

DEVELOPMENTS

The Efficiency Defense in Merger Review: Progress or Stagnation?

BY DAVID BALTO

EFFICIENCY ANALYSIS IS AND SHOULD be an integral part of merger analysis. Yet, though many applauded the enactment of revised efficiency Merger Guidelines in 1997 as signaling a new approach to the treatment of efficiencies in mergers, the antitrust enforcement agencies and courts have only slowly begun to consider efficiencies in merger analysis. This article addresses whether the promise of the revised Guidelines has been achieved and suggests how the agencies can embrace the opportunity to clarify the role of efficiencies in merger analysis.

Prior to the Clinton Administration, the antitrust agencies frequently were skeptical of efficiency claims in mergers. Commenting on this long history of skepticism, former FTC Chairman Robert Pitofsky observed in 1992 that "the [early] failure of United States enforcement agencies and courts to take into account efficiency . . . considerations in merger analyses was the principal cause of American firms' difficulties in international trade."¹ Thus, soon after the Clinton Administration took office, he advised: "If long-term U.S. economic interests turn on productivity and innovation, it may be time to treat assertions of efficiency in defense of a transaction in a less grudging way."²

Revising the approach to merger efficiency analysis became a priority of the early Clinton Administration antitrust enforcers. As a result of hearings held by the FTC on competition policy, the FTC Policy staff issued a report, *Competition Policy in the New High-Tech, Global Marketplace*, which concluded that there was a general consensus on the need to revise the treatment of efficiency claims under the Merger Guidelines. Less than a year later, the FTC and Department of Justice revised the efficiency section of the 1992 Merger Guidelines.³

The revised Guidelines were well received for several reasons. For some, the revisions suggested that the agencies and courts would be far more receptive to efficiency claims in

evaluating mergers. Others saw the possibility that the Guidelines might signal a more careful consideration and recognition of the important role of efficiencies in the competitive balance. Still others believed that the achievements of the Guidelines were modest, but at least suggested an increased commitment by the agencies to provide greater transparency in the evaluation of these claims.⁴ However, the promise of the 1997 Guidelines is largely unfulfilled, both in court decisions and in further guidance from the agencies.

Since the issuance of the Guidelines there have been three litigated decisions with extensive efficiency analysis: *FTC v. Staples*,⁵ *FTC v. Cardinal Health*,⁶ and *FTC v. Heinz*.⁷ In each case the efficiency defense was rejected. Moreover, there have been no agency decisions even articulating the agency's position on efficiencies much less approving a merger based on efficiency claims. In spite of the laudable intentions of the authors of the 1997 Guidelines, efficiency analysis seems firmly secured in the agency's "black box."

To assess the current state of the efficiencies defense, I analyze how, in recent cases, the courts have treated four types of efficiency claims: efficiencies from production, distribution, innovation, and purchasing. I then address several aspects in which the court decisions have failed to provide sufficient guidance on the analysis of efficiencies, and close by proposing several initiatives that the antitrust enforcement agencies can undertake to fulfill the promise of the Guidelines.

Production Efficiencies

Production efficiencies are frequently the subject of efficiency claims, and they often present the greatest potential for cost savings. As the Guidelines suggest, "efficiencies resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the marginal cost of production, are more likely to be susceptible to verification, merger-specific, and substantial, and are less likely to result from anticompetitive reductions in output." Merger Guidelines § 4 (revised 1997). The FTC Staff Report observes "[p]lant and production economies of scale are generally accepted as important to a firm's competitiveness and subject to reasonable assessment as to their likely magnitude and probability." Some commentators, including FTC Chairman Timothy J. Muris, assert that "plant size economies are among the most worthy of recognition."⁸

On the other hand, a merger of two companies, each with an inefficiently small plant, may simply result in a single firm with two inefficiently small plants. Other commentators argue that conventional plant-level scale economies "are perhaps least likely to be improved by merger, since generally little can be done to merge production at existing, separate facilities."⁹ In addition, economies of scale may be exhausted at firm sizes that are lower than those presented in a merger.¹⁰

Plant-level scale economies often may be improved by a merger. An obvious example involves two firms with plants that are large enough to offer scale economies but that are

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operating well below capacity because of overcapacity in the industry. A merger may allow the firms to close one plant and operate the other at the level that allows the scale economies to be captured. The economies in allowing a plant to operate, for example, 24 hours a day instead of 8, are obvious.¹¹ Moreover, when multiple plants are combined, the least efficient units can be shut down and the most efficient retained or even expanded.¹²

Production efficiencies were the centerpiece of the efficiency claims in the proposed merger between Beech-Nut and Heinz. The district court decided the merger would allow consolidation of Beech-Nut's production at the newer, automated, lower-cost Pittsburgh plant operated by Heinz (which was operating at about 40 percent capacity.) The variable cost savings would have resulted in savings of between \$9.4 and 12 million, about 43 percent in the cost of processing baby food currently processed by Beech-Nut. The district court found that that the merger "will achieve substantial cost savings in salaries and operating costs." 160 F. Supp. 2d at 199.

The D.C. Circuit rejected the district court's analysis of production efficiencies. From the appellate court's perspective, the problem with variable conversion cost savings analysis was that it seemed more significant than it really was. First, variable conversion cost was only a small percentage of total variable costs. Properly calculating the cost reduction as part of all variable manufacturing costs reduced the percentage from 43 to 22.3 percent. Second, the correct measure was not the reduction in Beech-Nut's costs, but the reduction in the costs of the merged firm. The district court failed to consider how the merger would effect the cost structure of the merged firm over its entire output. 246 F.3d at 721-22.¹³

The appellate court's review of the variable cost calculations suggests that courts need to parse carefully potential cost savings. But what is the appropriate denominator? Is it the costs of the acquired firm, the merged firm, or the entire market? In *Heinz*, the defendants mistakenly believed they had a compelling case because they looked only at the impact on Beech-Nut's manufacturing costs. Savings over the costs of the acquired firm alone are insufficient, since it must be shown how the merger affects the ability of the merged firm to compete. Mergers may lead to diseconomies of scale, or may have a relatively minor impact on the cost structure of the merged firm. The FTC proposed that the savings should be analyzed over the entire output of the market. Perhaps that approach was valid because of the threat of post-merger coordination between Gerber and Heinz. But if the anticompetitive concern had been solely over unilateral effects, that would probably not be the appropriate approach.

Perhaps a stronger efficiency argument is the claim that a merger will permit two firms to specialize operations to reduce costs. For example, a merger of two one-plant firms (each of which produces a range of products) can facilitate economies through specialization, by concentrating production of each item in one of the plants. This efficiency is rel-

evant primarily where market characteristics make it necessary or significantly advantageous for a firm to offer a product line rather than a single product.¹⁴ The strongest case of specialization economies would be where the merging firms found it necessary to offer a broad array of products that currently were all being produced inefficiently at unspecialized plants.¹⁵

Production efficiency arguments may be particularly persuasive where firms have complementary production techniques in an industry structure that makes it inefficient for the firms to remain unintegrated. For example, if the merging firms produce separate components of a product, they may be able to establish that it is inefficient to produce the separate components rather than the integrated product. The merger of two major U.S. steel firms, Republic and LTV, in the mid-1980s provides an example of this claim. The merger enabled the combined company to substantially reduce shipping costs by shipping unfinished steel to closer finishing plants.

Ultimately, specialization claims may be very difficult to achieve. For example, in a case that preceded the 1997 Guidelines, a district court approved the merger of the two largest hospitals in Grand Rapids, Michigan, based on the claim that with the merger the two hospitals could specialize operations at one of the two hospitals, significantly reducing operating costs.¹⁶ The hospitals claimed they could reduce costs by converting one of the hospitals into an outpatient facility, and by dedicating the other to inpatient services, or at least by focusing some specialities at one hospital. A recent study found that relatively little integration had occurred three years after the merger was consummated and only a modest portion of the projected savings was actually achieved.¹⁷

Distribution and Promotion

Large sectors of the U.S. distribution system are undergoing consolidation. Mergers among supermarkets, drug stores, club stores, all types of wholesalers, and others offer opportunities for significant cost savings in reducing distribution and promotion costs. For example, a merger between wholesalers may offer the opportunity to streamline warehouses and reduce transportation and distribution costs.

The revised Guidelines are silent on the treatment of distribution and promotion efficiencies. The FTC Staff Report is relatively skeptical about these claims, observing that they "are less likely to be substantial and are often likely to be difficult to assess." Report at 33. The staff's sole basis for that argument was an observation in the Areeda & Turner treatise, rather than any empirical observation that these claims are less likely to be significant. *Id.* FTC Chairman Muris has questioned the agencies' skeptical approach to distribution and promotion economies, observing that in

some industries, economies in product promotion are as important as economies of large scale production and distribution in providing cost advantages for market leaders. In

consumer goods, for example, promotional economies are substantial and may require larger market shares to achieve minimum efficient scale than would be suggested by only production and distributional efficiencies.¹⁸

As Chairman Muris notes in his *Interview* in this issue of ANTITRUST, “I disagree with disparagement of promotional, capital, and managerial efficiencies. To the extent there are real cost savings, there is no reason to disparage them. For example, one of the results of the advertising revolution is the recognition that advertising and promotion are usually pro-competitive.”¹⁹

In *Heinz*, the district court credited the suggestion that efficiencies would result from Heinz’s distributing Beech-Nut’s baby food. 116 F. Supp. 2d at 199. The court of appeals, however, rejected these claims because the lower court failed to find that Beech-Nut’s distribution system suffered from significant diseconomies of scale and did not evaluate whether the efficiency was merger-specific: “a firm the size of Beech-Nut does not need to merge to attain an efficient distribution system.” 246 F.3d at 721 n.19. The fact that many consumer goods firms efficiently distribute single products suggests that it would have been difficult for the parties to have demonstrated significant diseconomies, even if that effort had been undertaken.

Distribution and promotion efficiencies can be significant in certain cases. For example, in 1998 the FTC successfully challenged two mergers among the four largest drug wholesalers—McKesson with AmeriSource; and Cardinal Health with Bergen-Brunswig. *FTC v. Cardinal Health, Inc.*, 12 F. Supp. 2d 34 (D.D.C. 1998). If the mergers had been permitted, the two survivors would have controlled over 80 percent of the prescription drug wholesaling market, significantly reducing competition on price and services. This was the longest evaluation of efficiencies in any merger trial, with over four days of testimony. The defendants claimed several different sources of efficiencies, the most significant of which was due to the closing of overlapping distribution centers.²⁰ The parties estimated cost savings and other efficiencies of between \$220–307 million in the first three years after the merger for the Cardinal merger and about \$146 million for the McKesson merger. 12 F. Supp. 2d at 62.

The FTC disputed the amount of the claimed efficiencies but did not dispute the fact that there would be significant cost savings. The FTC argued that savings from distribution center consolidation were not merger specific because they could be achieved even without the mergers. Judge Sporkin accepted that argument and also examined the impact of removing excess capacity on the market. Although conceding those actions would produce cost savings, he noted that company documents equated excess capacity with pricing pressures and stiff competition and expressed hope that consolidation at the top of the industry would bring “a more orderly market” and “rational pricing.” *Id.* He relied as well on customer testimony that affirmed the competitive role of excess capacity. Judge Sporkin concluded that the “mergers would

likely curb downward pricing pressures and adversely affect competition in the market.” *Id.* at 64.

Perhaps the best case for a distribution economy defense arises where the merger will enhance the ability of the combined firm to offer new distribution services or expand its distribution operations. In some cases, a merger may enable a firm to build new and more efficient distribution facilities or offer new services. That appears to have been the case when the FTC examined and permitted the merger of Bergen and Amerisource three years after the *Cardinal Health* decision. Amerisource and Bergen were the third and fourth largest drug wholesalers. After an extensive investigation the FTC concluded that the merger would not adversely effect competition because neither “of the merging firms . . . contributed significantly to the ongoing trend of decreases in drug wholesale prices, or that the resulting industry structure would lead to price increases or prevent further price reductions.”²¹ The FTC also concluded there were significant efficiencies that met the Guidelines test. The merger “would give the merged firm sufficient scale so that it can become cost-competitive with the two leading firms and can invest in value-added services desired by customers.”²² In addition, the fact that these efficiencies would be achieved more rapidly by merger than through continued competition was “a cognizable merger-specific efficiency.”²³ Ultimately the merger would convert Amerisource and Bergen from two also-rans to a strong number three competing on a more equal footing (from a service perspective) as a single firm.

New Product Development and Innovation

The Merger Guidelines observe that efficiency claims “relating to research and development are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions.” Merger Guidelines § 4. In high-tech industries, much of the focus of efficiency analysis will be on R&D efficiencies. R&D efficiencies offer great potential, but because they tend to focus on future products, there may be formidable problems of proof.²⁴ The strongest R&D efficiency claims are ones where there are relatively clear synergies between R&D projects that will improve the chances of success. The FTC Staff Report observes,

Claims of innovation efficiencies may be more difficult to evaluate, depending on whether they rely on combinations of clearly complementary patent-protected technology or on vague assertions of synergies from combined personnel with certain scientific expertise, for example. Nonetheless, innovation efficiencies may make a particularly powerful contribution to competitive dynamics, the national R&D effort, and consumer (and overall) welfare.

Report at 32. Even in these cases, questions may arise whether there are less restrictive alternatives, such as a limited joint venture that can achieve the same efficiencies.

One example where innovation efficiencies played an important role was the Commission’s approval of the joint

venture between GM and Toyota to operate jointly a GM manufacturing facility in Fremont, California.²⁵ At the time, GM and Toyota were respectively the first and third largest automobile manufacturers in the world. One of the reasons that the Commission approved the merger, albeit with certain conditions, was to enable GM to learn Japanese production methods. Because such learning-by-doing efficiencies do not justify an endless joint venture, the Commission limited the duration of the venture to ten years.

In one matter that did not lead to enforcement action, the Commission staff evaluated a merger between two firms that manufactured an important tool used in the testing and production of integrated circuits.²⁶ Competitive concerns over the merger were not substantial, but the existence of very plausible efficiency claims strengthened the decision not to take enforcement action. The most significant claim in this matter was that quick improvements in current products could be accomplished by sharing the companies' respective proprietary technologies. There were two types of technologies involved, which were complementary to a certain extent. Through the merger, the combined firm might create a common platform to use both technologies more effectively. Particularly important in assessing the credibility of these claims was that they were supported by the vast majority of the firms' customers.

In *Heinz*, the parties created an innovation defense by suggesting that the merger would benefit consumers by combining Heinz's lower production costs with Beech-Nut's better tasting recipes. The district court found these "new product" efficiencies substantial (116 F. Supp.2d at 198–99), but the appellate court faulted the district court for failing to address whether Heinz could achieve the same efficiencies by investing more in product development. 246 F.3d at 722. That particular inquiry was never made by the district court.

Heinz also suggested that the merger would lead to greater innovation. The linchpin of the argument was that neither Heinz nor Beech-Nut appeared to possess the necessary distribution to innovate (in terms of their All Commodity Volume (ACV) throughout the United States). Heinz's President testified that a 70 percent ACV was necessary to introduce a new product. The district court found that without the merger, Heinz and Beech-Nut lacked the geographic scope to innovate effectively. 116 F. Supp. 2d at 200.

The appellate court rejected the claim for several reasons. First, the court found that a critical exhibit developed by the defendants' expert economist analyzing past new product introductions failed to support the 70 percent ACV claim. There were numerous faults, including the fact that the exhibit failed to plot profitability or any measure of cost-effectiveness and it included items other than baby food. Moreover, the appellate court suggested that "Heinz's insistence on a 70-plus ACV before it brings a new product to market may be largely to persuade the court to recognize promotional economies as a defense." 246 F. 3d at 723. Finally, the appellate court criticized the district court for failing to

determine whether: (1) there are substantial promotional scale economies; (2) Heinz and Beech-Nut operate at a significant competitive disadvantage because of those diseconomies; or (3) "there are effective alternatives to the merger by which the disadvantage may be overcome." *Id.* at 724. Ultimately, the fact that Heinz was the largest baby food manufacturer in the world and had implemented many of these innovations elsewhere undermined its claim that the merger was necessary to develop new products.

Increased Buying Power

One important source of potential savings, especially in distribution markets, is the ability to secure increased buying power through a merger. Firms can secure lower input prices just by increasing the amount of their purchases or by streamlining the purchasing process. The success of retailers like Wal-Mart and club stores are a testament to the importance of buying power in bringing lower costs and better products to consumers. Increased volume typically translates into lower costs. Moreover, a merger may enable firms to achieve significant cost savings by eliminating duplicate purchasing operations or adopting more efficient purchasing operations. Procurement savings are particularly persuasive where the reduction in the number of buyers or the streamlining of the buying process will reduce the costs of the suppliers and these reduced costs will be passed on to consumers. In spite of this potential, the Merger Guidelines take a fairly skeptical approach to purchasing efficiencies, observing that "procurement, management, or capital cost are less likely to be merger-specific or substantial, or may not be cognizable for other reasons." Merger Guidelines § 4. The FTC Staff Report is silent on the subject.

The treatment of buyer power was a central issue in the FTC's challenge to the proposed merger of the two largest office supply superstores—Office Depot and Staples. *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997). Both firms had an enviable record of reducing purchasing costs and passing on those cost savings to consumers through lower prices. Staples's "buying power was 'a catalyst that forced everyone else in the industry to focus on cutting their prices . . . [and] forc[ed] manufacturers and suppliers to implement efficiencies in their own businesses.'" *Id.* at 1093. Indeed, the unique efficiencies of office supply superstores was the foundation for the FTC's challenge to the merger. The FTC alleged that in a market of office supplies purchased at superstores the merger would reduce the number of competitors from three to two and threaten to slow the historical decrease in prices that resulted from the rivalry between Office Depot and Staples. *Id.* at 1082.

Staples argued that any anticompetitive effects would be dwarfed by the substantial efficiencies generated by the combination of the two firms (which they estimated at between \$4.9 to 6.5 billion over the five years following the merger). There were numerous distribution efficiencies, including eliminating warehouses, but the principal efficiency was that

the combined firm would have augmented purchasing power and could extract better prices from its various vendors (this was about 40 percent of the anticipated savings).

The district court rejected the efficiency claims, essentially on two grounds. First, it found that the claims were not based on “creditable evidence,” and appeared to be exaggerated. For example, the court noted that the defendants’ cost savings submitted to the court exceeded by almost 500 percent the figures presented to the Boards of Directors of the two firms when they approved the transaction less than a year earlier. *Id.* at 1089. As the court observed, “the defendants did not accurately calculate which projected cost savings were merger specific and which were, in fact, not related to the merger.” *Id.* at 1090. Of course, the parties may have secured a far more careful understanding of the projected savings during the FTC investigation. Moreover, during the litigation the FTC attempted to contact all the major vendors who the defendants claimed would provide lower prices, and the vast majority supported the defendants’ claims of anticipated savings.

Second, and more important, the court noted that the efficiencies were not merger specific. Both parties to the merger were expanding rapidly by opening new stores—as many as 100 or 150 new stores per year each—so that increased buying power, even assuming it could be used to extract better prices from vendors, would have occurred as a result of internal expansion in any event. If there was an efficiency, the FTC argued, it involved moving to a larger enterprise immediately rather than over a period of three or four years. The FTC estimated that 43 percent of the savings would have been achieved even in the absence of the merger. *Id.*

Reducing input costs will typically but not invariably be procompetitive. In some cases, a firm may become so large that increased buying power may reflect the exercise of monopsony power. In this situation a supplier will decrease the input quantity it buys in order to force down the price. If output decreases, overall welfare is harmed.²⁷ Some commentators have raised concerns over buyer power in retail markets.²⁸ This concern is overstated in most retail markets where the level of buyer concentration is modest, at best. Monopsony power will be present only in extraordinary cases, and in most retail markets—such as unconcentrated supermarket retailing markets—monopsony power is highly unlikely. Protecting the ability to secure lower prices is an important goal of the antitrust laws. As then-Judge Breyer advised: “the Congress that enacted the Sherman Act saw it as a way of protecting consumers against prices that were too high, not too low. [Courts] should be cautious—reluctant to condemn too speedily—an arrangement that on its face appears to bring low price benefits to the consumer.”²⁹

Problems with the Case Law

There is much about these decisions, and especially *Heinz*, that is praiseworthy: they accept efficiencies as a defense and

provide a strong endorsement of the standards in the Merger Guidelines. What is intriguing, however, is how the courts articulate the standards and try the efficiency claims. Although *Heinz* addresses efficiencies at length, unlike decisions like *University Health*,³⁰ the court declined to articulate the legal standards for evaluating the defense. The court failed to address important issues posed by the parties in their briefs, such as whether the defendants had to demonstrate that any cost savings would be passed on in lower prices to consumers, or whether the consolidation of brands, which would have reduced the variety of baby food in the market, was a cognizable efficiency.

The question of whether any efficiencies would be passed on to consumers was an important part of the efficiency dispute. There is a lively debate on whether there should be a pass-on requirement in the law. Although the case law generally suggests that pass on should be a requirement,³¹ many commentators question whether this requirement is appropriate.³²

In *Heinz*, the defendants claimed that efficiencies would be passed on to consumers, based on a statement by their expert that “any firm that experiences a variable cost decline will have an incentive to lower prices after that cost reduction . . . lowering prices means that the firm will sell more. So it will be able to expand output as a result.” Defendants Appellate Br. at 41. The FTC, however, presented evidence that the profit-maximizing strategy for Heinz would be to increase prices. Moreover, according to the FTC, Heinz could not expand output significantly if Gerber, the other firm in this duopoly, took countermeasures to discipline any competitive initiatives, as Gerber consistently had done in the past. The FTC suggested that courts should not credit such price-reduction theories when only two firms will remain in the market, because there is no reasonable assurance that the merged firm will in fact lower prices rather than opt for a comfortable existence of pricing in parallel with the remaining firm.

Another important question raised in the *Heinz* decision is if, as the D.C. Circuit suggests, extraordinary efficiencies are necessary in a highly concentrated market, what is the level of “extraordinary”? *See* 256 F.3d at 720. The court is silent on what “extraordinary” means. Elsewhere the Areeda treatise provides clearer thresholds for extraordinary. In a highly concentrated market, cost savings must be over 4–5 percent of the output of the merged firm. In a more concentrated market or where a merger creates a dominant firm, “provable efficiencies must be at least 8 percent across the entire output in the market . . . further, the defendants must show that the merger is unlikely to result in higher consumer prices.” 4A Areeda, ¶ 976d at 93–94. Yet the treatise fails to provide any basis for these thresholds.

Further guidance on the level of costs savings to overcome the anticompetitive effects based on certain HHI thresholds could be useful. Specifying a certain percentage would certainly provide greater clarity for firms planning mergers. But such a threshold may deny efficiency defenses

where legitimate and significant efficiencies exist. The more appropriate inquiry is whether the cost savings and market structure will lead to an increase in output. Any specific level of cost savings would only be suggestive that that degree of savings would result in a more competitive market.

One intriguing trend in *Staples*, *Cardinal Health*, and *Heinz* is the extent to which courts require the parties to document efficiency claims with greater than anticipated precision. Often the courts seem to require a level of specificity that is far greater than many businesses demand before making major investments. It is highly unusual for firms to be in a position to estimate savings with a high degree of accuracy. Moreover, the problems posed by the D.C. Circuit about the calculations of production savings in *Heinz* were not even raised by the government, nor were they at issue before the district court. As courts raise these thresholds, the parties must sense that they are increasingly sailing on uncharted waters. That seems contrary to Chairman Pitofsky's prediction in 1998 that as the Guidelines were litigated "defense counsel should become more sure and more comfortable in addressing efficiency claims."³³ Too high a standard on documentation may make efficiency trials battles of accountants, with precision being the enemy of the good. As the FTC Staff Report cautions, "[p]recise quantification of the magnitude and probability of claimed efficiencies is impossible, as is a finely tuned weighing of claimed efficiencies' likely timing or effects on post-merger competitive dynamics." Report at 34.

Another unsettling aspect of these decisions is that the FTC is held to a lower preliminary injunction burden than the Antitrust Division. As the appellate court in *Heinz* emphasized, it did not "decide whether the FTC will ultimately prove its case or whether the defendants' claimed efficiencies will carry the day." 246 F.3d at 727. Under Section 13(b) of the FTC Act, to secure a preliminary injunction the FTC only needs to demonstrate if it "raise[s] questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals." *Heinz*, 246 F.3d at 713. This is substantially weaker than the burden faced by the Antitrust Division in seeking either a preliminary or permanent injunction, under which they must demonstrate that the merger may substantially lessen competition. This lesser burden is based on the Commission's role as ultimate decision-maker; it seeks an injunction simply to enjoin the merger so it can conduct an administrative hearing on the merits. The reality is that, with one exception, no firm has ever continued to litigate a merger in administrative litigation with the FTC after losing the preliminary injunction motion. The costs and difficulty of keeping a merger agreement together are simply too great.³⁴ This difference in standards led one private counselor in a speech on the efficiency defense to advise, "Pray your merger is assigned to DOJ!"³⁵

A Recipe for the Future

The promise of the 1997 Efficiency Guidelines has yet to be fulfilled. In part, this is because there is so little guidance on the application of the Guidelines, how to make efficiency claims to the agencies, the extent to which they have led to decisions to approve mergers, and what types of claims work and why. Unfortunately, there are few court decisions applying the Guidelines, and in no case since the Guidelines were revised has a court approved an otherwise anticompetitive merger based on efficiency claims. Even though the agencies have intensely investigated over 500 mergers since the issuance of the 1997 Guidelines until Bergen/Amerisource, they never explained the application of the efficiency defense in any of those matters.

From my own experience at the FTC, there were very few matters where the agency struggled with efficiency issues. To the public, there is little evidence that the agencies have significantly "liberalized" their treatment of efficiencies. The agencies have never announced that they decided not to bring a merger case based on efficiencies. Moreover, since the revised Guidelines were issued, the only additional guidance provided by the agencies was in two speeches by former FTC Chairman Pitofsky.³⁶ During the Clinton Administration, efficiencies were never addressed in detail in *any* analysis to aid public comment or competitive impact statement.

Without further guidance, the bar and businesses have little idea of the importance of the efficiency defense. Is it simply a tipping factor in a rare close case or can it be effectively used to reverse a perception of potential anticompetitive effects? If it is used simply as a tipping factor, then the Guidelines give a false impression that the defense can be more prominent. Preparing and arguing an efficiency defense is a very expensive and time-consuming process. Until the agencies open their internal analysis to observation, the private bar cannot advocate effectively for its clients.

Moreover, the agencies position on some types of claims, such as promotion, distribution, managerial expertise and capital, seems inconsistent with their position on divestitures. The agencies typically give these claims little weight in analyzing efficiencies, usually because they believe there may be other means to achieve these cost savings.³⁷ Yet at the same time, when considering proposed divestitures or potential buyers of divested assets, the agencies will negotiate hard to make sure that the new firm has a comparable level of managerial expertise, capital, and comparable assets in promotion and distribution. Symmetry in divestiture and efficiency policies is appropriate.

In litigation, although the agencies no longer argue that efficiencies are irrelevant or non-cognizable as a matter of law, they advocate for a challenging legal burden. As FTC Chairman Muris has noted, the agencies' stance is one of "unrelenting hostility."³⁸ In litigation, the Justice Department advocates that the defendants prove efficiencies through "clear and convincing evidence," even though that standard is inconsistent with the decisions of some courts.³⁹

In *Staples*, the court rejected this standard because where a merger has not yet been consummated, “it is impossible to quantify precisely the efficiencies that it will generate” and such a burden “would saddle . . . defendants with the nearly impossible task of rebutting a possibility with a certainty.” *Staples*, 970 F. Supp. at 1089. Rather, the court declared the defendants’ burden was simply, through credible evidence, to rebut the presumption that the “merger will substantially lessen competition by showing that the Commission’s evidence gives an inaccurate prediction of the proposed acquisition’s probable effect.” *Id.* Mergers involve a certain degree of speculation, and attempting to block mergers because of the “potential” for competitive harm, while requiring parties to prove efficiencies through “clear and convincing evidence” is inconsistent with the law and will negate the potential for a meaningful efficiency defense.⁴⁰

Greater transparency. The most substantial issue is transparency. There are a number of ways in which the agencies can improve the analysis and understanding of the consideration of efficiency claims. The first and most important step is for the agencies to provide greater detail on their analysis of efficiency claims both in the cases they bring and in those they choose not to bring. The agencies certainly have the capability of providing guidance in this area and the statement in Bergin/Amerisource is a productive first step. One of the most important documents on efficiency analysis is the FTC Staff Report (and the hearings that led to the report). It would be useful to build on the analysis and questions posed in the Staff Report to provide further guidance.

Some of the issues that should be addressed include: how efficiencies may be inextricably linked; how efficiencies affect the analysis of competitive effects where there are significant cost savings and when costs are “sufficient to reverse” the mergers anticompetitive effects; the treatment of fixed and marginal costs; the treatment of innovation efficiencies; and the analysis of less restrictive alternatives or other issues addressed in the FTC Staff Report.

Self-evaluation of past agency decisions. With new administrations in place, it is a propitious time for the agencies to evaluate their analysis of efficiencies. They should review the past analysis of efficiency claims by the agency staffs, the degree that those claims have been recognized, and the extent to which the 1997 Guidelines have affected the analysis. Outside review of this process would be particularly meaningful, and the agencies could use academic experts on a confidential basis to conduct this assessment.

Evaluation of consummated mergers. The agencies have undoubtedly approved mergers based on efficiency claims. One valuable approach would be for the agencies to look retrospectively at consummated mergers in which efficiency claims were significant to determine whether those claims were actually achieved. A recent evaluation of a hospital merger in Grand Rapids, Michigan, that had been unsuccessfully challenged by the FTC, found that the planned integration of hospitals had not occurred and many of the

efficiency claims were not achieved.⁴¹ In addition, it would be useful for the agencies to approach industry associations in those markets undergoing substantial consolidation to see if they can document the degree to which mergers result in significant cost savings. Two important candidates would be supermarkets and pharmaceuticals in which there has been a substantial trend of consolidation.

Workshops and reports. It would be instructive for the FTC to hold a workshop on efficiencies that would bring together business persons, consultants, lawyers, and economists to discuss what the experience has been in achieving efficiencies. The 1996 hearings provided an invaluable dialogue on the analysis of efficiency claims. The questions identified above are a good starting point of the types of issues that need to be addressed. Beyond that, the agencies should try to address the analysis of efficiencies in a regular report, similar to the HSR Annual Report, detailing the types of efficiency claims evaluated in merger investigations, and their analysis of these claims.

Conclusion

Efficiency analysis is and should be an integral part of merger analysis. Yet, the promise of clearer guidelines in the 1997 Efficiency Guidelines has yet to be fulfilled by a clear and consistent application of efficiency analysis in litigated cases. However, there are a number of ways in which the agencies can provide guidance to the public and fulfill the goals of the Guidelines without relying on the courts. These include: providing greater transparency by detailing their efficiency analysis both in the cases they bring and in those they choose not to bring; self-evaluating their prior analysis of efficiencies; looking retrospectively at consummated mergers in which efficiency claims were significant to determine whether those claims were actually achieved; and holding evaluative workshops on efficiencies. ■

¹ See Robert Pitofsky, *Proposals for Revised United States Merger Enforcement in a Global Economy*, 81 GEO. L.J. 195, 198 (1992).

² Robert Pitofsky, *Antitrust in a Clinton Administration*, 62 ANTITRUST L.J. 217, 221 (1993).

³ See FTC News Release, FTC/DOJ Announce Revised Guidelines on Efficiencies in Mergers (April 8, 1997).

⁴ See, e.g. Deborah A. Garza, *The New Efficiencies Guidelines: The Same Old Wine in a More Transparent Bottle*, ANTITRUST, Summer 1997, at 6.

⁵ FTC v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997).

⁶ FTC v. Cardinal Health, Inc., 12 F. Supp.2d 34 (D.D.C. 1998).

⁷ FTC v. Heinz, 116 F. Supp.2d 190 (D.D.C. 2000), rev’d, 246 F.3d 708 (D.C. Cir. 2001).

⁸ Timothy J. Muris, *The Efficiency Defense Under Section 7 of the Clayton Act*, 30 CASE W. RES. L. REV. 381, 418–19 (1980); see 4A PHILLIP E. AREEDA ET AL., ANTITRUST LAW ¶ 975, at 69.

⁹ John E. Kwoka, Jr. & F.R. Warren-Boulton, *Efficiency, Failing Firms, and Alternatives to Merger: A Policy Synthesis*, 31 ANTITRUST BULL. 431, 433 (1986).

¹⁰ Fisher and Lande summarize studies purporting to show that beyond a certain point, generally a market share in the 10 to 15 percent range, average

costs do not vary substantially with plant size. Alan Fisher & Robert Lande, *Efficiency Considerations in Merger Enforcement*, 71 CAL. L. REV. 1582, 1607 (1983).

¹¹ One caveat is that not all savings associated with such a merger will be in the way of marginal costs. Much of the savings may reduce fixed costs, which may have less of a short-term effect on the merged firm's prices. Reductions in marginal cost will have a greater impact on short-term price than reductions in fixed costs.

¹² F.M. SCHERER & DAVID ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 164 (3d ed. 1990).

¹³ Neither court addressed an intriguing argument posed by the FTC. The merger would have combined the two brands and thus, significantly reduced the number of choices for consumers. The FTC questioned whether the production savings should be cognizable when they result from a reduction in choice.

¹⁴ See AREEDA, *supra* note 8, at ¶¶ 975c & 975d.

¹⁵ Kwoka & Warren-Boulton, *supra* note 9, at 438–39.

¹⁶ 946 F. Supp. 1285 (W.D. Mich. 1996), *aff'd in unpublished opinion*, 1997-2 Trade Cas. (CCH) ¶ 71,863 (6th Cir. 1997) (not for publication opinion).

¹⁷ See David Balto & Meleah Geertsma, *Why Hospital Merger Antitrust Enforcement Remains Necessary: A Retrospective on the Butterworth Merger*, 34 J. HEALTH L. 129 (Spring 2001).

¹⁸ Timothy J. Muris, *The Government And Merger Efficiencies: Still Hostile After All These Years*, 7 GEO. MASON L. REV. 729, 734 (1999).

¹⁹ Interview with FTC Chairman Timothy J. Muris, *supra*, this issue, at 52.

²⁰ Others included superior purchasing practices, increased buying power, and reduction in overhead and inventory costs.

²¹ Statement of the Federal Trade Commission, Amerisource Health Corp./Bergen Brunswig Co., File No. 011-0122 at 1–2 (Aug. 24, 2001), <http://www.ftc.gov/os/2001/08/amerisourcestatement.pdf>.

²² *Id.* at 2.

²³ *Id.* at 2–3.

²⁴ AREEDA, *supra* note 8, ¶ 975g, at 81.

²⁵ General Motors Corp., 103 F.T.C. 374 (1984).

²⁶ The author participated in the matter while at the FTC.

²⁷ Marius Schwartz, *Buyer Power and the Aetna-Prudential Merger*, Address Before the 5th Annual Health Care Antitrust Forum (Oct. 20, 1999), available at <http://www.usdoj.gov/atr/public/speeches/3924.htm>; Report on the Federal Trade Commission Workshop on Slotting Allowances and Other Marketing Practices in the Grocery Industry 55–82 (Feb. 2001).

²⁸ See Albert E. Foer, *Beware of the Bite of Big Food*, *LEGAL TIMES* (Oct. 25, 1999), at 30 (questioning efficiency of buying power in supermarket mergers).

²⁹ Kartell v. Blue Shield, 749 F.2d 922, 931 (1st Cir. 1984).

³⁰ FTC v. University Health, Inc., 938 F.2d 1206, 1222–23 (11th Cir. 1991).

³¹ See United States v. United Tote, Inc., 768 F. Supp. 1064, 1084–85 (D. Del. 1991) (efficiencies rejected because “there are no guarantees that these savings will be passed on to the consuming public”); California v. American Stores, 697 F. Supp. 1125, 1133 (C.D. Cal. 1988) (rejecting claim of over \$50 million in efficiencies since savings will not “invariably” be passed on to consumers); cf. United States v. Long Island Jewish Med. Ctr., 983 F. Supp. 121 (E.D.N.Y. 1997) (accepting efficiency claim based on assumption that the nonprofit nature of the merged hospitals would lead them to pass on cost savings).

³² See Paul L. Yde & Michael G. Vita, *Merger Efficiencies: Reconsidering the “Passing On” Requirement*, 64 ANTITRUST L.J. 735, 743–45 (1996). FTC Chairman Muris also criticizes the requirement. He observes that the pass-on requirement “appears to be based on the belief that efficiencies will be passed on to consumers only when there is intense competition. According to economists, this belief is a fundamental misconception.” Muris, *supra* note 18, at 733. The FTC Staff Report suggested that evaluation of the impact of efficiencies on consumers is subsumed in the competitive effects analysis. FTC Staff Report, *supra*, at 28.

³³ Robert Pitofsky, *Efficiencies in Defense of Mergers: 18 Months After*, Address to George Mason Law Review Antitrust Symposium (Oct. 19, 1998), available at <http://www.ftc.gov/speeches/pitofsky/pitoeff.htm>.

³⁴ FTC v. Occidental Petroleum Corp. 1986 W.L. 952, *13 (D.D.C. 1986) (“No substantial business transaction could ever survive the glacial pace of an FTC administrative proceeding.”)

³⁵ Tefft W. Smith, Remarks Before the ABA Antitrust Section Annual Meeting (Aug. 7, 2001).

³⁶ Pitofsky, *supra* note 33; Robert Pitofsky, *FTC Staff Report on Competition Policy: Six Months After*, Address to ABA Section of Antitrust Law (Nov. 7, 1996), available at <http://www.ftc.gov/speeches/pitofsky/fordham7.htm>.

³⁷ Current FTC Chairman Muris is critical of the agencies’ skepticism to these types of claims. Muris, *supra* note 18.

³⁸ *Id.* at 751.

³⁹ See United States v. Franklin Electric, Memorandum of United States in Support of Motion for a Temporary Restraining Order and a Preliminary Injunction (May 2000), available at <http://www.usdoj.gov/atr/cases/f4800/4883.pdf>.

⁴⁰ The FTC Staff Report made a similar observation: “Moreover, insofar as Section 7 involves the difficult task of assessing *probabilities*, the concerns of many witnesses that a clear and convincing standard could vitiate an efficiencies defense are well-founded.” Report at 38.

⁴¹ Balto and Geertsma, *supra* note 17; Craig W. Conrath & Nicholas A. Widnell, *Efficiency Claims in Merger Analysis: Hostility or Humility?*, 7 GEO. MASON L. REV. 685 (1999).

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