Aaron Director, Frank Easterbrook, George Stigler and others, laid the intellectual groundwork for a broad transformation of antitrust doctrine in the courts.

<sup>2</sup>*E.g.*, *Hospital Corp. of America v. FTC*, 807 F.2d 1381 (7th Cir. 1986 (Posner, J.) (upholding FTC injunction against an acquisition reducing the number of hospitals competing in Chattanooga from eleven to seven, and the number of major firms to four).

<sup>3</sup>RICHARD A. POSNER, *ANTITRUST LAW* (2d ed. 2001). Page references to this edition are set forth in the text in parentheses.

<sup>4</sup>See generally Jonathan B. Baker, *A Preface to Post-Chicago Antitrust*, in *POST-CHICAGO DEVELOPMENTS IN ANTITRUST ANALYSIS* (Roger van den Bergh, Roberto Pardolesi & Antonio Cucinotta eds., forthcoming 2002) (describing role of the Chicago school in antitrust history and evaluating prospects for further doctrinal change).

<sup>5</sup>*United States v. Von’s Grocery Co.*, 384 U.S. 270 (1966).

<sup>6</sup>*FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997). I was Director of the FTC’s Bureau of Economics during this litigation.

<sup>7</sup>*FTC v. H.J. Heinz Co.*, 116 F. Supp. 2d 190 (D.D.C. 2000), *rev’d*, 246 F.3d 708, 720 (D.C. Cir. 2001). I testified on behalf of the merging firms as an expert economic witness in this case.

<sup>8</sup>*FTC v. Butterworth Health Corp.*, 946 F. Supp. 1285 (W.D. Mich. 1996), *aff’d*, 121 F.3d 708 (6th Cir. 1997); *United States v. Long Island Jewish Med. Ctr.*, 983 F. Supp. 121 (E.D.N.Y. 1997).

<sup>9</sup>*E.g.*, *United States v. Waste Management, Inc.*, 743 F.2d 976 (2d Cir. 1984).

<sup>10</sup>See, *Broadcast Music, Inc. v. CBS*, 441 U.S. 1 (1979).

<sup>11</sup>Herbert Hovenkamp, *Post-Chicago Antitrust: A Review and Critique*, 2 *COLUM. BUS. L. REV.* 257, 332 (2001).

<sup>12</sup>This literature begins, I should disclose, with the articles I wrote with Timothy F. Bresnahan during the mid-1980s on estimating residual demand functions. Jonathan B. Baker & Timothy F. Bresnahan, *Estimating the Residual Demand Curve Facing a Single Firm*, 6 *INT’L J. INDUS. ORG.* 283 (1988); Jonathan B. Baker & Timothy F. Bresnahan, *The Gains from Merger or Collusion in Product Differentiated Industries*, 33 *J. INDUS. ECON.* 427 (1985).

<sup>13</sup>*Brown Shoe Co. v. United States*, 370 U.S. 294, 325 (1962).

<sup>14</sup>See generally Jonathan B. Baker, *Econometric Analysis in FTC v. Staples*, 18 *J. PUB. POLICY & MKTG.* 11 (1999) (discussing FTC’s econometric analysis of pricing data).

<sup>15</sup>*E.g.*, James F. Rill, *Practicing What They Preach: One Lawyer’s View of Econometric Models in Differentiated Product Mergers*, 5 *GEO. MASON L. REV.* 393, 400 (1997) (criticizing economists who suggest that market definition and analysis of market structure can be dispensed with in the analysis of certain differentiated products mergers).

<sup>16</sup>There is no logical contradiction between this alternative and the previous one. The existence of a broad market does not preclude the possibility that a more narrow market, also properly defined according to the substitution criteria of the case law and Merger Guidelines, is nested within it.