The Past and Future of Direct Effects Evidence

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I.

Direct effects evidence is evidence indicating the likely competitive effects of a transaction or practice that is not based on inferences drawn from market concentration alone. Examples of direct effects evidence include an acquiring company's post-merger plans, evidence that competition between the merging parties has led to lower prices or other competitive benefits, changes in prices or output from a consummated merger, and the results of natural experiments.[1]

The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my attorney advisor, Darren Tucker, for his invaluable assistance preparing this paper.

[1] In this context, a natural experiment refers to a prior change in industry structure – such as a merger, entry, failure, or temporary shutdown – or an analogous change in a related product or rging

alternative in the face of a 5% price increase is not an especially persuasive line of questioning, particularly because customers are not adverse witnesses so a plaintiff generally cannot lead them. Contrast that to the use of documents or testimony showing whether there have been recent competitive interactions between the merging companies resulting in lower prices or other consumer benefits.

This is not to say that all types of direct evidence are created equal. They aren't. For example, the parties' statements, written and oral, may be particularly powerful and probative. So can evidence about what actually happened post-transaction in consummated transactions.

II.

The 1992 Merger Guidelines offered little support for the use of direct effects evidence. Instead, the 1992 Guidelines required that merger analysis proceed in a step-by-step fashion starting with market definition. Only after the market is defined—and the market participants identified and concentration levels determined—are the likely competitive effects of a transaction assessed. On numerous occasions, I argued that the 1992 Guidelines' treatment of market definition as a "gating item" was a mistake and that more emphasis should be placed on direct evidence.[4]

Notwithstanding that direct effects evidence was given relatively short shrift in the 1992 Guidelines, the agencies did in fact consider such evidence in the course of merger review. In addition, the agencies usually avoided the rigid, step-by-step approach described in the 1992 Guidelines to focus instead on the most relevant evidence.

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[4] *See, e.g.*, J. Thomas Rosch, Commissioner, Federal Trade Commission, Enforcement Priorities in the New Administration, Remarks at the Global Competition Review's 2009 Competition Law Review at 9-12 (Nov. 17, 2009), *available at* http://www.ftc.gov/speeches/rosch/091117enforceprioritiesremarks.pdf.

As the 2006 *Merger Guidelines Commentary* stated, "the Agencies do not apply the Guidelines as a linear, step-by-step progression that invariably starts with market definition and ends with efficiencies or failing assets."[5] Rather the agencies favor "an integrated approach" where the emphasis is on competitive effects, and "evidence of effects may be the analytical starting point."[6] A merger's competitive effects, according to the *Commentary*, "also may be useful in determining the relevant market."[7] And the *Commentary* asserted that "[i]n some cases, competitive effects analysis may eliminate the need to identify with specificity the appropriate relevant market."[8] The report identified natural experiments and merger simulations as two types of evidence that directly address the core question of whether a merger is likely to create or enhance market power or facilitate its exercise.[9] Indeed, the *Commentary* declared that market definition and concentration often have little relevance in a unilateral effects analysis.[10]

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[5] U.S. Dep't of Justice & Fed. Trade Comm'n, Commentary on the 1992 Horizontal Merger Guidelines at 2 (2006), *available at* http://www.ftc.gov/os/2006/03/CommentaryontheHorizontalMergerGuidelinesMarch2006.pdf.

[6] *Id*. at 2, 10; *see also id*. at 10 ("In some investigations, before having determined the relevant market boundaries, the Agencies may have evidence that more directly answers the 'ultimate inquiry in merger analysis,' i.e., 'wheth

The FTC has brought several cases that relied to a large degree on direct evidence. In *Evanston*,[11] the Commission challenged a consummated merger between two hospitals in the North Shore suburbs of Chicago. The first count of the complaint alleged that the merger violated Section 7 of the Clayton Act in certain relevant product and geographic markets. The second count charged that the transaction violated the Clayton Act because it enabled Evanston to raise its prices to private payors. Unlike the first count, however, the second count did not allege a particular product or geographic market and did not incorporate the complaint's earlier product market and geographic market allegations by reference.

Both the ALJ and the Commission found liability under Count I but declined to reach the question of whether there was liability under Count II.[12] The Commission's unanimous decision nevertheless acknowledged the clear trend toward the use of direct evidence in lieu of market definition in Section 1 and Section 7 cases. The opinion explained that "market definition is not an end in itself but rather an indirect means to assist in determining the presence or the likelihood of the exercise of market power."[13] The decision observed that a number of courts had "endorsed the use of direct effects evidence to determine, even absent a market definition, whether ongoing *conduct* has facilitated the exercise of market power."[14] The Commission

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[11] Opinion of the Commission, In re Evanston Northwestern Healthcare Corp., FTC Docket No. 9315 (Aug. 6, 2007), *available at* http://www.ftc.gov/os/adjpro/d9315/070806opinion.pdf.

[12] *Id*. at 86 ("Having found that the evidence is sufficient to define the product and geographic markets, and that complaint counsel has prevailed under Count I, we consider it unnecessary to decide whether the law permits establishing a violation of Section 7 without defining a relevant market.").

[13] *Id*.

[14] *Id*. at 88 (emphasis added).

competition between the merging parties.[19] In *Staples*, the FTC offered evidence at trial that indicated that prices tended to increase as the number of office superstores declined.[20] And in *Ovation*, the agency presented evidence that shortly after the transaction was consummated, prices increased nearly 1,300 percent.[21]

I was not alone in advocating for greater emphasis on use of direct evidence at the FTC. Then-Commissioner Leibowitz joined in my concurring statement in *Evanston* as to the role of market definition.[22] Former Chairman Majoras, who authored the Commission's decision in *Evanston*, asked aloud at a workshop if we are "ready to touch the third rail and discuss whether market definition is necessary in a case in which we can present direct evidence of competitive effects."[23] Several of the panelists in the workshops leading up to the 2010 Merger Guidelines also advocated for greater reliance on direct evidence.

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[19] For example, the company's CEO advised a member of his board that the transaction would help "avoid nasty price wars" in certain local markets and elsewhere opined that Whole

III.

The 2010 Merger Guidelines made a monumental leap forward with respect to the use of direct evidence in several regards.[24] First, the rigid, step-by-step analytical approach of the 1992 Guidelines is gone. Section 4 of the new Guidelines explains that "[t]he Agencies' analysis need not *start* with market definition."[25] Rather, the Agencies will "consider any reasonably available and reliable evidence to address the central question of whether a merger may substantially lessen competition."[26]

Second, the 2010 Guidelines endorse the use of direct evidence of competitive effects. The Guidelines explain that direct evidence can reduce or eliminate the need to rely on

diagnosing unilateral price effects . . . ."[29] The 2010 Guidelines also note that use of direct

evidence can be particularly va

weight" to "the actual history of entry into the relevant market."[32] Direct evidence of a transaction's likely efficiencies include the buyer's success in achieving projected efficiencies in past transactions, as well as evidence that the transaction was motivated by the expectation of efficiencies. Such motivation could be shown by projections generated in the "usual business planning process" or from a "purchase price in excess of the acquired firm's stand-alone market value."[33]

The 2010 Guidelines do note some important caveats with regard to direct effects evidence. In particular, the new reliance on direct evidence does not mean that the agencies are abandoning market definition. The Guidelines make this point repeatedly.[34] The same is true when the agencies go into court. Section 4 states that "[i]n any merger enforcement action, the Agencies will normally identify one or more relevant markets in which the merger may substantially lessen competition."[35] So concerns that have been raised about the Agencies using

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http://www.ftc.gov/speeches/rosch/100819horizontalmergerstatement.pdf. Section 6.1 also explains that a variety of evidence – including "documentary and testimonial evidence, win/loss reports and evidence from discount approval processes, customer switching patterns, and customer surveys" – can help identify the extent of direct competition between the merging parties, which is "central to the evaluation of unilateral price effects."

[32] *See also* 2010 Guidelines § 2.1.2. ("[T]he agencies may examine the impact of recent . . . entry . . . in the relevant market.").

[33] *Id.* § 2.1.2; *see also* Merger Guidelines Commentary at 53 ("The best way to substantiate an efficiency claim is to demonstrate that similar efficiencies were achieved in the recent past from similar actions.").

[34] 2010 Guidelines § 5 ("The Agencies normally consider measures of market shares and market concentration as part of their evaluation of competitive effects."); *id.* § 5.2 ("The Agencies normally calculate market shares for all firms that currently produce products in the relevant market, subject to the availability of data."); *id.* § 5.3 ("Market concentration is often one useful indicator of likely competitive effects of a merger."); *id.* § 4 ("[E]valuation of competitive alternatives available to customers is always necessary at some point in the analysis.").

[35] *But see id.* § 1 n.2 ("These Guidelines are not intended to describe how the Agencies will

the 2010 Guidelines as the impetus for urging the courts to abandon market definition are, in my view, misplaced.[36]

In addition, direct effects evidence may play a lesser role when the concern is limited to coordinated interaction. According to the Guidelines, the Agencies will only challenge a merger on coordinated effects grounds if "the merger w

Despite the 2010 Guidelines' goal of moving away from an upfront structural case and toward the use of direct evidence of a merger's anticompetitive effects, it's not clear to me that agency practice – at least at the FTC – has actually changed much since those Guidelines became effective. Exhibit A in that regard is the Commission's *Polypore* opinion,[40] which follows the analytical approach of the 1992 Guidelines, rather than the 2010 Guidelines.

Polypore, like *Evanston*, involved a consummated merger that resulted in significant price increases. There was also compelling evidence in *Polypore* that the transaction was motivated by an expectation of reduced competition and higher prices. The Commission's decision acknowledged that both the courts and the Commission have recognized that the traditional burden-shifting framework that begins with defining the relevant market "does not exhaust the possible ways to prove a § 7 violation on the merits."[41] The opinion also stated that "[i]n a consummated merger, post-acquisition evidence of actual anticompetitive harm may in some cases be sufficient to establish Section 7 liability without separate proof of market definition."[42] (I would use the word "upfront," instead of "separate," before "proof.") Nevertheless, the Commission's opinion embraced a traditional analytical framework, including precise upfront market definition, before turning to consideration of the transaction's competitive effects.[43]

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[40] Opinion of the Commission, In re Polypore Int'l, Inc., Docket No. 9327 (Dec. 13, 2010), *available at* http://www.ftc.gov/os/adjpro/d9327/101213polyporeopinion.pdf.

[41] *Id*. at 11 (quoting *FTC v. Whole Foods Market*, 548 F.3d 1028, 1036 (D.C. Cir. 2008) (Brown, J.)).

[42] *Id*.

[43] *Id*. ("Both Complaint Counsel and Respondent developed their evidence and litigated this case by reference to a relevant market and this traditional burden-shifting framework. The ALJ relied on the same legal framework in the ID. We find that this framework illuminates the factual record and competitive issues in this case and therefore apply it in this opinion.").

I wrote a concurring opinion praising the rigor of the Commission opinion but lamenting that the Commission had declined to take the opportunity to apply the advances in the 2010 Guidelines. I explained that "especially where, as here, the merger at issue is consummated, it is generally preferable to determine whether a merger has had anticompetitive effects by reference to the parties' motives for the transaction and the actual effects resulting from the merger instead of trying first to define with precision the dimensions of relevant market."[44]

I would offer several comments about *Polypore*. First, there is no doubt in my mind that the majority opinion, which began by defining the relevant market, was the smart way to secure an appellate victory, particularly given the fact that the decision was issued shortly after issuing the 2010 Merger Guidelines. Second, at the same time, I thought is was important to articulate a contrary approach that would be simpler and arguably more consistent with the new Guidelines so that the courts would have an opportunity to consider this less economic-based approach. It may be that some courts will have to get used to this analysis before adopting it.

V.

Let me next say a few words about how the courts are likely to treat direct effects evidence in future Section 7 cases. As I mentioned before, the Agencies have relied on direct effects evidence in a number of recent merger and non-merger cases. The courts have sometimes been receptive to this approach.

The Supreme Court has held that direct effects evidence can establish a violation of the Sherman Act in a non-merger case, even without proof of market power in a relevant market. In *Indiana Federation of Dentists*, the Court stated that "[s]ince the purpose of the inquiries into

[44] Concurring Opinion of Commissioner J. Thomas Rosch at 5, In re Polypore Int'l, Inc., Docket No. 9327 (Dec. 13, 2010), *available at* http://www.ftc.gov/os/adjpro/d9327/101213polyporeconcurringopinion.pdf.

market definition and market power is to determine whether an arrangement has the potential for genuine adverse effects on competition, proof of actual detrimental effects, such as a reduction of output, can obviate the need for an

them."[48] In the D.C. Circuit's *Whole Foods* decision, Judge Brown (joined by Judge Tatel in this regard) stated that "defining a market and show

markets under the usual methodology. Thus, I would suggest that the full range of "practical indicia" is pertinent in all merger cases, regardless of whether one is using the term "market" or "submarket."

Also, several of the *Brown Shoe* practical indicia are on the supply-side, which indicates that both demand and supply-side factors should be relevant to determining the relevant market. Nevertheless, our Merger Guidelines take a slightly different approach. Since 1982, the Merger Guidelines have defined relevant markets only with regard to demand-side considerations, and looked to supply-side factors when determining who participates in the relevant market. But regardless of whether we are following *Brown Shoe* or the Merger Guidelines, it is important to consider supply-side substitution, even in unilateral effects cases, where the usual focus is on the degree of substitution between the merging parties' products.

VII.

I'd also like to briefly touch on challenges the FTC faces in some future unilateral effects cases. Under the 2010 Merger Guidelines, mergers that result in an HHI below 1,500 or that involve an increase of less than 100 are described as "unlikely to have adverse competitive effects and ordinarily require no further analysis."[51] I worry that these thresholds, which are generally viewed as safe harbors, may handcuff us from challenging some unilateral effects mergers where the merging parties have low shares but are very close substitutes. This isn't a new concern for me. You will recall that I was critical of the new Guidelines for creating the illusion that these were safe harbors when the Guidelines were issued.[52]

[51] 2010 Merger Guidelines § 5.3.

[52] Statement of Commissioner J. Thomas Rosch on the Release of the 2010 Horizontal Merger Guidelines, Project No. P092900 (Aug. 19, 2010), *available at* http://www.ftc.gov/speeches/rosch/100819horizontalmergerstatement.pdf.

This concern is exacerbated in potential competition cases. In mergers between potential competitors, one or both of the parties have no current sales, which means that the transaction will not lead to an immediate increase in concentration.[53] Compounding the concern with the HHI requirements in the Merger Guidelines is the Supreme Court's *Marine Bancorporation* case, which requires a showing that the potential competitor would substantially deconcentrate