DEPARTMENT OF JUSTICE
FEDERAL TRADE COMMISSION
MERGER WORKSHOP

"COORDINATED EFFECTS"

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Why, and with what consequence to Antitrust Enforcement Policy, is it more difficult to prove criminal and civil collusion than it is to establish a likelihood of enhanced coordinated effects arising from the ultimate form of collusion – a proposed merger?[1] Is there a policy bias against mergers?[2] Or, are the analytical tools simply different?

I. The Sherman Act vs. The Clayton Act

The Sherman and Clayton Acts embody quite different elements for a violation. The Sherman Act requires an agreement, and according to the Supreme Court, for a criminal violation, *mens rea*.[3] The Sherman Act is not a "no fault" statute.[4] Despite its origins in a time when trusts and cartels caused near slavery of the workforce, unstable and unreliable financial markets and at best unsavory politics, the Sherman Act did not reach conditions that caused reduced output and supra-competitive prices unless those conditions were the product of an

[1] This paper drew upon the following excellent source materials: A.I. Gavil, W.E. Kovacic, and J.B. Baker, Antitrust Law in Perspective: Cases, Concepts and Problems in Competition Policy (Thomson West 2002); H. Hovenkamp, Federal Antitrust Policy The Law of Competition and Its Practice (2d ed. 1999); D.W. Carlton and J.M. Perloff, Modern Industrial Organization (3d ed. 2000); and T.J. Muris, *Improving the Economic Foundations of Competition Policy*, George Mason University Law Review's Winter Antitrust Symposium, Washington, D.C., January 15, 2003. The assistance of Danielle K. Moskowitz is also gratefully acknowledged.

[2] For a review of the history and contemporary thinking on coordinated effects and the role of concentration in merger analysis, see Perspectives on Fundamental Antitrust Theory, American Bar Association Section of Antitrust Law (July 2001).

[3] *United States v. United States Gypsum Co.*, 438 U.S. 422, 98 S. Ct. 2864, 57 L. Ed.2d 854 (1978).

[4] 438 U.S. at 436 ("We are unwilling to construe the Sherman Act as mandating a regime of strict-liability criminal offenses.").

agreement.[5] The Sherman Act does not prohibit concentration in the form of oligopoly so long as it is the product of coordination, absent agreement. Interdependent, yet individual, decisions made on the basis of the observed and expected price and output decisions by rivals are not actionable under the Sherman Act.[6]

This circumstance was at the crux of the famous Posner/Turner debate.[7] As a policy matter should the Sherman Act be construed to cover non-competitively performing oligopolies, in the absence of their being caused by an agreement? Posner; yes. Turner; no – what is there for a court to enjoin? How can a court order a firm not to take account of its rivals' behavior?[8]

As Hovenkamp has observed, oligopoly can for antitrust purposes usefully be thought of in two classifications: cooperative oligopoly where price tends to the monopoly level; and non-cooperative oligopoly where price and output, while not competitively optimal, tend toward competition.[9] Highly simplified, the prerequisites for cooperative oligopoly are some form of consensus on price or output plus effectiveness – transparency, policing and reconciliation of accounts. The prerequisites for non-cooperative oligopoly are the absence of the elements required for effectiveness. In the absence of agreement in the legal sense, determining whether

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5 E.T. Sullivan and H. Hovenkamp, Antitrust Law, Policy and Procedure: Cases, Materials, Problems, 26-27 (5th ed. 2003).

6 *See* J.R. Loftis, III, *That Ever-So Fine Line Between Inference and Agreement*, The International Cartel Workshop – 2004, New York, NY, February 5-6, 2004.

7 *See* Gavil, Kovacic, and Baker, *supra* note 1, at 255-56; Hovenkamp, *supra* note 1, at 165-67.

8 See D. Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655, 669-71 (1962).

9 Hovenkamp, *supra* note 1, at 160-63.

oligopoly is the product of circumstances from which the requisite Sherman Act agreement will be inferred can be quite difficult.[10]

By contrast, the Clayton Act prohibits the ultimate form of collusion – a merger – whenever it merely "may . . . tend" to create a restraint of trade, or "may . . . tend" toward monopoly.[11] Mergers, which some would contend are important economic engines for constructive change, are in this sense more susceptible to government interdiction than criminal and civil Sherman Act violations, which cause unambiguous harm to consumer welfare.[12] The Merger Guidelines appear to invite conjecture about the likelihood of coordinated effects with a checklist for indicia of coordination that could provide a basis for intervention: market condition information availability; firm and product homogeneity; price and marketing practices; buyer and seller characteristics; transaction characteristics; and, any history of actual collusion.[13] While it is true that the federal enforcement agencies have moved beyond the checklist approach to coordinated effects analysis, it is not entirely clear where they have landed; nor is it clear that they have landed upon common ground.[14]

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[10] See text and cases cited at note 29 *infra*.

[11] 15 U.S.C. § 18 (2003) (Section 7 prohibits transactions "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly").

[12] *See, generally* Perspectives on Fundamental Antitrust Theory, *supra* note 2.

[13] *See* U.S. Department of Justice and the Federal Trade Commission, Horizontal Merger Guidelines, issued April 2, 1992, revised, April 8, 1997 *available at* http://www.usdoj.gov/atr/public/guidelines/hmg.htm (hereinafter Merger Guidelines).

[14] *See* D.T. Scheffman and M. Coleman, *Quantitative Analyses of Potential Competitive Effects from A Merger*, June 9, 2003 *available at* http://www.ftc.gov/be/quantmergeranalysis.pdf.

II. Effective Coordination Under The Sherman Act

In contrast to the Clayton Act, the law and economics that has developed around the Sherman Act require either direct proof of an agreement to fix prices, restrict output or allocate customers, or proof of effective coordination from which an agreement may plausibly be inferred.[15]

Direct proof is conceptually the easy case, and might be thought of as the counterpart of merger to monopoly. Direct proof is that which establishes an agreement, with nothing more being required. No inferences are necessary.[16] The economically pernicious effects of agreements to fix prices, reduce output or allocate customers are so well established and uncontroversial that nothing more is needed for a violation.[17] The agreement is the violation. In one sense the same is true for merger to monopoly in many circumstances.[18]

At this point, however, for every other market circumstance, the Sherman and Clayton Acts appear to part company.

For a Sherman Act violation, in the absence of direct proof of agreement, it is increasingly accepted that there must be circumstantial proof of effective coordination; not just

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15 *Interstate Circuit, Inc. v. United States*, 306 U.S. 208, 59 S. Ct. 467, 83 L. Ed. 610 (1939). *See generally* Gavil, Kovacic, and Baker, *supra* note 1, at 306-308; Hovenkamp, *supra* note 1, at 171-78.

16 *In re Baby Food Antitrust Litigation*, 166 F.3d 112, 118 (3d Cir. 1996).

17 *United States v. United States Gypsum Co.*, *supra* note 3, at 435. *See, generally,* Section of Antitrust Law, *Antitrust Law Developments,* at 730 (5th ed. 2002).

18 *See* Scheffman and Coleman, *supra* note 14. *See also* note 27 *infra*.

coordination.[19] Effective coordination requires a consensus on the price to be charged customers, or upon the amount of output to be restricted below competitive norms, or on which firms will deal with which customers while the others refrain from competing for those customers.[20] In addition, for this consensus to be effective, actual transaction prices with customers must be transparent to all participants.[21] This is because the consensus that works to create supra-competitive prices by definition simultaneously creates powerful incentives for the participants to make sales outside the consensus because the incremental value of each such sale has been enhanced.[22] Of course, if that happens, the supra-competitive price tends to fall toward competitive norms and if that were forecast, there would have been no consensus in the first place.[23] So, transparency is vital. It is a kind of insurance policy, ensuring the consensus. But then, so too is the threat of retribution required. Once detected, each participant must fear punishment for cheating or else the incentive to make sales outside the consensus overwhelms the consensus.[24] One other factor is required for effective coordination. Despite their best efforts, the participants often find unpredictable market conditions will cause variations in the extent to which each participant actually benefits. For the consensus to continue, accounts must

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19 *See, e.g.*, *Williamson Oil Co. v. Philip Morris USA*, 346 F.3d 1287, 1301 (11th Cir. 2003); *In re Baby Food Antitrust Litig.*, *supra* note 16.

20 Hovenkamp, *supra* note 1, at 144-47; Scheffman and Coleman, *supra* note 14, at 8.

21 Gavil, Kovacic, and Baker, *supra* note 1, at 235-36; Scheffman and Coleman, *supra* note 14, at 13-15.

22 Hovenkamp, *supra* note 1, at 147-49.

23 *Id.*

24 *Id.* at 149-52.

be reconciled.[25] When these conditions are present, the law will permit an inference of agreement.

The courts' and federal enforcement agencies' interpretation of the Clayton Act's "may tend" standard does not appear to require nearly so rigorous an analysis in determining the outlook for anticompetitive effects being caused by a proposed merger's creation or enhancement of coordination.[26] With a three to two proposed transaction, there has been support for a per se presumption of anticompetitive effect arising solely from high levels of concentration and what is assumed to be attendant, enhanced coordination.[27] Clearly with this and other levels of increased concentration, the standards for analyzing the likelihood of anticompetitive effects in fact arising from coordination lack rigor.[28]

III. A Trend Toward Convergence of the Sherman and Clayton Act Standards for Coordination?

The concept of there being a requirement for <u>effectiveness</u> of coordination, and particularly for proof of the elements needed for effectiveness, may provide a useful discipline for the application of coordination theories in merger analysis in some circumstances.

The case law that is developing under the Sherman Act has addressed specific factors in particular industries and has found that as a matter of law, singularly and in the aggregate, that

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[25] *Id.* at 154-56.

[26] *See, generally,* Merger Guidelines, *supra* note 13.

[27] *See, generally, Federal Trade Commission v. H.J. Heinz and Milnot Holding Corp.,* 246 F.3d 708 (D.C. Cir. 2001), note 35 *infra*; Scheffman and Coleman, *supra* note 14, at 6. *See also FTC v. Alliant Techsystems Inc.*, 808 F. Supp. 9, 20-21 (D.D.C. 1992) (a merger to monopoly suggests a per se violation of the Clayton Act which is rarely rebuttable).

[28] *See, generally*, Gavil, Kovacic, and Baker, *supra* note 1, at 282-83.

following do not raise an inference of agreement (or effective coordination): exchanging price lists, publication of price lists, publication of prices in advance of their effective dates, fewness of sellers, decisions based on observed and anticipated decisions by rivals about price and output, parallelism in prices and price announcement dates, and follow-the-leader pricing.[29] Nevertheless, these are often proverbial red flags in merger analysis. Capacity expansions, new product introductions, increased research and development and changes in market share are indicators that effective coordination is unlikely.[30] Nevertheless these often take on a discounted value when mustered against a presumption arising from increased concentration.

Some recent commentary concerning merger enforcement standards points generally in the same direction that the case law is taking on Sherman Act coordination, albeit using a different lexicon.[31] Chairman Muris endorses the New Institutional Economics ("NIE") with its focus on the real world facts of why transactions in an industry take place, and therefore how a merger would affect them.

> "For antitrust, NIE teaches that the nature of industry organization (*e.g.*, the type and extent of vertical relationships and the level of horizontal concentration) and of competition in a specific industry are not a black box to be analyzed only through the lens of industry structure and market power-based theories. A broader set of tools and presumptions is required to enforce the antitrust laws in the public interest. . . . antitrust analysis, if done correctly, uses the NIE approach

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[29] *See, e.g.*, *Williamson Oil Co.*, *supra* note 19; *In re Baby Food Antitrust Litig.*, *supra* note 16, at 122; *Blomkest Fertilizer, Inc. v. Potash Corp.*, 203 F.3d 1028, 1036 (8th Cir. 2000); *In re Citric Acid*, 191 F.3d 1090, 1103 (9th Cir. 1999); *Reserve Supply Corp. v. Owens-Corning Fiberglas Corp.*, 971 F.2d 37, 54 (7th Cir. 1992); *Clamp-All Corp. v. Cast Iron Soil Pipe Institute*, 851 F.2d 478, 484 (1st Cir. 1988); and *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 762-63 (1984).

[30] *See* Scheffman and Coleman, *supra* note 14.

[31] *See* T.J. Muris, *supra* note 1; Scheffman and Coleman, *supra* note 14.

> – that is, a careful, fact-based economic analysis grounded in a thorough understanding of the relevant institutions. Especially through its emphasis on transaction costs, NIE is a most promising strand of economic research, both for its theoretical elegance and for its ability to explain real-world phenomena."[32]

David Scheffman treats the Merger Guidelines checklist approach to coordination as an only somewhat useful generality; a starting point for more rigorous fact intensive inquiry into how a proposed merger would likely change the way transactions occur.

> "The existing literature and our experience across many industries indicates that such Check Lists are too crude to provide much assistance in determining whether a coordinated interaction theory is relevant. Specifically, many industries that fit the Check List do not appear to exhibit outcomes that are consistent with coordinated interaction. Moreover, this approach does not focus on why the merger should affect the likelihood of coordination. Thus, while the Check List can provide a starting point, it is necessary to analyze in more detail the nature of competition in the market at issue. . . . detailed transaction-specific information where available is likely to be more informative as to the presence of or proclivity for coordinated interaction than is the typical Check List."[33]

Scheffman and others appear to embrace the concept of coordination effectiveness, not for what it implies about agreement; but, in the merger context, for what it implies about the likelihood of a merger to create or enhance anticompetitive effects through coordination in the real world.[34]

Addressing the American Bar Association's Section of Antitrust Law's Review of Fundamental Theory, in what became titled, "Perspectives on Fundamental Antitrust Theory," Professors Baker and Salop expressed caution about wholesale changes in the Merger Guidelines:

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[32] T.J. Muris, *supra* note 1, at 1.

[33] Scheffman and Coleman, *supra* note 14, at 7.

[34] *Id.* at 21.

> "For these reasons, it may be useful to clarify the role of concentration analysis in the Guidelines. But if the task force proceeds down this road, we do not think that it is necessary or productive to start on a clean slate. The Merger Guidelines provide a useful and robust analytic framework that has successfully been revised over time to incorporate developments in industrial organization economics and business strategy analysis. Any effort to clarify the role of market shares and market concentration in merger analysis should approach that project with the goal of proposing amendments to the existing Merger Guidelines, not a total rewrite. The revisions should not deny a role for market concentration. Instead, they should more carefully determine and explain the appropriate strength of the concentration presumption on the basis of decision theoretic considerations. Such a clarification also promises to be influential in helping courts apply *Baker Hughes* in the wake of *Heinz*."[35]

Perhaps it would be useful to acknowledge that there are additional ways to articulate the coordination theory of competitive effect in merger analysis; ones that are at least complementary, and perhaps in some circumstances superior to what is in the current Merger Guidelines:

- For a coordination theory plausibly to lead to anticompetitive results, there must be proof of facts that the hypothesized coordination would be effective in creating or enhancing those anticompetitive results.
- Effectiveness in a merger context (under the Clayton Act standard) requires
  - interdependent group decision making on price, output or customers
  - transparency
  - policing
  - reconciliation of accounts

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[35] J. B. Baker & S.C. Salop, *Should Concentration Be Dropped From the Merger Guidelines?*, published in Perspectives on Fundamental Antitrust Theory, *supra* note 2, at 348. In *Heinz*, *supra* note 27, the FTC took the unhelpful position that an HHI increase of more than 100 where the post-merger HHI exceeds 1800 entitles it, without more, to a preliminary injunction blocking the transaction. *Id.* at 716-717.

- Coordination is not a viable theory where there is proof of the impossibility of effective coordination.