

Chapter 13

Conglomerate Mergers and Acquisitions

This chapter focuses on the legally-relevant economic effects and legality of conglomerate mergers and acquisitions (hereinafter conglomerate mergers) under U.S. antitrust law and E.C./E.U. competition law. Conglomerate mergers are mergers that are neither horizontal nor vertical—*i.e.*, are mergers between MPs that (1) are not equal-best-placed, respectively best-placed and second-placed, or respectively best-placed and well-enough-placed to affect the oligopolistic margins that a best-placed MP would find *ex ante* profitable to attempt to contrive and (2) are not in a supplier-supplied relationship to each other. Three types of conglomerate mergers can be distinguished:

- (1) product-diversification conglomerate mergers (between MPs whose products would not be well-placed to obtain the patronage of any common buyer even if geographic location were not an issue);
- (2) geographic-diversification conglomerate mergers (between MPs that produce products that would be rivalrous if they produced them in the same geographic area but, for reasons of geography, are not well-placed to supply any common buyer despite this fact); and
- (3) conglomerate mergers that eliminate an effective potential competitor, which may or may not yield product or geographic diversification but whose defining characteristic is that they eliminate an effective potential competitor (a potential entrant that will enter if the established firms do not engage in otherwise-unprofitable conduct to prevent its doing so [or perhaps that was misperceived by the relevant established firm to be sufficiently likely to enter if nothing were done to prevent this outcome]).

1. The Sherman and Clayton Act Tests for the Illegality of Conglomerate Mergers

The Sherman Act's "specific anticompetitive intent" test of illegality applies to conglomerate mergers just as it does to the other types of conduct the Act covers, and the Clayton Act's "organizational-economic-efficiency-defense-qualified competitive-impact test" is defined in the same way when the Clayton Act legality of conglomerate mergers is at issue as when the Clayton Act legality of all other Clayton-Act-covered types of conduct is at issue. It is important to emphasize that the Clayton Act test for the illegality of conglomerate mergers incorporates the same "defendant-do-nothing" baseline for competitive-impact measurement as does the Clayton Act test for the illegality of all the other types of conduct the statute covers: the Clayton Act does not obligate firms that propose to execute a conglomerate merger to execute the most-procompetitive conglomerate merger they would find more profitable than doing nothing—just prohibits such parties from executing any conglomerate merger that would reduce the intensity of competition below the level it would have if they did nothing. As we shall see, this feature of the Clayton Act test of illegality renders lawful under the Clayton Act

- (1) any geographic-diversification conglomerate merger whose substitution for no attempt to enter into the acquired or merged-with firm's territory would not reduce competition in that area of product-space when the prohibition of the proposed merger would have made it profitable for the firm seeking geographic diversification to execute an alternative, more procompetitive geographic-diversification conglomerate merger in the same market or to execute a more procompetitive independent entry into that market,
- (2) any product-diversification conglomerate merger whose substitution for no attempt to diversify into the acquired or merged-with firm's product market would not reduce competition in that market when the prohibition of the proposed merger would have made it profitable for the firm seeking to enter the acquired/merged-with firm's product market to execute an alternative, more procompetitive product-diversification conglomerate merger in the same product market or to execute a more procompetitive independent entry into that market, and
- (3) any conglomerate merger that would eliminate a particular effective potential competitor whose substitution for no attempt to prevent the merged-with firm's entry would not decrease competition when the prohibition of the proposed merger would have led the non-potential-competitor MP to execute a more procompetitive merger with a firm that was not an effective potential competitor or with a different effective potential competitor.

2. The Sherman-Act-Licit and Sherman-Act-Illicit Ways in Which Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor Can Increase Their Participants' Profits and the Appropriate Structure of Trials About the Legality of Such Conglomerate Mergers Under the Sherman Act

A. The Sherman-Act-Licit Ways in Which Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor Can Increase Their Participants' Profits

The Sherman Act regards as illicit any tendency of a choice to increase the chooser's profits by reducing the absolute attractiveness of the offers against which it must compete in some way that would critically inflate the profitability of the choice in an otherwise-Pareto-perfect economy but regards as licit any tendency of a choice to increase the chooser's profits in any other way. Conglomerate mergers of all sorts can increase their participants' profits in all the Sherman-Act-licit ways that horizontal mergers can do so—in particular,

- (1) by generating static and/or dynamic purchasing, production, distribution, marketing, R&D, and finance economic efficiencies;
- (2) (in my judgment, though this is not the view of the U.S. antitrust-enforcement authorities or the U.S. courts) by increasing the merged firm's bargaining power as a buyer above the sum of the MPs' pre-merger bargaining powers as buyers when this effect benefits ultimate consumers;
- (3) by creating a merged firm that must incur lower mechanical costs to change its initially-announced prices (which may increase the merged firm's profits both directly when the MPs obtained NOMs pre-merger and indirectly by enabling the merged firm to obtain OMs naturally from buyers from which the MPs could otherwise not have done so);
- (4) by enabling the merged firm to obtain NOMs the MPs could not have secured by creating a merged firm that would be able to orchestrate a series of natural-oligopolistic-pricing-enabling premature price-announcements that the MPs and their *Rs* would not have made;
- (5) in across-the-board-pricing contexts, by creating a merged firm that can orchestrate a sequence of mature price-announcements (by itself and its rivals) that will increase the HNOP array for it and its rivals;
- (6) by enabling the owners of one MP to profit by selling tax losses that the MP in question could not use to the other MP, which could use them; and
- (7) by enabling the owner of one of the MPs to obtain an equivalent-dollar gain by liquidating his or her holding in the MP company (for money or for more liquid shares in the merged company) and perhaps by enabling the owner in question to turn over his or her managerial responsibilities to the merged company.

B. The Sherman-Act-Illicit Ways in Which Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor Can Increase Their Participants' Profits

Conglomerate mergers that do not eliminate an effective potential competitor can increase their participants' profits in all the Sherman-Act-illicit ways that horizontal mergers can do so except by freeing the merger partners from the price (or, more generally, the non-QV-investment) competition they waged against each other pre-merger. Thus, conglomerate mergers can yield their participants' Sherman-Act-illicit profits by increasing the profits the merged firm obtains by securing through contrivance the cooperation of remaining rivals, by erecting retaliation barriers against other rivals' expansions or entries, and by engaging in predation above the sum of the profits the MPs would have obtained over the same time-period in these ways. And conglomerate mergers between an established firm and an effective potential competitor can yield Sherman-Act-illicit profits by reducing the QV-investment competition the established firm faces.

To facilitate my explanation of these contrivance, retaliation-barrier, and predation claims, I will assume (1) that the conglomerate merger in question is being proposed by firms MP1 and MP2, (2) that the firm the merger would create would have an MP1 division and an MP2 division, and (3) that contrived oligopolistic pricing, the creation of retaliation barriers to entry or expansion, and predation were not so unprofitable for each MP pre-merger for any tendency of the merger to increase the profitability of such conduct to leave such conduct still unprofitable for the merged firm post-merger. I focus first on how such a merger can increase the profits that the merged firm can make by engaging in contrived oligopolistic pricing above the profits that MP1 and MP2 could have made by engaging in such pricing. First, even if the MPs do not have a common conglomerate rival—*i.e.*, even if the economy does not contain a conglomerate firm that is requisitely-well-placed to obtain the patronage of at least one buyer each MP is best-placed to supply, their conglomerate merger could increase the profits the merged firm could realize by engaging in contrived oligopolistic pricing in at least the following five ways:

- (1) by enabling the division of the merged firm whose MP-antecedent had a weaker reputation for contrived oligopolistic pricing to take advantage of the other MP's stronger reputation for such contrivance when the merged company will inherit the reputation of the MP with the stronger reputation for contriving;
- (2) by enabling the merged company to take advantage of economies of scale in estimating its HNOPS and NOMs accurately or one division of the merged company to take advantage of the other division's expertise in making such estimates;
- (3) when one MP has personnel that are more skilled at contrivance than are the personnel of the other MP or has developed better contrived-oligopolistic-pricing-related data-collection protocols and delivery/inventory-inspection regimes by enabling the division of the merged company whose MP-antecedent had less-relevantly-skilled personnel and less-cost-effective protocols and regimes to use the other MP's personnel and regimes or obtain training from the other division;

- (4) in individualized-pricing contexts in which pricing is secret and it is therefore more difficult for an undercut firm both to determine whether it has been undercut by a rival that is worse-placed to obtain the patronage of the buyer in question and to identify its undercutter, by enabling the merged company to take advantage of economies of scale in collecting sales-data, observing deliveries, and inspecting inventories; and
- (5) by enabling the merged company to take advantage of company-wide economies of scale (related to the number of customers that the company is best-placed to supply and hence from which it could secure a COM) in building and maintaining a reputation for carrying out contrived-oligopolistic-pricing-related threats and promises.

Second, when the MPs do have a common conglomerate rival, their conglomerate merger may increase the profits the merged firm can realize from contrived oligopolistic pricing in at least the following five additional ways:

- (1) by reducing the mechanical and legal costs the merged firm would have to incur to communicate its contrived oligopolistic intentions to such *Rs* below those the MPs would have to incur to do so by enabling the merged firm to use one communication to each such *R* to convey its intention to practice contrived oligopolistic pricing on the products of both MPs that that *R* was well-placed to steal (instead of the separate communications the MPs would have to make to communicate their respective intentions) and by enabling the merged firm to communicate its contrived oligopolistic intentions simply by charging a contrived oligopolistic price (when the merged firm has a stronger reputation for contrivance and for estimating its [HNOP + NOM]s accurately than one or both of the MPs had);
- (2) in individualized-pricing contexts in which pricing is secret, by increasing the ability of the merged firm to infer from circumstantial sales-evidence whether it has been undercut by an *R* that was worse-placed to secure a relevant buyer's patronage above the ability of the MPs to do so by enabling the merged firm to pool the sales-data of the MPs that relate to customers the relevant *Rs* are well-placed to supply;
- (3) in individualized-pricing contexts in which pricing is secret, by increasing the ability of the merged firm to identify the rival that has undercut it from a position of inferiority by enabling it to pool the information the MPs have about their common *Rs*' relevant competitive positions and dispositions to undercut;
- (4) by enabling the merged company to take advantage of any excess reciprocatory power one MP had in its relations with such a common *R*; and
- (5) by enabling the merged company to "pool the MPs' retaliation power"—*i.e.*, to reduce the loss it must incur to inflict some relevant amount of harm on any such common *R* that undercut it from a position of inferiority by facilitating its engaging in more retaliation (more retaliatory price-cuts, more retaliatory advertising, and conceivably more creations of retaliatory QV investments) through one MP division and less through the other MP division than the separate MPs would have practiced on their own when the harm-inflicted to

loss-incurred ratio for the additional retaliation by the former division is higher than the harm-inflicted to loss-incurred ratio for the foregone retaliation of the latter division.

I hasten to add that conglomerate mergers that (do or) do not eliminate an effective potential competitor may also tend to reduce the profits that the merged firm can make by engaging in contrived oligopolistic pricing in at least two ways:

- (1) by increasing the amount of safe profits the merged firm must put at risk to attempt to contrive an OM (A) by yielding static marginal efficiencies that increase its OCAs directly, (B) in across-the-board-pricing situations, by creating a merged firm that can orchestrate an HNOP-array-raising change in the sequence in which it and its rivals announce their prices, (C) by increasing the NOMs the merged firm can obtain by enabling it to take advantage of economies of scale in changing initially-announced prices and enabling it to orchestrate a series of natural-oligopolistic-pricing-facilitating premature price-announcements, and (D) by increasing the prices its customer-by-customer best-placed rivals charge its customers (in individualized-pricing situations by raising the relevant CMC it and they must incur and, in across-the-board-pricing contexts, by raising the prices it would charge its own customers in the above ways even if its pricing would not affect its rivals' prices and thereby raising the prices its rivals charge their customers and hence its customers as well) and
- (2) by increasing (A) the inclination of antitrust authorities and potential private plaintiffs to pay attention to the merged firm's conduct and prosecute/sue it if it engages in contrivance, (B) the likelihood that on any given evidence a trier-of-fact will find the merged firm guilty of contrived oligopolistic conduct, and (C) the sentences, fines, or damage-awards that will be imposed on or assessed against the merged firm or its managers if it is convicted/found liable.

I also hasten to repeat a point I made in the preceding three chapters: the fact that a particular type of conduct (in this case, contrived oligopolistic pricing) is more profitable for an actor (in this case, for the merged firm relative to the MPs) does not guarantee that the actor will engage in the conduct in question (in this case, contrived oligopolistic pricing): the firm's managers' preference for obeying (desirable) laws may lead them to reject such profit opportunities.

With two exceptions, the preceding ways in which a conglomerate merger that does not eliminate an effective potential competitor can increase the profits the merged firm can realize by engaging in contrived oligopolistic pricing applies *mutatis mutandis* when the issue is the possible tendency of such a conglomerate merger to increase the profits the merged firm can make by erecting retaliation barriers to the entry of an effective potential competitor and/or the QV-investment expansion of an established firm that is an effective potential expander. Thus, conglomerate mergers that do not eliminate an effective potential competitor can also increase the profits the merged firm can make by erecting retaliation barriers above those that the independent MPs could realize by doing so by creating a merged firm that inherits the reputation for retaliating against new investors of the MP with the stronger such reputation, by creating a merged firm that can take advantage of

company-wide economies of scale in building such a reputation, and (when the MPs face common conglomerate *Rs*) by enabling the merged firm to communicate its barrier-erection-relevant intentions in relation to the markets in which both MPs operate in one rather than two communicative acts, to take advantage of any excess reciprocatory power one MP had in its relations with a potential rival investor or co-barrier-erector,¹¹⁰⁴ and to pool the MPs' retaliatory power in relation to any such investor or co-barrier-erector, *etc.* The two exceptions are:

- (1) since the identity/identities of the potential entrant and/or potential expander in question is/are usually known and cannot in any event be inferred from circumstantial sales-evidence, the parts of the contrived-oligopolistic-pricing analysis that relate to the possibility that any such conglomerate merger that was executed in an individualized-pricing context would tend to facilitate the merged firm's (A) determination of whether it has been undercut by a rival that occupied an inferior competitive position and (B) identification of its undercutter have no counterpart in the "erection of retaliation barriers to entry or expansion" analysis, and
- (2) any tendency a conglomerate merger that does not eliminate an effective potential competitor has to increase the amount by which the merged firm's actual price exceeds its overall marginal costs above the amount by which the MPs' actual prices exceeded their overall marginal costs will tend to *increase* the profits the merged firm can make by erecting retaliation barriers to expansion or entry by increasing the amount of profits a new rival QV investment will take away from it whereas, as we saw, the same tendency of a conglomerate merger will tend to *decrease* the profits the merged firm can make by practicing contrived oligopolistic pricing by increasing the safe profits its attempts to engage in such contrivance put at risk.

With the same two exceptions, the analysis of the ways in which a conglomerate merger that does not eliminate an effective potential competitor can increase the profits the merged firm can make by engaging in contrived oligopolistic pricing will apply *mutatis mutandis* when the issue is the possible tendency of such conglomerate mergers to increase the profits the merged firm can realize by driving an established rival out of business (or inducing an established rival to sell out to it at a distressed price after threatening to drive it out).¹¹⁰⁵

¹¹⁰⁴ The text assumes that, in some cases, the merged firm and the MPs might find it profitable to deter an entry or rival QV-investment expansion *inter alia* by rewarding the potential investor for not investing by allowing it to make COM-containing deals the barrier-erector would otherwise have found profitable to prevent.

¹¹⁰⁵ The tendency of a conglomerate merger to enable the merged firm to take advantage of any excess reciprocatory power an MP has in relation to a particular rival could increase its ability to induce a target rival to exit or sell out to the extent that it will increase the merged firm's ability relative to the MPs' to secure this outcome by promising to increase the profits the target's other QV investments yield by allowing the target to secure COMs when selling the products those investments created when neither MP would otherwise have done so. Admittedly, unless the effort to secure the exit of a rival involved a threat to engage in inherently-unprofitable conduct to inflict a loss on the target, it would be inappropriate to label it "predatory." However, the conduct in question would still violate the Sherman Act.

3. The Various Ways in Which Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor Can Decrease and Increase Competition in the Clayton Act Sense and the Appropriate Structure of Trials About the Legality of Such Conglomerate Mergers Under the Clayton Act

A. The Various Ways in Which Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor Can Decrease Competition in the Clayton Act Sense of That Expression

I will first examine the various ways in which such conglomerate mergers that do not generate any purchasing, production, distribution, or finance economic efficiencies can impose a net equivalent-dollar loss on Clayton-Act-relevant buyers by reducing the absolute attractiveness of the best offer they respectively receive from any inferior supplier and then examine the two (unusual) sets of circumstances in which, perversely, the purchasing, production, distribution, or finance economic efficiencies that such a conglomerate merger can generate can impose a net equivalent-dollar loss in this way on Clayton-Act-relevant buyers.

First, in across-the-board-pricing contexts, to the extent that the merged firm is able to orchestrate an HNOP-array-raising sequence of price-announcements that would not otherwise have been made in the order in question, the merger will inflict an equivalent-dollar loss on the customers of the merged firm and its *R*s on this account. Second, to the extent that the cost to the merged firm of changing its initial prices is lower than the cost to the *MP*s of doing so (because the merged firm can take advantage of economies of scale in making such changes), a conglomerate merger that does not eliminate a potential competitor will tend to inflict an equivalent-dollar loss on the Clayton-Act-relevant customers of the merged firm by increasing the *NOM*s they pay—in particular, will do so to the extent that the cost-reduction critically affects the ability of the merged firm to secure *OM*s naturally. Third, to the extent that the merger in question creates a firm that can orchestrate a series of premature price-announcements that would not otherwise have been made and that permit both the merged firm and its rivals to secure *OM*s naturally, it will inflict an equivalent-dollar loss on the customers of both the merged firm and the customers of its rivals on this account. Fourth, to the extent that the merged firm chooses to take advantage of the merger-generated increase in its opportunity (see Sect. 2A(2)) to profit by contriving *OM*s, erecting retaliation barriers to new entry or established-rival expansions, or engaging in predation, the merger will tend to inflict equivalent-dollar losses on both the merged firm's customers and the customers of its rivals on those accounts as well. Fifth, to the extent that the merged firm faces one or more conglomerate *R*s that compete against both the *MP1* and *MP2* division of the merged firm, the merger will inflict an equivalent-dollar loss on the customers of such conglomerate *R*s by increasing the *COM*s those *R*s obtain from them if the *R*s in question choose to take advantage of

the tendency of the merger to increase the profits they can make by contriving OMs (1) by reducing the cost to them of communicating their contrivance intentions to the merged firm relative to the cost they had to incur to do so separately to each MP, (2) by enabling the *Rs* to take advantage of any excess reciprocatory power they had in relation to one MP, (3) by spreading the merged firm's defenses—*i.e.*, by reducing the loss the *Rs* have to incur to inflict some relevant amount of harm on the merged firm below the loss they had to incur to inflict the same total amount of harm in appropriate proportions on the two MPs separately by enabling the *Rs* to inflict the requisite total amount of harm on the merged firm by inflicting more harm on the MP1 division of the merged firm than they had to inflict on MP1 pre-merger and less harm on the MP2 division of the merged firm than they had to inflict on MP2 pre-merger (or *vice versa*) when the harm-inflicted to loss-incurred ratio for the additional harm inflicted on the MP1 division was higher than its counterpart for the foregone retaliation on the MP2 division, and (4) by increasing the harm-inflicted to loss-incurred ratio for retaliating against the merged firm by stealing one of the merged firm's customers below its counterpart for retaliating against the relevant MP by stealing the same customer from the MP pre-merger by increasing the NOM and COM components of the merged firm's price to that buyer above their counterparts for the relevant MP. Sixth, to the extent that such a merger increases the prices the merged firm and its *Rs* charge their own respective customers in one or more of the preceding five ways, it will increase the prices the *Rs* and the merged firm secure from their customers indirectly: in individualized-pricing contexts, because the higher prices the merged firm charges its own customers (the *Rs* charge their own customers) will increase the CMC it (they) have to incur to match any offer the *Rs* (the merged firm) charge their (its) customers, and, in across-the-board-pricing contexts, because the fact that the merged firm (*Rs*) will be charging the *Rs*' (merged firm's) customers the same price it is (they are) charging its (their) own customers means that the merged firm (the *Rs*) can piggyback ride on the higher prices the *Rs* (the merged firm) is charging, and so on and so forth. Seventh, conglomerate mergers that generate static marginal efficiencies that (1) would increase the merged firm's BCAs above the BCAs a best-placed MP enjoys in its relations with buyers it is best-placed to supply and/or (2) would give the merged firm a BCA in relation to a buyer that no MP is best-placed to supply that exceeds the BCA that the *R* that is best-placed to supply that buyer pre-merger enjoys in its relations with the buyer in question may inflict an equivalent-dollar loss on the relevant buyers by increasing the NOMs they pay (by more than any amount by which the static marginal efficiencies reduce the COMs they must pay by increasing the amount of safe profits the merged firm must put at risk to attempt to contrive an OM [though this effect may be outweighed by the possible tendency of the efficiencies in question to increase the merged firm's ability to reciprocate to competing rivals and to retaliate cost-effectively against undercutters]). Eighth, conglomerate mergers that do not eliminate an effective potential competitor can also inflict an equivalent-dollar loss on the customers of the merged firm and its *Rs*

by deterring the merged firm from making a QV-investment expansion that no-one else will replace either at all or with a project that is as beneficial to Clayton-Act-relevant buyers by critically raising (1) the $(\Pi_D + R)$ barriers the merged firm would face above those that face an effective-potential-expander MP pre-merger (by making it profitable for the merged firm to allocate to consolidation resources the MP would have devoted to expanding) and/or (2) the retaliation barriers the merged firm would face above the L barriers the relevant MP faces by enabling the merged firm to obtain higher prices from the MPs' customers and by spreading the merged firm's defenses—*i.e.*, by enabling a conglomerate *R* that competes against both MP1 and MP2 to retaliate against the merged firm's execution of an expansion that one of the MPs would otherwise have executed on its own by retaliating against both divisions of the merged firm (and conceivably, by enabling individual *R*s that compete against either MP1 or MP2 but not against both to make more cost-effective "cross-market" joint-retaliation arrangements). Ninth, perversely, rarely, and I suspect practically irrelevantly, a conglomerate merger that does not eliminate an effective potential competitor can also inflict an equivalent-dollar loss on Clayton-Act-relevant buyers by generating dynamic efficiencies that convert a situation in which an *R* of the MPs would otherwise execute a QV-investment expansion even though it would face a monopolistic QV-investment disincentive to make the investment in question into a situation in which the merged firm and that *R* would confront each other with critical natural oligopolistic QV-investment disincentives. Tenth, finally, perversely, rarely, but I suspect occasionally possibly relevantly, such a conglomerate merger can inflict an equivalent-dollar loss on Clayton-Act-relevant buyers if the static efficiencies it generates leads enough of these *R*s to exit (by improving the merged firm's competitive-position arrays and concomitantly making the MPs' *R*s' competitive-position arrays worse) to produce this effect.

Now that I have explained the various ways in which a conglomerate merger that does not eliminate an effective potential competitor can inflict equivalent-dollar losses on Clayton-Act-relevant buyers, I want to repeat two points I made in the horizontal-merger context about the Clayton Act relevance of some of these possibilities. First, if as I argued in Chap. 4 it is correct as a matter of law to read an organizational-economic-efficiency defense into the Clayton Act, a conglomerate merger that would not inflict a net equivalent-dollar loss on Clayton-Act-relevant buyers if it did not lead one or more *R*s of the merged firm to exit by worsening their competitive-position arrays by improving the merged firm's competitive-position array by generating organizational efficiencies that are allocative as well as private will not violate the Clayton Act (though the burden of proving the elements of this defense will fall on the defendants). Second, if contrary to my own conclusion it is incorrect as a matter of law to hold against a conglomerate merger any tendency it has to inflict an equivalent-dollar loss on Clayton-Act-relevant buyers by inducing the merged firm and/or its *R*s to engage in illegal oligopolistic or predatory conduct post-merger, these possible effects of such mergers will be irrelevant to their legality under

the Clayton Act. (As I indicated in Chap. 12, I do not think it legally incorrect to consider the tendency of mergers to induce subsequent illegal conduct that is difficult to detect, prove, and deter when assessing their Clayton Act legality, though, of course, I agree that defendants must be given the opportunity to rebut any claim that they will take advantage of any opportunity their merger will give them to make additional profits by committing illegal acts that will harm Clayton-Act-relevant buyers by putting on evidence of their past conduct or current intentions and/or evidence that suggests that it will be easy for the authorities or a potential private plaintiff to detect and prove any such illegal conduct the merged firm might engage in.)

Conglomerate mergers that do not eliminate an effective potential competitor can generate both static and dynamic efficiencies. Thus, since the production of goods that are non-rivalrous can “consume” identical inputs that share certain production steps, conglomerate mergers can enable their participants to take advantage of purchasing and production economies of scale; since given distributors often resell non-rivalrous products and the separate resellers of non-rivalrous products often are located conveniently near to each other, conglomerate mergers can enable their participants to take advantage of distribution economies of scale; since readers and viewers of given media often are interested in purchasing various non-rivalrous products, conglomerate mergers can enable their participants to take advantage of promotional economies of scale; since there are some economies of scale and scope in both product R&D and production-process R&D, conglomerate mergers can enable their participants to execute both these types of research more proficiently; and since it is possible to finance more than one non-rivalrous operation at one time and one can sometimes reduce risk costs by developing an appropriate portfolio of QV-investment projects, conglomerate mergers can also enable their participants to take advantage of finance economies of scale and to reduce risk costs by creating a risk-cost-reducing portfolio of projects. Conglomerate mergers can also generate allocative efficiencies for non-scale (or scope) reasons by enabling their participants to combine assets that are complementary for non-scale non-risk-related reasons—*e.g.*, by combining one firm with excess production-management personnel and insufficient distribution-management personnel with another firm with a production-management-personnel shortage and a distribution-management-personnel glut.

Although, as Sect. 3A stated, both the static and the dynamic efficiencies that a conglomerate merger generates can in some circumstances inflict an equivalent-dollar loss on Clayton-Act-relevant buyers, I am confident that in the overwhelming majority of situations such efficiencies will confer an equivalent-dollar gain on such buyers. The analysis of the impact of such efficiencies on such buyers in the normal case in which they benefit them is the same as the counterpart analysis of the impact of the efficiencies that a horizontal merger can generate.

I start with the static efficiencies. To save space and simplify the exposition, I will assume that

- (1) the MPs, the merged firm, and their R s all set individualized prices,
- (2) the static efficiencies in question are marginal-cost reductions,
- (3) each relevant buyer will buy one unit of the relevant product regardless of whether the merger is executed,
- (4) the magnitude of the static efficiency in question equals the marginal-cost reduction that the relevant conglomerate merger will generate, and
- (5) unless otherwise specified, the static efficiencies in question will not cause any rival of the merged firm to exit or affect the NOMs or COMs any relevant buyer pays for any other reason.

On these assumptions, the equivalent-dollar impact of the static efficiencies a conglomerate merger generates on any given buyer will depend not only on the magnitude of the relevant static efficiencies but on the competitive position of the better-placed MP in relation to that buyer:

- (1) when the better-placed MP is best-placed in relation to a buyer, the static efficiency will not directly affect that buyer (though it may inflict a loss on the buyer by enabling the merged firm to obtain an OM naturally or confer a benefit on the buyer by deterring the merged firm from attempting to contrive an OM);
- (2) when the better-placed MP is second-placed pre-merger, the static efficiency will benefit the buyer in question: the equivalent-dollar gain will equal the smaller of the static efficiency and the original OCD of the better-placed MP;
- (3) when the better-placed MP is worse-than-second-placed by an amount that is smaller than the static efficiency, the static efficiency will benefit the relevant buyer: the equivalent-dollar gain will equal the smaller of the original best-placed supplier's OCA and the positive difference between the static efficiency and the amount by which the better-placed MP is worse-than-second-placed; and
- (4) when the better-placed MP is worse-than-second-placed by an amount that exceeds the static efficiency that is generated, there will be no effect on the buyer in question unless the improvement in the position of the merged firm reduces the OMs the buyer's best-placed supplier attempts to contrive by making it inherently profitable for the merged firm to beat a contrived oligopolistic offer that the relevant best-placed firm would otherwise have made.

I turn now to the dynamic efficiencies that a conglomerate merger can generate for one or more of the reasons that such mergers can generate static efficiencies. In the normal case, any such reductions in the $(\Pi_D + R)$ barriers to expansion the merged firm faces will—if anything—confer an equivalent-dollar gain on Clayton-Act-relevant buyers. In particular, to the extent that such efficiencies would make it profitable for the merged firm to make a QV investment if no rival made a limit QV investment to deter it from doing so when it would not be profitable for any MP to expand and would otherwise also not be profitable for any potential competitor or other established firm to add to total QV investment in the relevant area of

product-space, the dynamic efficiencies would benefit relevant buyers either by inducing the merged firm to make such an investment or by inducing an *R* to make a limit QV investment to deter the merged firm from doing so.

B. The Appropriate Structure of Trials About the Clayton Act Legality of Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor

We have just seen that, like horizontal mergers, a conglomerate merger that does not eliminate an effective potential competitor will tend to decrease competition in the Clayton Act sense if they generate no static or dynamic efficiencies but will not decrease such competition on balance if (1) it generates static and/or dynamic efficiencies and (2) those efficiencies confer sufficient equivalent-dollar gains on Clayton-Act-relevant buyers to fully offset the net equivalent-dollar loss the merger would impose on the relevant buyers if it did not generate any such efficiencies. I suspect that conglomerate mergers that do not eliminate an effective potential competitor are less likely to violate the Clayton Act than are horizontal mergers: any tendency of conglomerate mergers to yield buyers lower efficiency-related equivalent-dollar gains than horizontal mergers yield is likely to be outweighed by the fact that, unlike horizontal mergers, conglomerate mergers that do not eliminate an effective potential competitor do not inflict equivalent-dollar losses on Clayton-Act-relevant buyers by freeing the MPs from each other's non-QV-investment competition. However, I do not think that this difference affects the appropriate structure of trials about the Clayton Act legality of such conglomerate mergers.

In my judgment, the appropriate structure for trials about the Clayton Act legality of conglomerate mergers that do not eliminate an effective potential competitor is the same as the appropriate structure for trials about the legality of such mergers under the Sherman Act. First, the government should be required to establish a *prima facie* case against the legality of a proposed merger of the relevant type by providing evidence that (1) one of the MPs had orchestrated premature price-announcements in the areas of product-space in which it operated and that natural oligopolistic pricing was not currently being practiced in the other MP's "markets," (2) one of the MPs had orchestrated an HNOP-array-increasing sequence of mature price-announcements in across-the-board-pricing markets in which it operated and that the other MP operated in an across-the-board-pricing "market" in which the sequencing of mature price-announcements was suboptimal from the sellers' perspective, (3) one MP had a stronger reputation for contrivance and/or predation than the other and that the merged company was likely to inherit that MP's reputation, and/or the fact that the merged firm would be best-placed or second-placed to supply

more buyers than either MP would have been would critically increase the profitability to the merged firm of building and maintaining a reputation for engaging in strategic conduct (4) the merged firm would face conglomerate rivals that competed against both MPs, and/or (5) the MPs and their Rs had engaged in contrived oligopolistic pricing in the past. (If the merger in question has already been consummated, the government can establish its *prima facie* case not only by introducing a requisite amount of evidence on these matters but also by putting on evidence about post-merger contrivance and predation, post-merger increases in prices, and post-merger rejections of expansion and entry plans.) Second, once the government has made out its *prima facie* case, the defendants should be permitted to defeat the government's case by rebutting the government's evidence, explaining that any post-merger rival exits (and related price-increases and/or QV-investment decreases) that the government had documented resulted from the organizational allocative efficiencies the merger generated, and/or establishing the requisite probability that the merger would (or did) benefit Clayton-Act-relevant buyers sufficiently by generating static and dynamic efficiencies to leave them no worse-off in equivalent-dollar terms. Third, the government should be permitted to rebut the defendants' evidence, and fourth and finally, the defendants should be permitted to rebut the government's rebuttal evidence.

4. The U.S. Case-Law and DOJ/FTC Positions on the Economic Consequences and Antitrust Legality of Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor

A. Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor, Will Not Induce the Merged Firm to Engage in Additional Reciprocity or Execute Additional Tie-Ins, and Do Not Enable One MP to Achieve Sought-After Geographic Diversification

I have argued that conglomerate mergers in this category can reduce competition (1) by increasing the COMs the merged firm will obtain relative to the COMs the MPs would have secured and by increasing the COMs the merged firm's rivals obtain, (2) by increasing the amount of predatory conduct in which the merged firm will engage above the amount in which the MPs would have engaged, (3) by increasing the retaliation barriers the merged firm will erect against its established rivals' and potential competitors' making QV investments above the L barriers the MPs would have erected, (4) by increasing the retaliation barrier to expansion the merged firm will face above the L barriers the MPs would have faced, and (5) by increasing the $(\Pi_D + R)$ barriers to expansion the merged firm will face above those the MPs

would have faced. Neither the U.S. courts nor the U.S. antitrust-enforcement agencies have ever adverted to any of the last three of these possibilities. In the late 1960s, both the FTC¹¹⁰⁶ and the Justice Department¹¹⁰⁷ believed that conglomerate mergers could facilitate and encourage price-fixing (though they were unable to explain how such mergers would do so). However, the courts were not always so willing to accept this contention. Admittedly, in *Procter & Gamble (Clorox)*,¹¹⁰⁸ the Supreme Court accepted the proposition that, in the Court's words, "the substitution of the powerful acquiring firm [Procter & Gamble] for the smaller, but already dominant, firm [Clorox]. . . may substantially reduce [competition]. . . by dissuading the smaller firms from aggressively competing...." However, it is not clear whether the desired "aggressive competition" was a refusal to cooperate with contrivance or the execution of more positive competitive moves. And, in at least one case, the courts did not seem to grasp the contrived-oligopolistic-pricing argument even when it was presented to them—in particular, interpreted a government contention that "the most important anticompetitive effect of the trend toward conglomeration by merger is 'conglomerate interdependence and forbearance'" to be a social and political argument for preventing the concentration of society's resources across the economy as a whole rather than as an argument for preventing decreases in competition.¹¹⁰⁹ By way of contrast, not only the DOJ but also the courts in the 1960s did seem to believe that conglomerate mergers could lead to predation. Once more, however, the Agencies' and courts' understanding of how conglomerate mergers could increase the profitability of predation was limited—viz., focused on the possibility that a conglomerate merger could create a merged firm that engaged in predation in which neither MP would have engaged on its own because the merged firm could have a larger pool of capital to use to finance a predation campaign¹¹¹⁰ and ignored the possibility that the conglomerate merger could also encourage predation by creating a merged company that had a stronger related reputation for engaging in such conduct than did either or both MPs, by creating a merged company that could pool the MPs' retaliatory and reciprocatory power (particularly when the MPs faced common conglomerate rivals), by creating a merged company that was best-placed and second-placed more often than either MP was and could on that account profit more by building and maintaining a reputation for engaging in strategic conduct, and by generating static efficiencies that increased the cost-effectiveness of the merged company's predatory moves.

¹¹⁰⁶ See FTC Staff, *An Economic Report on Corporate Mergers* at 458–71 (1969), reprinted in *Antitrust and Monopoly Subcommittee, Senate Judiciary Committee, 91st Cong., 1st Sess., Hearings on Economic Concentration*, pt. 8-A (1969).

¹¹⁰⁷ See the Justice Department argument in *United States v. International Tel. and Tel. Corp.*, 324 F. Supp. 19 (D. Conn., 1970).

¹¹⁰⁸ *Federal Trade Commission v. Procter & Gamble Co. (Clorox)*, 386 U.S. 568, 578 (1967).

¹¹⁰⁹ *United States v. International Tel. and Tel. Corp.*, 324 F. Supp. 19, 53 (D. Conn. 1970).

¹¹¹⁰ *United States v. Aluminum Co. of Am. (Cupples)*, 233 F. Supp. 718 (E.D. Mo. 1964), *aff'd per curiam*, 382 U.S. 12 (1965), and 233 F. Supp. 718 (E.D. Mo. 1964), *aff'd per curiam*, 382 U.S. 12 (1965) and *Reynolds Metal Co. v. FTC*, 309 F.2d 223 (D.C. Cir. 1962).

B. Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor and Do Not Enable One MP to Achieve Sought-After Geographic Diversification but Do Create a Merged Firm That Will Enter Into More Tying and Reciprocity Agreements Than the MPs Would Have Done

Conventionally, tie-ins are defined to be agreements in which a seller either (1) conditions its willingness to supply one product on stated terms on the buyer's agreeing to purchase one or more other products on stated terms or (2) agrees to supply a buyer with a package of products for a stated total price. In fact, tie-ins can also be arranged by a buyer that either (1) conditions its agreement to buy one product on stated terms on the seller's agreement to supply it with another product on stated terms or (2) agrees to purchase a package of products from a given seller for a stated total price. Conventionally, reciprocity agreements are defined to be agreements in which a buyer conditions its agreement to purchase a product from a given seller on stated terms on that seller's agreeing to purchase a product from the buyer on stated terms. Once more, however, in some situations it will be more accurate to say that reciprocity involves a seller's conditioning its agreement to supply a buyer with a product on stated terms on the buyer's agreeing to supply the seller with another product on stated terms. As Chap. 14 explains, for close to 100 years, U.S. courts and antitrust-enforcement agencies assumed that the exclusive or inevitable function of tie-ins is to enable a seller that has market power in the sale of one of the goods the tie-in involves (the so-called tying product) to use that power to lever itself into a position of market power in the sale of the second (so-called tied) product. Since reciprocity agreements perform the same functions as tying agreements, one should expect that those that subscribe to this leverage theory of tie-ins would also believe that the exclusive or inevitable function of reciprocity is to enable an actor that has market power when *buying* one good to use that power to lever itself into a position of market power when *selling* the other good. One would also expect decisionmakers that believe in the leverage theory of tie-ins and reciprocity to conclude that any tendency of a conglomerate merger to increase the extent to which the merged firm employs tie-ins and practices reciprocity (because enforcement of the alleged prohibition of such agreements was imperfect) should count against its legality. It is therefore not surprising that, at a time at which U.S. officials believed in the leverage theory of tie-ins and reciprocity (1965), the U.S. Supreme Court in *Consolidated Foods* held that an acquisition that is conventionally deemed to be conglomerate but might better be classified as vertical violated the Clayton Act because (1) the acquiring firm purchased a large share of the final products (processed foods of various types) for whose production the acquired firm's products (dehydrated onion and garlic) was an input and (2) the merger put the merged firm in a position to condition its purchase of those final products on their producers' purchasing the acquired firm's products.¹¹¹¹ However, although this case

¹¹¹¹ See Federal Trade Commission v. Consolidated Foods Corp., 380 U.S. 592 (1965).

has never been overruled, I am confident that the DOJ and FTC will no longer attack conglomerate mergers on the ground that they will lead the merged firm to employ more tie-ins and reciprocity agreements than the MPs would have done and suspect that the Supreme Court would either overrule or work its way around *Consolidated Foods* if it were presented with a case to which that precedent applied.

I base those conclusions on the following “facts” that Chap. 14 discusses in more detail:

- (1) neither the leverage theory of tie-ins and reciprocity nor the legal conclusions it would warrant can bear scrutiny:
 - (A) there is a generation gap in the leverage theory—although in a wide variety of circumstances and in a wide variety of ways tie-ins and reciprocity agreements can increase their employer’s profits, they cannot “generate leverage” in the sense of that expression that is relevant to Sherman Act and Clayton Act legal analysis;
 - (B) most of the functions of tie-ins and reciprocity are Sherman-Act-licit, and most tying and reciprocity agreements perform only Sherman-Act-licit functions;
 - (C) many of the minority of such agreements that perform the illegitimate function of concealing the existence or extent of independently-illegal behavior conceal tax and contract frauds and price-regulation violations rather than antitrust violations;
 - (D) the fact that a tie-in or reciprocity agreement has been used to conceal an independent antitrust violation is irrelevant to the illegal status of the underlying violation (though in some instances it may make the perpetrator’s conduct a violation of the Clayton Act as well as the Sherman Act when it otherwise would have been only a Sherman Act violation);
 - (E) if the Clayton Act is correctly interpreted to make the legality of a firm’s use of tying and reciprocity agreements depend on the consequence of a rule allowing it and its rivals to use such agreements, the use of tie-ins and reciprocity agreements to perform Sherman-Act-licit functions will rarely inflict a net equivalent-dollar loss on Clayton-Act-relevant buyers by reducing the absolute attractiveness of the best offer they respectively receive from any inferior supplier and, in some of the few instances in which the general availability of such agreements does impose such a loss on such buyers in this way, the perpetrators will be able to make out an organizational-economic-efficiency defense for their conduct;
- (2) in conversations with me, economists at the DOJ have made it clear that they recognize the truth of all or virtually all of the preceding claims;
- (3) the DOJ’s 1984 Vertical Merger Guidelines come close to abandoning the foreclosure theory of vertical mergers, which is related to the leverage

theory of tie-ins and reciprocity; since 1984, the DOJ has not challenged a single vertical merger; and between 1996 and 2003, the FTC issued second requests (for additional information) in response to only 12 vertical-merger proposals¹¹¹²;

- (4) despite the fact that *Consolidated Foods* had not been reversed, the DOJ's 1984 Conglomerate Merger Guidelines made no reference to the possibility that a conglomerate merger might be rendered illegal by its tendency to cause the merged firm to engage in more reciprocity or enter into more tying agreements than the MPs would have done;
- (5) in 1993, without explanation, the DOJ rescinded its 1985 Vertical Restraints Guidelines, which while acknowledging the fact that tie-ins can perform some legitimate functions state incorrectly that (even when the tying seller does not have dominant power in the tying-product market) tie-ins that require the buyer to enter into a full-requirements contract on the tied product can endanger competition in the tied-product market;
- (6) in recent years, the DOJ has virtually stopped bringing suits against firms for
 - (A) employing tie-ins or engaging in reciprocal dealing or
 - (B) for including vertical territorial restraints, customer-allocation clauses, or resale-price-maintenance terms in their contracts with their distributors—a fact that is relevant because the argument for the illegality of such practices has many of the same deficiencies as the leverage theory of tie-ins and reciprocity;
- (7) more specifically, in 2000, the DOJ decided not to challenge a proposed merger between GE and Honeywell that the EC believed would reduce competition by putting the merged company into a position to engage in reciprocity by refusing to buy airplanes that did not include Honeywell equipment¹¹¹³;
- (8) although the Supreme Court has not yet disavowed the leverage theory of tie-ins—indeed, has relied on it in some recent cases, in other cases the Court has upheld the legality of tie-ins in circumstances in which the leverage theory implies they should be deemed illegal simply by refusing to acknowledge that the business conduct in question involved the use of the tie-ins¹¹¹⁴; and
- (9) the Supreme Court has recently held that the legality of (A) vertical territorial restraints and customer-allocation clauses¹¹¹⁵ and (B) the vertical fixing of

¹¹¹² See FTC, Horizontal Merger Investigation Data: Fiscal Years 1996–2003 at Table 1 (2004).

¹¹¹³ For an official explanation that admittedly focuses more on the facts of the case than on the deficiencies of the leverage theory of reciprocity, see William J. Kolasky, Deputy Assistant Attorney General, U.S. DOJ, *Conglomerate Mergers and Range Effects: It's a Long Way From Chicago to Brussels* (2001).

¹¹¹⁴ See *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1 (1979).

¹¹¹⁵ See *Continental T.V., Inc. v. GTE Sylvania, Inc.* 433 U.S. 36 (1997).

maximum and minimum resale prices¹¹¹⁶ should be determined on a case-by-case basis through the application of a Rule of Reason analysis.

I should add, however, that (for reasons that Sect. 7 of this chapter and Subject. 3B(2) of Chap. 14 will explain) although the EC and the E.C./E.U. courts have come to a better understanding of the functions and consequences of tie-ins and reciprocity, it is still uncertain whether they would count any tendency of a conglomerate merger to create a merged firm that would participate in more tying and reciprocity agreements than the MPs would have done against the legality of the merger in question.

C. Conglomerate Mergers That Do Not Eliminate an Effective Potential Competitor and Do Not Create a Merged Firm That Will Enter Into More Tying and Reciprocity Agreements Than the MPs Would Have Done but Will Enable One MP to Achieve Sought-After Geographic Diversification: The “Toe-Hold Merger” Doctrine

Since 1970, both the U.S. antitrust-enforcement agencies and the U.S. courts have been developing and applying a special, somewhat-unclearly-specified, so-called “toe-hold merger” doctrine to prevent firms K that are seeking to achieve geographic diversification from achieving this goal by merging with or acquiring another established firm E that sells a product that is intrinsically rivalrous with the K-firm’s product in a different geographic market when, in their view, the merger or acquisition in question would violate the Clayton Act. According to the version of this doctrine that I think one should read the U.S. courts and antitrust-enforcement agencies to have developed,¹¹¹⁷ in order for such a merger to pass Clayton Act scrutiny, the firm K must demonstrate both (1) that it would not enter E’s market independently if it were prohibited from entering it through merger or acquisition and (2) that either (A) the E it merged with or acquired was a relatively-small firm (E_S)—*i.e.*, was small relative to the other firms in its market—or (B) if the K was proposing to merge with or acquire a relatively-large E-firm (E_L), it had made

¹¹¹⁶ *State Oil Co. v. Khan*, 522 U.S. 3 (1997) reached this conclusion about the vertical fixing of maximum resale prices, and *Leegin Creative Leather Products v. PSKS, Inc.*, 555 U.S. 877 (2007) reached this conclusion about the vertical fixing of minimum resale prices.

¹¹¹⁷ I find this reading of the doctrine appropriate because it brings it into line with the failing-company doctrine that the U.S. courts announced in *Citizen Pub. Co. v. United States*, 394 U.S. 131 (1969)—*i.e.*, at about the same time that the FTC first relied on the “toe-hold merger” doctrine in *Bendix Corp.* 77 F.T.C. 731 (1976), vacated on procedural grounds, 450 F.2d 534 (6th Cir. 1971), consent order, 84 F.T.C. 1291 (1974)—and that the DOJ and FTC adopted in their 1992 Horizontal Merger Guidelines, the 1997 Revision of those Guidelines, and the 2010 Horizontal Merger Guidelines.

reasonable efforts to identify a relatively-small firm in that market whose “acquisition” would be more profitable than not entering that market through merger or acquisition at all and failed to identify an E_S that would satisfy this criterion.¹¹¹⁸ I have described the “toe-hold merger” doctrine as a “special” doctrine because it implies *inter alia* that (1) $K-E_S$ or $K-E_L$ geographic-diversification conglomerate mergers that would not decrease the intensity of competition in the E-firm’s market below the level it would have if the K-firm did nothing to enter the E-firm’s market or would increase the intensity of competition in the E-firm’s market above what it would be if the K-firm did nothing to enter that market will violate the Clayton Act if the prohibition of the merger in question would lead the K-firm to enter the E-firm’s market independently and (2) $K-E_L$ geographic-diversification conglomerate mergers that would not decrease the intensity of competition in the E-firm’s market below the level it would have if the K-firm did nothing to enter the E-firm’s market or would increase the intensity of competition in the E-firm’s market above what it would be if the K-firm did nothing to enter that market will violate the Clayton Act if the prohibition of the K-firm’s executing a merger with a relatively-large firm E_L in the E-firm’s market would make it profitable for the K-firm to execute a merger with a relatively-small firm E_S in the E-firm’s market. (I should add that, although the “toe-hold merger” doctrine has been applied only in geographic-diversification conglomerate-merger cases [and the text that follows will assume that it applies only to such mergers], if valid it would be equally applicable to product-diversification conglomerate-merger cases.)

I should admit at the outset that the positive-law status of the “toe-hold merger” doctrine is somewhat uncertain. As already noted, a version of it was first used by the FTC in 1970 in a case in which the Commission found a geographic-diversification conglomerate acquisition of a relative-large E-firm (an E_L) in a concentrated market unlawful on the ground that the K-firm would have entered the firm’s market by acquiring an E_S firm had it not merged with the E_L firm in question.¹¹¹⁹ Since that time, the FTC has accepted the doctrine in cases that hold geographic-diversification conglomerate mergers lawful on the ground that the E-firm was an E_S firm or unlawful on the ground that the E-firm was an E_L firm,¹¹²⁰ and the DOJ implicitly accepted the doctrine in its 1984 Conglomerate Merger Guidelines.¹¹²¹ Moreover, several Court of Appeals opinions have

¹¹¹⁸ The alternative versions of the “toe-hold merger” doctrine that the U.S. courts and antitrust-enforcement agencies may have in mind would respectively (1) establish an irrebuttable presumption that $K-E_L$ geographic-diversification conglomerate mergers violate the Clayton Act or (2) empower the government to establish the illegality of a $K-E_L$ geographic-diversification conglomerate merger by demonstrating that the K-firm would have found either independent entry or some $K-E_L$ merger more profitable than not diversifying into the E market at all.

¹¹¹⁹ See *Bendix Corp.*, 77 F.T.C. 731 (1970).

¹¹²⁰ See, e.g., *SKF Indus.*, 1979 Trade Reg. Rep. ¶21595 at 21724 (FTC) and *Budd Co.*, 86 F.T.C. 518, 582–83 (1975).

¹¹²¹ See United States Justice Department 1984 Conglomerate Merger Guidelines, 2 Trade Reg. Rep. ¶¶ 14490–4495 (1984).

expressed sympathy for the doctrine,¹¹²² and a number of lower-court opinions have implicitly relied on it.¹¹²³ The positive-law status of the “toe-hold merger” doctrine is uncertain despite all this because the Supreme Court has never ruled on the doctrine—indeed, has in *Falstaff Brewing* expressly reserved the question of its correctness.¹¹²⁴

However, given the empirical importance of geographic-diversification conglomerate mergers, the doctrine is potentially sufficiently significant to merit detailed consideration. In my judgment, all variants of the “toe-hold merger” doctrine are unjustified and/or incorrect for two economic reasons (which relate primarily to its “privileging” K-E_S mergers over K-E_L mergers) and one legal reason (which relates equally to its “privileging” independent entry over merging and its “privileging” K-E_S mergers over K-E_L mergers). I will now discuss these three objections to the doctrine in turn.

(1) The Doctrine’s Economic Assumption That the Less-Profitable K-E_S Merger That a Firm Seeking Geographic Diversification Will Find More Profitable Than No Merger Will Be More Procompetitive Than the More-Profitable K-E_L Merger the Firm Would Prefer So That, if the Doctrine Always Leads K-Firms to Substitute the Less-Profitable K-E_S Merger for the More-Profitable K-E_L Mergers, It Will Increase Competition on That Account

The first economic reason that the “toe-hold merger” doctrine is wrong relates to its premise that—if the doctrine succeeds in inducing K-firms to substitute less-profitable K-E_S mergers for the more-profitable K-E_L mergers they would have preferred to execute—it will always or at least across all cases tend to increase competition on that account. This premise is based on two, more-basic assumptions both of which I think are clearly unjustified and probably incorrect:

- (1) from the perspective of the goal of increasing competition or preventing decreases in competition, there is a bias in favor of Ks’ finding K-E_L mergers more profitable than K-E_S mergers—*i.e.*, if $P\pi$ stands for the private profits yielded by any merger, $\uparrow C$ stands for the increase in competition the relevant merger generates, and the parentheticals (K-E_L) and (K-E_S) indicate the type of merger in question, the relevant bias will be present to the extent that $P\pi(K-E_L) - P\pi(K-E_S) > \uparrow C(K-E_L) - \uparrow C(K-E_S)$, and
- (2) this bias must be sufficiently large relative to the $P\pi$ difference in question for the K-E_L mergers that would be executed in the absence of a “toe-hold merger” doctrine (because they were the most-profitable conglomerate mergers the

¹¹²² See *Bendix Corp.*, 450 F.2d 534, 541–42 (6th Cir. 1971) and *Kennecott Copper Corp. v. FTC*, 467 F.2d 67, 79 (10th Cir. 1972), cert. denied, 416 U.S. 909 (1974).

¹¹²³ See, *e.g.*, *Washington Mt. Sav. Bank v. Federal Dep. Ins. Corp.*, 347 F. Supp. 790, 798–800 (W.D. Wash. 1972), aff’d, 482 F.2d 459 (9th Cir. 1973) and *United States v. Phillips Petro. Co.*, 367 F. Supp. 1226, 1258 (C.D. Cal. 1973), aff’d mem. 418 U.S. 906 (1974).

¹¹²⁴ See *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 537 (1973).

parties identified) to be less procompetitive on balance than the K-E_S mergers we are currently assuming would be substituted for them if the “toe-hold merger” doctrine were applied.

Mathematically, the profit bias just defined (hereinafter “ πB ”) will be critical wherever $\uparrow C(K-E_S) > \uparrow C(K-E_L)$ despite the fact that $P\pi(K-E_L) > P\pi(K-E_S)$, which will occur whenever the bias— $(P\pi[K-E_L] - P\pi[K-E_S]) - (\uparrow C[K-E_L] - \uparrow C[K-E_S])$ —exceeds the amount by which the K-E_L merger was more profitable than the K-E_S merger: $P\pi(K-E_L) - P\pi(K-E_S)$. The amount by which the K-E_L merger whose profitability was actually biased (from the perspective of the goal of increasing competition) would have increased competition by less than the K-E_S merger we are assuming would be substituted for it if the “toe-hold merger” doctrine were applied would be the bias just defined *minus* $(P\pi[K-E_L] - P\pi[K-E_S])$. And if we let (1) “#” stand for the number of cases in which the K-E_L merger would be more profitable than the K-E_S merger, (2) “ $\%(*\pi B)$ ” stand for the percentage of the relevant K-E_L mergers for which there was a critical profit-bias in favor of the K-E_L merger from the perspective of the goal of increasing competition, (3) “ $(1 - \%[*\pi B])$ ” stand for the percentage of such mergers for which there was no such critical profit-bias, (4) “ $\text{ave}(\uparrow C[K-E_L] - \uparrow C[K-E_S])_{N*\pi B}$ ” stand for the average amount by which the K-E_L mergers were more procompetitive than the K-E_S mergers that we are now assuming the “toe-hold merger” doctrine would cause to be substituted for them in those cases in which there was “no critical profit-bias”— $N*\pi B$, and (5) “ $\text{ave}(\pi B - [P\pi(K-E_L) - P\pi(K-E_S)]_{*\pi B})$ ” stand for the average amount by which the K-E_L mergers would be less procompetitive than the K-E_S mergers we are now assuming the “toe-hold merger” doctrine would cause to be substituted for them in those cases in which there was a critical profit bias— $*\pi B$, the K-E_S mergers we are now assuming the “toe-hold merger” doctrine will cause to be substituted for all the more-profitable K-E_L mergers that would be executed by their potential participants in its absence only if

$$\begin{aligned} & \#(1 - \%[*\pi B])(\text{ave}[\uparrow C(K-E_L) - \uparrow C(K-E_S)]_{N*\pi B}) < \\ & \#(\%[*\pi B])(\text{ave}[\pi B - (P\pi[K-E_L] - P\pi[K-E_S])_{*\pi B}]), \end{aligned}$$

where the first expression indicates the total reduction in competition that the “toe-hold merger” doctrine will generate by causing less procompetitive K-E_S mergers to be substituted for more procompetitive K-E_L mergers and the second expression indicates the total increase in competition the doctrine will generate by causing more procompetitive K-E_S mergers to be substituted for less procompetitive K-E_L mergers.

To see whether the first of the above two conditions is fulfilled, one must list the various ways in which a conglomerate merger can increase the profits of its participants or the pre-merger stockholders of one of its participants and then examine whether the size of the established merger partner (whether the merger involves an E_L or an E_S) will affect the relationship between the contribution the merger makes to the relevant profits and the intensity of competition (in the relevant

sense) in each of these ways. A conglomerate merger can increase the profits of the merging companies or the welfare of the pre-merger owners of its initiator in the following ways:

- (1) by enabling an initiator's pre-merger stockholders to take advantage of investor misperceptions of the likely impact of such mergers on the MPs' profits¹¹²⁵;
- (2) by yielding tax advantages—*e.g.*, when one MP can take advantage of tax losses of the other MP that the other MP cannot use;
- (3) by enabling the pre-merger owner of an E (probably an E_S) whose stock is not publicly traded to retire without damaging its company and to exchange its interest for assets (cash or stock in the K company) that are more liquid;
- (4) by enabling the acquiring firm to profit by purchasing the acquired firm at a bargain-basement price by threatening to enter particularly close to it in product-space and/or to make it the target of predatory or retaliatory moves post-entry;
- (5) by generating static efficiencies and dynamic efficiencies (including static efficiencies that carry over to QV-investment expansions);
- (6) when the MPs and the merged company set across-the-board prices, by creating a merged company that can enable its rivals and itself to lock themselves into prices in a sequence that maximizes its and their HNOP array;
- (7) by increasing the profits that the merged firm can realize through natural oligopolistic pricing above the profits that K and E realized in this way pre-merger by generating static marginal efficiencies that increase the merged firm's BCAs above the MPs' BCAs, by creating a company that can initiate a series of facilitating premature price-announcements, and by creating a merged company that can take advantage of economies of scale in changing its initially-announced prices;
- (8) by enabling the merged company to earn more profits through contrivance than K and E would have earned after the date of the merger in this way;
- (9) by enabling the merged firm to earn more profits through predation or threatening predation than K and E would have earned after the date of the merger in these ways.

I will now discuss whether a bias in favor of $K-E_L$ mergers relative to $K-E_S$ mergers from the perspective of the goal of increasing competition is likely to be operative in relation to these respective possible sources of conglomerate-merger profits. I will first discuss the bias issue as it relates to profit-sources for which the analysis is not difficult and then discuss it in relation to profit-sources for which the analysis is more complex.

From the perspective of the goal of increasing competition, the facts that investor misperceptions and tax considerations can make conglomerate mergers

¹¹²⁵ Admittedly, although there is some evidence that this consideration played an important role in the 1960s and 1970s, I doubt its significance today—*i.e.*, I think that investors have learned to be more skeptical about claims that mergers are inevitably advantageous to their participants.

profitable create a bias in favor of firms' engaging in conglomerate mergers (as opposed to doing nothing) since no increase in competition will be associated with the profits that investor errors and tax considerations can yield. Indeed, these purely-private advantages may actually cause conglomerate mergers to be executed that decrease competition because they are profitable despite the fact that they reduce the organizational economic efficiency of their participants. However, these factors will be likely to bias a merger-partner-size choice from the perspective of the goal of increasing competition only to the extent that there are transaction-cost economies of scale in executing mergers: otherwise, the K -firm could achieve the same gains by executing more conglomerate mergers with (E_S)s rather than fewer with (E_L)s. Indeed, to the extent that (E_L)s are less likely to have tax losses of which they cannot take advantage, the tax consideration might be associated with a bias in favor of K - E_S mergers from the perspective of the goal of increasing competition.

Some conglomerate mergers are initiated by the owner of a closely-held corporation who wants to retire and convert his property into more liquid assets that will be of more use to him during his retirement and can be more fruitfully passed on to his beneficiaries. Since these mergers tend to maintain the competitive position of their E_S -participants (which would otherwise have declined as the company's single-person or small-team management grew older and less able or willing to function), the associated private gain may not be associated with any bias in favor of their profitability in comparison with their not merging at all. However, since many of the E_S -firms in question were founded by middle-level or high-level managers of larger concerns that decided to strike out on their own—in essence, to divest themselves from well-established firms—and since decisions by K_S -firms to merge with such (E_S)s rather than with (E_L)s will tend to increase competition by encouraging managers of well-established firms to set out on their own by increasing the ability of such owners of E_S -firms to sell out when they want to do so and the attractiveness of the terms on which they can effectuate their company's sale, this possibility may be associated with a bias against K - E_S and in favor of K - E_L mergers from the perspective of the goal of increasing competition.

The ability of a firm to profit by inducing a non-rival to accept a bargain-basement buy-out or merger offer by threatening to make an otherwise-unprofitable location-decision and/or to make retaliatory or predatory moves after locating also obviously creates a bias in favor of conglomerate mergers from the perspective of the goal of increasing competition. Once more, however, unless there are transaction-cost economies of scale in executing such mergers, this possibility will create no bias in favor of K - E_L mergers over K - E_S mergers. Indeed, to the extent that the (E_L)s of this world are less intimidatable than the (E_S)s, this possibility may be associated with a bias in favor of K - E_S mergers relative to K - E_L mergers.

The same conclusions apply in relation to the ability of conglomerate mergers to increase their participants' profits by facilitating their contrived oligopolistic pricing, predation, or retaliation against rival QV investors. However, two additional points do need to be made in this context. First, the bias (from the perspective of competition) toward firms' engaging in conglomerate mergers that will yield

contrived-oligopolistic-pricing, predation, and retaliation-barrier advantages to the MPs will be increased by the tendency of such mergers to increase the OM_s that the MPs' conglomerate rivals can obtain (*e.g.*, by increasing the MPs' OCAs and natural OM_s, creating a merged firm whose defenses are spread, *etc.*) as well as the L barriers that the merged firm faces. Second, those oligopolistic and predatory realities will be less likely to create a bias in favor of K–E_L mergers relative to K–E_S mergers (indeed, may tend to create the opposite bias) because (E_L)_s may have less need of the information and retaliatory and reciprocatory abilities of K_S than do (E_S)_s, though this consideration will be offset to the extent that contrived oligopolistic pricing is less likely to have been so unprofitable for an E_L (than for an E_S) pre-merger for the practice still to be unprofitable for the “E division” of the merged concern post-merger and by the fact that the E_L firm will have more buyers in relation to which it will be able to obtain gains by engaging in these types of conduct.

Conglomerate mergers can increase the NOM_s of the merger partners not only by generating static efficiencies that increase their OCAs but also by enabling the K and E firms to take advantage of economies of scale in changing their initially-announced prices (say, of changing their advertising or instructing their distributors of a price-change or altering their posted prices or computer entries) and/or by substituting for E a K-firm whose reputation increases its ability to organize a facilitating series of premature price-announcements. Once more, however, although those possibilities create a bias in favor of conglomerate mergers, a bias which in some cases reflects the fact that the mergers in question will increase the NOM_s not only of the MPs but also of their R_s, it is not so clear that it creates a bias in favor of K–E_L mergers relative to K–E_S mergers. This conclusion partially reflects the fact that (E_L)_s may be more likely than (E_S)_s to have been able to obtain OM_s naturally pre-merger, though the fact that the E_L has more sales than the E_S favors the conclusion that this NOM-possibility creates a bias in favor K–E_L mergers over K–E_S mergers because the E_L firm has more sales on which it can obtain NOM_s.

All things considered, I do not think that the various possibilities so far canvassed suggest the existence of a strong bias in favor of K–E_L conglomerate mergers over K–E_S conglomerate mergers from the perspective of the goal of increasing competition. Unfortunately, it will be far more complicated to analyze whether any such bias is created by the two remaining sources of conglomerate-merger profits—static efficiencies and dynamic efficiencies (including static efficiencies that carry over to QV-investment expansions). I will analyze these issues despite this fact not only because they critically affect the competitive impact of the “toe-hold merger” doctrine but also because the extant analyses of these issues are completely inadequate¹¹²⁶ (in large part because the relevant analysts were not accustomed to thinking in non-market-oriented terms).

¹¹²⁶ Thus, in addition to assuming incorrectly either (1) that the effect of any event or act on the intensity of competition in the Clayton Act sense is monotonically related to its impact on economic efficiency and/or (2) that the Clayton Act promulgates an economic-efficiency as

I focus first on static efficiencies that will not carry over to any new QV investments the MPs execute. If the efficiencies relate to the fixed costs of the merged concern, they will increase the merged company's profits by an amount equal to the efficiency in question but will have no effect on Clayton-Act-relevant buyers (assuming that they do not critically affect K's or E's survival) since they will not affect K's or E's competitive position vis-à-vis any buyer. If the efficiencies are "marginal"—*i.e.*, entail a simple reduction in the marginal costs of the merged concern or an improvement in its competitive position in relation to particular buyers that reflects an increase in the attractiveness of its product to those buyers not fully offset by any related increase in its marginal costs, a decrease in the attractiveness of its product to some buyers that is smaller than the associated decrease in its marginal costs, or an increase in the attractiveness of its product to some buyers that is not accompanied by an increase in its marginal costs, four cases will have to be distinguished. For simplicity, I will assume that in each case prices are being set on an individualized basis.

First, to the extent that the static marginal efficiencies affect the merged company's position in relation to buyers that one MP would have been best-placed to supply after the date of the merger and the merged company was best-placed to supply after the merger, the efficiencies will increase the merged company's profits by the amount of the marginal efficiency in question (since it will increase the relevant OCA by that amount) *plus* any NOM that the increase in the relevant OCA enables the merged concern to realize *minus* any loss the efficiency imposes on the merged concern by reducing the profits it can realize by practicing contrived oligopolistic pricing (by increasing the amount of safe profits it must put at risk to do so) and/or by reducing the profits the merged concern realizes by undercutting its rivals' oligopolistic prices (by increasing the merged company's vulnerability to retaliation). By way of contrast, to the extent that the efficiencies relate to buyers K or E would have been best-placed to supply after the date of the merger and KE was best-placed to supply post-merger, they will impose an equivalent-dollar loss on Clayton-Act-relevant buyers by the amount of additional NOMs they enable KE to obtain *minus* the amount by which they reduce KE's COMs *plus* the amount by which they increase the KE's Rs' HNOPS (by increasing KE's prices to its own

opposed to a competitive-impact test of illegality, Bork's analysis of the "toe-hold merger" doctrine assumes that the contribution that a conglomerate merger's efficiencies make to the MPs' profits is monotonically related to their contribution to both the intensity of competition and economic efficiency. See ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 260–62 (Basic Studies, 1978). I critiqued Bork's analysis of the competitive impact of the "toe-hold merger" doctrine in Richard S. Markovits, *Monopolistic Competition, Second Best, and THE ANTITRUST PARADOX: A Review Article*, 77 MICH. L. REV. 567, 635–39 (1979). As I pointed out in Chap. 12, the 1992 Horizontal Merger Guidelines, their 1997 revision, and the 2010 Guidelines also fail to analyze the factors that determine the competitive impact of any efficiencies a horizontal merger may generate (though, unlike their 1984 predecessor, they do recognize that the legal relevance of a merger's efficiencies relates to their competitive impact as opposed to their contribution to economic efficiency and do identify this competitive impact with the effect of the efficiencies on the welfare of the customers of the MPs and their product-Rs).

customers and hence the CMCs KE will have to incur to charge any given lower price to an *R*'s customers relative to the CMCs the relevant merger partner would have had to incur to do so) *plus* the amount by which they increase the *Rs*' NOMs by increasing their OCAs on the preceding account *plus* the amount by which they increase the *Rs*' COMs by reducing KE's willingness to undercut the *Rs*' contrived oligopolistic prices by increasing KE's vulnerability to retaliation (by raising KE's [OCA + NOM + COM]s and spreading its defenses when the relevant *R* operates in both *K*'s and *E*'s markets) and its rivals' ability to reciprocate to KE's collaboration: note that the preceding analysis assumes that any efficiency-related increase in KE's OCAs will not improve the terms the merged concern offers its customers—that, for example, the merged firm will not pass on any reduction in its marginal costs the merger generates.

Second, to the extent that the static marginal efficiencies that a conglomerate merger generates affect KE's position in relation to buyers either *K* or *E* would have been second-placed to supply after the date of the merger and that KE was second-placed to supply post-merger, they will not increase KE's profits at all but will increase competition by the size of the efficiency in question (which will reduce the OCA of the *R* that is the best-placed supplier of the relevant buyer) *plus* any NOM the efficiencies preclude the relevant best-placed *R* from securing (by reducing its OCA) *plus or minus* any amount by which it reduces or increases the *R*'s COM, by increasing or reducing the number of firms in a position to profit by beating any given contrived oligopolistic offer it makes.

Third, to the extent that the static marginal efficiencies that a conglomerate merger generates affects KE's position in relation to buyers that *K* or *E* would have been third-placed to supply to *n*th-placed after the date of the merger and KE was second-placed to supply after the merger, they will not increase KE's profits at all but will confer an equivalent-dollar gain on the buyers in question equal to the positive difference between the efficiency and the amount by which the relevant *K* or *E* would have been worse-than-second-placed after the date of the merger *plus* any associated reduction the efficiency generates in the relevant *R*'s NOMs and COMs.

Fourth, to the extent that the static marginal efficiencies that a conglomerate merger generates affect KE's position in relation to buyers that *K* or *E* would have been worse-than-best-placed to supply after the date of the merger and KE is best-placed to supply post-merger, the efficiencies will increase the merged company's profits by the OCAs they enable KE to enjoy post-merger (the difference between the sum of the static marginal efficiencies that the merger enabled KE to secure in its relations with the buyers in question and the sum of the OCDs under which the *K* or *E* whose products became best-placed post-merger would have operated after the date of the merger in its relations with the buyers in question) *plus* any NOMs KE secured from the relevant buyers *plus* any COMs it secured from them *minus* any reductions in the COMs it secured from others caused by any related increase in its vulnerability to retaliation *minus* any reduction in the profits it realized by undercutting others' contrived oligopolistic prices attributable to the efficiency-related increase in its vulnerability to retaliation. By way of contrast, to the extent that the efficiencies in question make KE best-placed, it will benefit the

relevant buyers by the OCAs of their no-merger best-placed suppliers *plus* any decrease or *minus* any increase in the sum of the NOMs and COMs the buyers that the efficiencies made KE best-placed to supply had to pay *minus* any amount by which the efficiencies raised the COMs other buyers paid by reducing KE's willingness to undercut its rivals from a position of inferiority by increasing its vulnerability to retaliation (as well as its rivals' ability to reciprocate to its cooperation).

This analysis suggests that the relative number of cases in these four categories will substantially affect whether, from the perspective of the goal of increasing competition in the Clayton Act sense, there is a static-marginal-efficiency-related bias in favor of (1) firms' engaging in conglomerate mergers as opposed to doing nothing to enter and (2) K-E_L mergers relative to K-E_S mergers. I will focus on this second issue and address it in a crude way. Roughly speaking, there will be a static-marginal-efficiency-related bias in favor of K-E_L conglomerate mergers over K-E_S conglomerate mergers if the ratio of the number of customers for which larger established firms are best-placed to the number for which they are second-placed or close-to-second-place is greater than its counterpart for small established firms—*e.g.*, if (E_L)s tend to be best-placed more often than they are second-placed or close-to-second-placed while (E_S)s tend to be best-placed less often than they are second-placed or close-to-second-placed. I have no hard data and no real basis for guessing about whether this condition is fulfilled. To the extent that (E_L)s tend to produce highly-differentiated products that consumers either strongly prefer or prefer by far less than their extra cost while (E_S)s tend to produce undifferentiated products, (E_L)s will tend to be best-placed far more often than they are second-placed or close-to-second-placed while (E_S)s will tend to be second-placed or close-to-second-placed far more often than they are best-placed. However, although this description clearly fits some (E_L)s and some (E_S)s, some (E_S)s produce highly-differentiated products that a small number of devotees adore, and some (E_L)s produce generics or old reliables that are not strongly differentiated. I simply do not trust my hunch about which of these situations is typical. I therefore do not know whether there is a static-marginal-efficiency-related bias in favor of K-E_L conglomerate mergers over K-E_S conglomerate mergers from the perspective of the goal of increasing competition.

The final source of conglomerate-merger profits that might create a bias in favor of K-E_L mergers over K-E_S mergers from the perspective of competition are the dynamic efficiencies such a merger may generate. Unfortunately, the relationship between the private-profit-yield and competitive impact of such efficiencies is at least as complicated to analyze as its counterpart for static marginal efficiencies that do not carry over to expansions. I will initially assume that in any given situation the relevant K-E_L and K-E_S mergers will generate the same amount and types of dynamic efficiencies and that the relevant E_L and E_S firms' QV-investment-expansion-related positions are the same. On those assumptions, six categories of situations must be distinguished.

In the first, the dynamic efficiencies that I am now assuming that either the relevant K-E_L or the relevant K-E_S merger would generate would not affect equilibrium QV investment in the relevant area of product-space even though the

merged firm will make a QV investment that takes advantage of them because the relevant K or E merger partner would have expanded anyway. In this case, the efficiencies will increase the profitability of the merger by an amount equal to the number of buyers the efficiencies cause KE's new investment to be best-placed to supply and the average difference between the OCD under which the new QV investment would have otherwise operated in those instances and the size of the per-unit efficiency in question (if each buyer is assumed to buy one unit) *plus* the number of buyers (if any) that the efficiencies cause KE's new investment to be best-placed to supply and obtain (by raising KE's OCAs on its new investment) *plus* the related amount by which the efficiencies raise KE's NOMs above the NOMs the relevant MP would have obtained *minus* the amount by which they reduce the OMs KE contrives (by increasing the safe profits KE would have to put at risk to practice contrived oligopolistic pricing on its new product) *minus* the amount by which they reduce the profits KE realizes by undercutting its rivals' contrived oligopolistic prices (by increasing KE's vulnerability to retaliation and its rivals' ability to reciprocate to KE's collaboration) *plus* or *minus* any increase or decrease in the damage KE's new QV investment does to the profit-yield of its pre-existing QV investments in the relevant ARDEPPS. If the dynamic efficiencies are fixed-cost efficiencies and do not affect the product the merged company introduces, they will have no effect on competition—*i.e.*, on the welfare of the customers of K, E, and their product-Rs. However, if the dynamic efficiencies are marginal efficiencies (as I will hereinafter assume), they will increase competition by the amount by which they reduce the Rs' OCAs (which will depend not only on the size of the efficiencies but on the amount by which they increase the frequency with which the [perhaps changed] product the merged firm introduces is second-placed and reduce the amount by which it is worse-than-best-placed when it is second-placed)¹¹²⁷ *plus* the related amount by which they reduce the Rs' NOMs (by reducing their OCAs) *minus* the amount by which they increase the KE's NOMs (by increasing its OCAs) *plus* the net amount by which they reduce or *minus* the net amount by which they increase the sum of the COMs of KE and its product-Rs (through producing a variety of effects that I will not review here). These conclusions suggest that, in the case now under investigation, the sign of the bias that dynamic efficiencies create in the profitability of the conglomerate merger that generate them from the perspective of the goal of increasing competition will depend substantially on the ratio of the number of times the new product is best-placed to the number of times it is second-placed. Relatedly, they suggest that there will be a dynamic-efficiency-related bias in favor of K-E_L mergers over K-E_S mergers if the preceding ratio is sufficiently higher for (E_L)s than for (E_S)s to overcome any bias against K-E_L mergers in favor

¹¹²⁷ If the relevant efficiencies do not change the product the merged firm introduces, this impact will depend not only on the size of the marginal dynamic efficiencies in question but also on the frequency with which after the date of the merger the relevant MP would have been either second-placed or worse-than-second-placed by less than the improvement in its position yielded by the efficiencies in question.

of $K-E_S$ mergers created by the greater M disincentive the $K-E_L$ firm will have to expand relative to the M likely to confront the $K-E_S$ firm.

In the second situation that needs to be distinguished, the dynamic marginal efficiencies that I am now assuming that either the relevant $K-E_L$ or the relevant $K-E_S$ merger would generate would not affect equilibrium QV investment in the relevant ARDEPPS either because, despite them, expansion would still be unprofitable for the merged firm or because a rival of the merged firm that would have made the additional QV investment anyway makes the investment in question (because, despite the efficiencies, expansion would still be more profitable for this rival than for KE). In this case, the dynamic efficiencies will have no impact either on the profits the merger yields its participants or on Clayton-Act-relevant buyers, and no dynamic-efficiency-related bias will affect the choice of whether to engage in the merger rather than not doing anything at all or whether to execute a $K-E_L$ merger rather than a $K-E_S$ merger.

In the third relevant situation, the relevant dynamic efficiencies have no effect on equilibrium QV investment but do cause the merged firm to make an investment that deters an R from making an alternative, equally-large QV investment (by making expansion more profitable for KE than for an R or by making expansion profitable for a K -firm that can commit itself to making a new QV investment more quickly than can the relevant R). In this case, the relevant dynamic efficiencies will increase the profitability of the merger by the sum of the nominal supernormal profits yielded by the QV investment they enable KE to make *plus* the amount by which the substitution of the KE's QV investment for the rival QV investment it deters reduced the damage the additional QV investment did to the profit-yields of the relevant K 's or E 's pre-existing projects in the relevant area of product-space (a monopolistic-QV-investment-incentive-related amount that will probably tend to be larger for $[E_L]$ s than for $[E_S]$ s.) Unfortunately, in this case, it is complicated to predict the competitive impact of the dynamic efficiencies a conglomerate merger generates. The efficiency-induced substitution of the KE expansion for the R expansion will affect competition in three ways:

- (1) by altering the sum of the pre-expansion OCAs of the sellers that lose their best-placed position to the new investor,
- (2) by altering the amount by which the new investment reduces the OCAs of other sellers whose patronage the new product is second-placed to secure, and
- (3) by altering the NOMs and COMs of both the new investor and its rivals as well as the OCAs of the new investor's rivals by changing the new investor's CMCs.

I will assume that the fact that the KE makes the new QV investment implies that its QV investment is more profitable than the QV investment it deters (and not that KE was able to commit itself to investing before the relevant R could do so) and that the greater profitability of the KE's QV investment reflects the fact that the product it creates is best-placed more often than the product that would have been created by the QV investment that was deterred (rather than the fact that KE

enjoyed higher OCAs when dealing with the buyers in relation to which its new product was best-placed than the deterred R would have enjoyed when dealing with the buyers in relation to which its deterred QV investment's product would have been best-placed and/or the fact that KE had higher monopolistic QV-investment incentives to make its QV than the deterred R had to make its QV investment). To the extent that these assumptions are justified (and I do believe that to some extent they are), the dynamic efficiencies a conglomerate merger generates will increase competition in the Clayton Act sense by substituting a QV investment that totally removes more OCAs than would have been removed by the QV investment it deters. However, although I do suspect that dynamic efficiencies will increase competition in the preceding way, I am far less certain that they will increase competition by reducing the OCAs of sellers that were best-placed prior to the QV-investment expansion and remain best-placed post-expansion though by a smaller margin (since the product created by the new QV investment is second-placed post-expansion). Once more, my doubts reflect my suspicion that there is little correlation between the frequency and amount by which a product is best-placed and the frequency and amount by which it is second-placed (as opposed to worse-than-second-placed). To the extent that there is a negative correlation between these components of a product's competitive-position array (and I would not be at all surprised to discover that there were), the dynamic efficiencies a conglomerate merger generated would tend to decrease competition on this account. Finally, to the extent that the dynamic efficiencies in question raise the average OCA the (changing) new investor enjoys when dealing for the patronage of the buyers in relation to which the new product is best-placed, they may decrease competition in various ways—by enabling KE to realize more NOMs than the relevant R would have done, by raising KE's CMCs and hence its various non-deterred and deterred R s' HNOPs by more than the deterred QV investment would have raised the deterred R 's CMCs and hence the HNOPs of the sellers that were best-placed to supply buyers the deterred R was originally second-placed to supply, and perhaps by increasing COMs by increasing KE's vulnerability to retaliation by more than the deterred R 's QV investment would have increased its vulnerability to retaliation and by substituting an expansion by KE for a new entry. On balance, I suspect that in this case the dynamic efficiencies a conglomerate merger generates will cause it to confer an equivalent-dollar gain on Clayton-Act-relevant buyers, though the size of the gain to the relevant buyers will have little connection to the contribution the efficiencies made to the merged company's profits.

Unfortunately, in this case, I cannot even speculate in a worthwhile way as to whether, from the perspective of the goal of increasing competition, there is a bias in favor of the conglomerate merger in question. Moreover, although, *ceteris paribus*, monopolistic-QV-investment-incentive considerations will create a bias in favor of $K-E_L$ mergers over $K-E_S$ mergers from the above perspective, this consideration seems likely to be dwarfed by other factors.

In the fourth situation that should be distinguished, the dynamic efficiencies that I am assuming that either the relevant $K-E_L$ or the relevant $K-E_S$ conglomerate merger would generate would increase equilibrium QV investment by making it

profitable for KE to introduce an additional QV investment into the ARDEPPS when no-one else would otherwise have done so. In this case, these efficiencies will increase the merged firm's profits by the difference between the nominal supernormal profits the investment in question will yield and the amount by which its execution will reduce the profit-yield of KE's pre-existing projects. By way of contrast, in this case, the relevant efficiencies will confer an equivalent-dollar gain on Clayton-Act-relevant buyers equal to the OCAs enjoyed pre-expansion by the sellers that were best-placed to supply the buyers the new product became best-placed to supply *plus* the amount by which the new product reduced the OCAs of sellers that continued to be best-placed post-expansion (because the new product was second-placed to supply the relevant buyers) *plus* any related reduction in the relevant Rs' NOMs *minus* any increase in the COMs the new QV investment enabled KE's Rs to obtain by increasing their ability to reciprocate to KE's collaboration and/or to retaliate against its undercutting.

Once more, in this case, I am unable to put a sign on the dynamic-efficiency-related bias in the profitability of the relevant conglomerate mergers. Once more as well, although a bias in favor of K-E_L over the K-E_S mergers from the perspective of the goal of increasing competition will be produced by *M* considerations, this bias is likely to be sufficiently small relative to and uncorrelated with the bias in this choice created by all the other biasing factors combined to make me reluctant to reach any conclusions on this basis.

In the fifth relevant type of situation, the dynamic efficiencies that I am assuming that either the relevant K-E_L or the relevant K-E_S conglomerate merger would generate would raise equilibrium QV investment in the relevant ARDEPPS by inducing a rival of the merged firm to make a QV investment when neither it nor anyone else would otherwise have added a QV investment to the ARDEPPS. The efficiencies in question could produce this effect by eliminating or reducing the monopolistic QV-investment disincentive the R faced or giving it a monopolistic QV-investment incentive when it previously faced a disincentive by making it profitable for KE to expand when neither the relevant E nor any other rival of the R in question would otherwise have found a QV investment profitable. In this case, the relevant efficiencies will decrease the profits of the MPs by the amount by which the QV investment they induce R to execute reduces the profit-yield of the investment(s) KE owns in R's ARDEPPS. By way of contrast, in this case, the dynamic efficiencies in question will confer an equivalent-dollar gain on Clayton-Act-relevant buyers by producing the same types of equivalent-dollar impacts on the relevant buyers that the induced KE expansion did in the preceding case.

Hence, in this type of situation, the relevant efficiencies will clearly create a bias against the MPs' merging as opposed to doing nothing from the perspective of the goal of increasing competition. However, since the QV investment the relevant efficiencies will induce R to make will presumably reduce an E_L's pre-existing projects' profit-yields by a larger absolute amount than the sum by which it would

reduce an E_S 's pre-existing projects' profit-yields (in that E_L has more such projects than E_S), there will tend to be a dynamic-efficiency-related bias against E_L mergers and in favor of E_S mergers in this type of case.

The sixth and final situation worth distinguishing presents a perverse case. In it, the dynamic efficiencies that I am assuming that either the $K-E_L$ or the $K-E_S$ conglomerate merger would generate would cause one or more QV investments not to be added to the relevant ARDEPPS that would otherwise have been made by converting a situation in which a given R originally faced non-preclusive monopolistic QV-investment disincentives into one in which the R and KE would face preclusive natural oligopolistic QV-investment disincentives (by critically raising the nominal profitability to KE of expanding). In this type of situation, the efficiencies in question will increase the profitability of the merger to KE by an amount equal to the loss the deterred rival QV investment(s) would otherwise have imposed on KE but will decrease competition by preventing the relevant buyers from obtaining the net benefits the deterred QV investment(s) would have conferred on them (as explained when discussing dynamic efficiencies that increase equilibrium QV investment in the ARDEPPS in question). In this type of situation, the dynamic efficiencies that the relevant conglomerate merger would generate will clearly create a bias in favor of the merger from the perspective of the goal of increasing competition. Moreover, since an E_L would tend to gain more from the relevant QV investment's or QV investments' being deterred than would an E_S , the dynamic efficiencies in question will also create a bias in favor of $K-E_L$ mergers over $K-E_S$ mergers in this type of case.

Across all the relevant types of situations, if the relevant $K-E_L$ and $K-E_S$ mergers would generate the same amount and type of dynamic efficiencies and the QV-investment-expansion-related positions of the relevant E_L and E_S firms and of their rivals were the same, the fact that geographic-diversification conglomerate mergers can generate dynamic efficiencies probably would create a small *ceteris paribus* bias in favor of $K-E_L$ mergers over $K-E_S$ mergers if the only distortion in the private profitability of that choice related to the effect of new QV investments in the ARDEPPS on the profit-yields of the MPs' pre-existing projects. Clearly, however, any final assessment of the likely bias in merger-partner selection from the perspective of the goal of preventing the lessening of competition or of increasing competition that is associated with the fact that geographic-diversification conglomerate mergers can generate dynamic efficiencies will also have to take account of any systematic differences in the quantity and types of the dynamic efficiencies that would be generated respectively by relevant $K-E_L$ and $K-E_S$ mergers and any systematic differences in the QV-investment-expansion positions of the relevant (E_L)s and (E_S)s and of their rivals whose salience the preceding analyses reveal. Because there are some limits to even my willingness to try my readers' patience, I will comment no further on these issues.

Having reviewed all the ways in which a conglomerate merger can either increase its participants' profits or the welfare of the owners of one of its participants, it should now be possible to assess whether, from the perspective of

the goal of increasing competition, there is a net bias in favor of K-E_L mergers relative to K-E_S mergers. As we have seen, although some factors do create such a bias, others (such as tax considerations and the desire of owners of small businesses to preserve the value of their businesses in the face of their prospective retirement or to exchange their holdings for liquid assets that put them in a position to retire and to benefit their beneficiaries) create the opposite bias. More importantly, the individual biases to which I have been able to give a sign seem likely to be small and uncorrelated with the net sum of the other biases whose size and magnitude I cannot even usefully guesstimate. Surely, even if this complicated analysis does suggest that on balance there is a bias in favor of K-E_L mergers relative to K-E_S mergers from the perspective of the goal of increasing competition, there is absolutely no reason to believe that this bias is likely to be sufficiently large relative to the relevant profit-difference to justify the conclusion that a “toe-hold merger” doctrine whose only relevant effect was to cause K-E_S mergers to be substituted for K-E_L mergers to be procompetitive on balance. The contrary assumption of the developers and proponents of the “toe-hold merger” doctrine is clearly unjustified and probably incorrect. Perhaps the most important implications of the preceding analysis of the relevant profit-bias claim are that those who make this claim have no idea about the proper way to assess it and that the conceptual structures Chap. 2 developed can play a useful role in its assessment.

(2) The Doctrine’s Economic Assumption That—If It Will Increase Competition in Those Cases in Which It Will Lead K-firms to Substitute K-E_S Mergers for K-E_L Mergers—It Will Increase Competition

The second economic objection to the claim that the part of the “toe-hold merger” doctrine that privileges K-E_S mergers over K-E_L mergers will increase competition is that, even if, *ceteris paribus*, the doctrine would increase competition by inducing K-firms to substitute K-E_S mergers for K-E_L mergers, it might not increase competition all things considered because, in at least some cases, the doctrine will cause K-firms that would otherwise have executed K-E_L mergers that would have increased competition relative to the defendant-do-nothing baseline to do nothing—*i.e.*, not to enter the firm’s market at all rather than to execute an (assumed to be) procompetitive merger with E_S. If K-firms know *ab initio* that they will not be allowed to execute K-E_L mergers that they would find most profitable unless they can show that they made unsuccessful “reasonable efforts” to identify an E_S-firm whose acquisition would be more profitable than not entering the firm’s market at all, the cost of making the relevant search (which includes not only the cost of identifying acquisition targets or merger partners but also the cost of negotiating the terms of the acquisition or merger [which in the case of the merger might include the cost of revealing to the relevant E proprietary information about the K’s customer lists, costs, trade secrets, and expected merger-generated efficiencies])

might be prohibitively high. Although, admittedly, the probability that the “toehold merger” doctrine will produce this outcome depends in part on how the requirement that K-firms that want to merge with an E_L establish that they made “reasonable efforts to identify a suitable E_S firm and failed to do so” is interpreted and applied, I suspect that the prospect of having to engage in such a search and having to forego a more profitable E_L merger if a “suitable” E_S partner is identified may render the search for an E acquisition-target or merger-partner *ex ante* unprofitable for at least some (I suspect, many) Ks that would otherwise attempt to achieve geographic diversification by executing conglomerate mergers or acquisitions. Obviously, to the extent that this is the case, the substitution of the part of the “toehold merger” doctrine that privileges K- E_S mergers over K- E_L mergers might not increase competition even if all the substitutions of K- E_S for K- E_L mergers it induces do increase competition. I must admit, however, that the argument that the toehold-merger doctrine will increase competition if the K- E_S mergers it causes to be substituted for K- E_L mergers are more procompetitive than the K- E_L mergers will be strengthened to the extent that—by increasing the market value of E_S firms—the doctrine increases the extent to which managers of well-established firms leave their positions to set up their own new companies.

(3) The Doctrine’s Legal Assumption That, If It Will Increase Competition, It Is Correct as a Matter of Law

The DOJ, FTC, and those U.S. courts that have promulgated, applied, or commented positively on the “toehold merger” doctrine have all assumed that—if its application would increase competition—the doctrine would be correct as a matter of law. I disagree. The doctrine assumes that the Clayton Act forbids a firm from achieving geographic diversification (1) by merging with or acquiring an established firm of any relative size in the target area even when the merger or acquisition in question would not decrease the intensity of competition in the target market below the level it would have if the K-firm did nothing to enter the market in question or if the K-firm could execute an independent entry into that market that would be more profitable than not diversifying into the territory in question at all on the usually-accurate assumption that the independent entry would be more procompetitive than the merger or acquisition and (2) by merging with a relatively-large established firm (E_L) in the target area rather than with a relatively-small established firm (E_S) in the target area even when its merger with or acquisition of the E_L firm would not reduce or would increase the intensity of competition in the target area relative to what it would be if the K-firm did not enter the target market unless the K-firm can show that it had made a reasonable effort to identify an E_S whose acquisition would be more profitable than not entering the target market at all and had failed to do so (on the dubious assumption that K- E_S mergers that would be more profitable for the K-firm than not entering the firm’s market at all would be more procompetitive than the K- E_L merger the K-firm would find more profitable to execute). Both these branches

of the “toe-hold merger” doctrine therefore assume that the Clayton Act imposes a duty on any firm that wants to achieve geographic diversification not just to avoid doing so in a way that would decrease competition but in some respects to do so in a way that would increase competition. (I say “in some respects” because the doctrine does not require firms that would find one independent entry into a new geographic market more profitable than not entering that market at all to choose the number or the set of independent-entry projects that were more profitable than not entering at all that was most procompetitive.) In my view, because the “toe-hold merger” doctrine imposes (1) a duty to increase competition when choosing between (A) geographic-diversification mergers and geographic-diversification entries and (B) geographic-diversification mergers or acquisition partners as opposed to (2) a duty not to decrease competition by choosing to engage in geographic diversification through merger or acquisition instead of not achieving such diversification at all, the doctrine is wrong as a matter of Clayton Act law in that it rejects the Clayton Act’s “defendant-do-nothing” baseline for competitive-impact measurement.

* * *

To my knowledge, no U.S. case about the legality of a conglomerate merger that does not eliminate an effective potential competitor has ever argued (1) that the static efficiencies such a merger generates will reduce competition by causing one or more of the merged firm’s established competitors to exit by worsening its array or their arrays of OCAs or by deterring a rival entry or expansion by worsening the potential investor’s array of prospective OCAs or (2) that the dynamic efficiencies such a merger generates will reduce competition by inducing a merged-firm expansion that deterred a more procompetitive entry or by substituting a situation in which the merged firm and an established rival faced critical natural oligopolistic QV-investment disincentives for one in which the rival faced non-critical monopolistic QV-investment disincentives. Nor, to my knowledge, has any U.S. case on such conglomerate mergers ever had to respond to a situation in which one of the MPs or the acquired firm was a failing company. However, although as Sect. 6C(1) will indicate some 1960s opinions on the legality of conglomerate mergers that would eliminate an effective potential competitor did express the then-popular view that the efficiencies yielded by any type of merger count against its legality, I am confident that contemporary courts would take the opposite position on this issue not only in potential-competition conglomerate-merger cases but also in cases about the legality of conglomerate mergers that do not eliminate an effective potential competitor. I also see no reason to believe that contemporary courts would not follow the *Citizen Publishing Co.*/1992 and 2010 Horizontal Merger Guidelines failing-company doctrine in conglomerate-merger cases, regardless of whether the merger eliminated an effective potential competitor.

5. The Conditions Under Which Competition Will Be Effective and the Economic Effects of the Fact That a Conglomerate Merger Has Eliminated or Would Eliminate an Effective Potential Competitor

A. The Conditions Under Which Potential Competition Will Be Effective and the Competitive Impact of Effective Potential Competition

(1) The Conditions Under Which Potential Competition Will Be Effective

If (as I will do in this section) one ignores the possibility that an ARDEPPS' established firms may incorrectly believe that an entry will be executed if they do nothing to prevent it, potential competition will be effective in a given ARDEPPS if one or more entries would be executed at the level of ARDEPPS QV investment that would be the equilibrium QV-investment level in that ARDEPPS if entry were barred—*i.e.*, if the entry-preventing QV-investment level were higher than the entry-barred, expansion-preventing QV-investment level. In the QV-investment-competition-related terminology that Chap. 2 developed, the preceding (obvious) claim implies that potential competition will be effective in a given ARDEPPS if the sum of the barriers to entry facing the firm that would be the ARDEPPS' best-placed potential competitor at the ARDEPPS' entry-barred, expansion-preventing QV-investment level were lower than the sum of the barriers to expansion and monopolistic or natural oligopolistic QV-investment disincentives that would (I will assume) just deter the established firm that would be the ARDEPPS' best-placed potential expander at the entry-barred, expansion-preventing QV-investment level from executing a QV-investment expansion. As we shall see, it is important to note that, on this account, the effectiveness of potential competition in a given ARDEPPS depends not exclusively on the height of the barriers to entry facing its best-placed potential competitor (at a particular ARDEPPS QV-investment level) but on the magnitude of those barriers *relative to* the magnitude of the counterpart barriers and possible additional disincentives facing the established firm that would be the ARDEPPS' best-placed potential expander at the relevant QV-investment level if entry were barred.

So far, this discussion of the conditions under which potential competition will be effective has been static in the sense that it has made no reference to the reality that conditions in virtually all ARDEPPSes change through time—in particular, that most ARDEPPS' $H\Pi_E$ curves vary through time as technological developments and changes in the prices of relevant inputs alter the cost of producing the ARDEPPS' products and changes in population size, population wealth, and consumer preferences alter the demand curves for the ARDEPPS' products. *Ceteris paribus*, the faster an ARDEPPS' " $H\Pi_E$ " curve (the quotation marks are necessary because I am ignoring related changes in the monopolisticness of the ARDEPPS'

pricing) moves to the right through time (because of cost reductions and/or demand increases), the more likely potential competition will be effective at at least some point in time because the barriers to expansion that an ARDEPPS' individual established firms will face on their first, second, . . . *n*th expansion will increase *inter alia* with the rate at which they are expanding through time and, *ceteris paribus*, the rate at which they will have to expand through time to deter new entry will increase with the rate at which the ARDEPPS' " Π_E " curve is moving to the right through time.

(2) The Competitive Impact of Effective Potential Competition (and Hence of Conglomerate Mergers That Eliminate an Effective Potential Competitor)

I believe that in the overwhelming majority of situations effective potential competition will affect competitive outcomes either (1) by becoming kinetic (*i.e.*, by leading to entry) and thereby benefitting Clayton-Act-relevant buyers both directly by providing them with more quality or variety and indirectly by causing prices to drop in the relevant area of product-space or (2) by inducing one or more established firms to make limit investments (QV investments they would not otherwise have made to deter entry) and thereby benefitting Clayton-Act-relevant buyers in the same two ways. As Sect. 5(B)(2) discusses, this conclusion is at odds with the conclusion to which many economists seem to continue to subscribe—*viz.*, the conclusion of limit-price theory that in a broad range of circumstances effective potential competition will affect competitive outcomes by inducing the relevant ARDEPPS' established firms to charge lower prices than they would otherwise have charged to deter entry (to limit price to limit entry). In my judgment, the presence of an effective potential competitor will induce an established firm to lower its prices to deter the potential competitor's entry in only four, empirically-unimportant situations:

- (1) a relatively inefficient producer in a little-explored area of product-space that cannot increase the proficiency of its current project, make a new, more-efficient QV investment in the relevant niche, or sell to a potential investor that would be able to operate more proficiently its knowledge of the existence of a profitable investment opportunity may keep its prices down to conceal the profit-potential of the relevant area of product-space to deter the entry of more-efficient firms whose (non-predatory) operation would reduce its profits even more than they were reduced by its low pricing and might even lead to its exit;
- (2) a producer in a little-explored area of product-space may keep its prices down in the short run if it believes that if it prevents the "outside" firms that could profit by entering its niche from identifying this opportunity in the short run they will alter their entry positions by using their entry-relevant resources and capital in other ways;
- (3) a producer in a little-explored area of product-space may keep its prices down if it fears that any revelation of the profit-potential of its niche will lead to more

QV investments being made in that area of product-space than can be sustained in equilibrium; and

- (4) a seller that faces a strong buyer that is threatening to integrate backward into the seller's field of production may offer the buyer a price-reduction to deter the buyer from entering (though I would hesitate to characterize such price-reductions as "limit pricing" because they are not designed to deter entry in any of the ways in which it is claimed limit pricing would do so).

Obviously, the preceding analysis yields the conclusion that, in the vast majority of cases, the fact that a conglomerate merger eliminates an effective potential competitor implies that it (1) will yield the merger partners Sherman-Act-illicit profits either by freeing them from the competition with which the new entry it prevents on this account would have confronted them or by obviating their making a limit investment that would have been unprofitable had it not deterred the relevant new entry and (2) will impose either a larger equivalent-dollar loss on Clayton-Act-relevant rivals by deterring a new entry or a somewhat-smaller equivalent-dollar loss on Clayton-Act-relevant buyers by deterring one or more established firms' making a limit QV investment (smaller because a limit investment by an established firm will tend to be less procompetitive than a new entry). The preceding analysis also yields the conclusion that, in a few cases, the fact that a conglomerate merger eliminates an effective potential competitor implies that it (1) will yield the merger partners Sherman-Act-illicit profits by obviating the relevant established firms' lowering their prices (though the illicitness of these profits may be contestable when the foregone price-reduction would have been executed because the incumbent feared that investors would otherwise bring total QV investment in the ARDEPPS to a supra-equilibrium level) and (2) will impose an equivalent-dollar loss on Clayton-Act-relevant buyers by obviating the incumbents' making price-reductions to deter entry.

B. A Statement and Critique of Limit-Price Theory: The Conditions Under Which the Theory Alleges Potential Competition Is Effective, How Limit Pricing Allegedly Deters Entry, Its Alleged Effectiveness, and Its Profitability Relative to Allowing Entry If Bribing or Buying the Potential Entrant Is Impossible

(1) The Conditions Under Which, According to at Least Some Limit-Price Theorists, Potential Competition or a Particular Potential Competitor Will Be Effective

I have not done a systematic empirical study of the extent to which contemporary Industrial Organization economists support limit-price theory, but my impression is that most Industrial Organization graduate students are still taught limit-price

theory not as an historical curiosity but as a correct analysis of the impact of effective potential competition. I also do not know the proportion of those IO economists who subscribe to limit-price theory who agree with the position its major developer—Joe Bain—took on the conditions under which potential competition would be effective. However, both Bain and his signature work on limit pricing¹¹²⁸ appear to me to be sufficiently-highly-regarded today to justify my recounting and criticizing his position on the conditions under which potential competition will be effective. According to Bain, a market's best-placed potential competitor(s) will be effective whenever the barriers to entry they face are either low (in which case the established firms will not limit price and the potential competitor will enter) or moderate to substantial (in which case the established firms will not limit price and entry will be deterred) but not when the barriers to entry they face are high since in high-barrier-to-entry situations entry will be "blockaded" in that the highest profitable price the established firms could manage to set if they were not concerned about entry will be lower than the limit price (the price that will deter entry).¹¹²⁹ I should state at the outset that Bain does not define the concept of a barrier to entry in the same way that I do.¹¹³⁰ However, the relevant

¹¹²⁸ BAIN BARRIERS.

¹¹²⁹ *Id.* at 34–41.

¹¹³⁰ For Bain, barriers to entry are factors that raise the potential entrants' post-entry average total costs above technological minimum average total cost (where the product is defined without reference to any images that advertising could link to it and without reference to the speed with which it will be supplied at different stages of a fluctuating-demand cycle). More specifically, Bain distinguishes three types of barriers to entry: (1) absolute cost barriers to entry, which reflect the fact that the potential entrant would have to pay more to use a patented or secret production process than its established firm "owner" had to pay to discover it or buy it, would have to pay more for raw materials or other types of inputs than the established firms have to pay for them, or can make less-profitable labor and management "purchases" than the established firms made; (2) product-differentiation barriers to entry, which equal the additional cost per unit the potential entrant would have to incur to overcome the product-differentiation-related advantage of the established firms; and (3) scale barriers to entry, which he defines to equal the amount by which entry would cause the established firm's average total costs to exceed technological minimum average total cost by reducing its output further below the average-total-cost-minimizing level (and simultaneously cause the new entrant's costs to be higher by causing its sales to be lower than they would be if its entry did not raise QV investment in the ARDEPPS in question). (Bain should also have included in his scale barrier to entry category the amount by which the established firms' pre-entry average total costs exceeded technological minimum average total cost because even pre-entry their sales were lower than their average-total-cost-minimizing outputs.) Bain argued that the limit price depended as well on what he called the "percentage effect" of entry—the amount by which entry would reduce prevailing prices in the market in question. According to Bain, the limit price equaled (actually, was infinitesimally below) minimum average total cost *plus* the three barriers to entry *plus* the percentage effect of entry. In Bain's view, limit pricing would deter entry because if the established firms charged that price (P_L) the potential entrant would realize that the price it could obtain post-entry— P_L *minus* the percentage effect of entry—would be lower than its post-entry average total costs—minimum average total cost *plus* the three barriers to entry. This arithmetic argument would be incorrect even if Bain altered the definition of his scale barrier to entry to include the amount by which the established firms' pre-entry average total costs exceeded technological minimum average total cost because even pre-entry they could not take full

definitional difference is not relevant to the point I am making. I should also say that even if one believed that limit pricing would deter entry, would be more profitable than any other means of deterring entry, and would be more profitable than allowing entry to occur (see below) there would be no reason to believe that entry will be blockaded so that potential competition will be ineffective when barriers to entry are high. Admittedly, on Bain's account of the limit price, the height of the limit price (P_L) in any market—more precisely the difference between P_L and minimum average total cost in that market—will increase with the barriers to entry into that market. However, on Bain's account of the various barriers to entry, the height of the conventional-profit-maximizing price in any market will also increase with the height of its various barriers to entry: product differentiation tends to be associated with higher OCAs and NOMs, and absolute cost differences and high economies of scale relative to the extent of the market tend to be associated with higher OCAs and NOMs as well (given the degree of product differentiation) by being linked to what would conventionally be denominated higher seller-concentration ratios. Hence, even if I accepted Bain's "theory" of limit pricing (which I do not—see below), there would be no reason to believe that the limit price in a market (P_L) will be especially likely to be higher than the profit-maximizing price in that market when P_L is high relative to average total cost (ATC) or marginal cost (MC)—*i.e.*, there would be no reason to conclude that there was a positive relationship between the height of the barriers to entry into a given market and the likelihood that entry into it would be blockaded.

The preceding analysis focused on Bain's position about whether *any potential entrant* into a particular market would be effective. Some economists have also expressed to me their agreement with a position that the U.S. DOJ took in its 1984 Conglomerate Merger Guidelines on a different "potential-competitor-effectiveness" issue—*viz.*, whether *a particular potential competitor* is effective. Although I have no idea whether the economists at the DOJ were responsible for this position, the

advantage of the available technological economies of scale. In particular, Bain's arithmetic argument for the efficacy of limit pricing would be wrong even if it were improved in this way because it is based on the highly-unrealistic assumption that what he denominates the percentage effect of entry will not be affected by whether the established firms were limit pricing pre-entry. Assume that, if the established firms were charging the highest conventionally-profitable prices they could charge pre-entry, the entry would cause them to reduce their prices by X cents (by reducing their OCAs, NOMs, and COMs and perhaps by causing them to retaliate). If, alternatively, pre-entry, the established firms were charging prices that did not take advantage of their OCAs, their ability to secure NOMs, and their ability to profit by charging contrived oligopolistic prices, post-entry they would almost certainly reduce their prices by less than X cents—*e.g.*, having failed to deter entry by deceiving the potential competitor into underestimating the highest price they could charge, the established firms would give up attempting to do so and would charge the most-conventionally-profitable price they could charge post-entry (a price that might even be higher than the limit price though it would presumably be lower than the most-conventionally-profitable price they could have charged pre-merger).

1984 Guidelines state that—unless there is strong evidence that a particular potential competitor will enter—the Department will assume that only the best-placed, second-placed, and third-placed potential entrant into a given market are effective potential competitors. I disagree with this position. In many situations, no potential competitor is effective because the entry-barred, expansion-preventing QV-investment level is higher than the entry-preventing QV-investment level; in many situations, only one or two potential competitors are effective because (1) the $H\Pi_E$ curve for the relevant ARDEPPS is not rising quickly and either (2) (A) the entry-barred, expansion-preventing QV-investment level is only one or two QV investments below the entry-preventing QV-investment level and/or (B) the barriers to entry facing the second-placed potential competitor are much higher than those facing the best-placed potential competitor and/or the barriers to entry facing the third-placed potential competitor are much higher than those facing the second-placed potential competitor; and in many situations, more than three potential competitors are effective because (1) the entry-barred, expansion-preventing QV-investment level is now or will become more than three QV investments below the entry-preventing QV-investment level (given the rate at which the relevant ARDEPPS' $H\Pi_E$ curve is rising through time) and (2) the barriers facing the fourth-placed, fifth-placed, *etc.*, potential entrants are not significantly higher than those facing the best-placed potential competitor. I am also not sure why the fact that a particular potential entrant that was part of a group of four or more equally-well-placed potential entrants was clearly going to enter should make one conclude that it was effective: its prospective entry would not increase the effectiveness of potential competition if its entry would deter the entry of another equally-well-placed potential entrant unless the fact that its plans were well-advanced meant that, if it were not eliminated, it would enter more quickly than the firm its entry deterred would have done.

I want to close this subsection by commenting on one relevant evidentiary point that several economists have made to me and that various courts have also accepted—*viz.*, the claim that the fact that no entry has taken place into a given ARDEPPS for a considerable period of time implies that potential competition is not effective in that ARDEPPS. In my judgment, this claim is wrong because it ignores the fact that potential competition can be effective even if it never becomes kinetic by inducing one or more of an ARDEPPS' established firms to make a limit investment to deter the effective potential competitor from entering.

(2) The Alleged Competitive Impact of Effective Potential Competition, How Limit Pricing Allegedly Deters Entry, Its Alleged Effectiveness, and Its Alleged Profitability Relative to Allowing Entry If Bribing or Buying the Potential Entrant Is Impossible

A considerable number of economists in both the U.S. and Europe continue to believe that in a broad range of circumstances effective potential competition will affect competitive outcomes not by leading to entry or inducing incumbents to

make limit investments but by inducing incumbents to charge lower prices than they would otherwise have found profitable to charge to deter entry. Bain claimed that the established firms in a market would respond to potential competition by engaging in limit pricing whenever the best-placed potential entrant faced moderate to substantial barriers to entry (because he believed that potential competitors that faced moderate to substantial barriers to entry would always be effective and that limit pricing—which he assumed would always be effective—would be more profitable than conventional profit-maximization when the potential competitor that had to be deterred faced moderate to substantial as opposed to low barriers to entry).¹¹³¹ Some limit-price-theory supporters appear to believe that limit pricing will always be profitable for established firms confronted by an effective potential competitor, while others seem to think that limit pricing will sometimes be profitable for such incumbents and sometimes not be profitable for them but that the profitability of the practice does not depend solely on the height of the barriers to entry the best-placed, effective potential competitor faces.¹¹³² However, all limit-price theorists believe that limit pricing will always deter entry, will sometimes be more profitable than allowing entry to occur, and when it is more profitable than allowing entry to occur will be the most profitable way for established firms to deter entry. I will now explain why I reject all three of these claims.

¹¹³¹ I should also point out that Bain's explanation of the efficacy of limit pricing would not imply that limit pricing will tend to be more profitable than conventional profit-maximization when barriers to entry are moderate to substantial and less profitable than conventional profit-maximization when barriers to entry are low even if it did imply that the limit-price rate-of-return (Π_L) in a given market would increase with the barriers to entry into that market. More particularly, Bain's limit-price "theory" would not imply this result because there are good reasons to believe that the conventional-profit-maximizing rate-of-return in a given market will also increase with "the height of its barriers to entry" on Bain's definition. Thus, to the extent that Bain's absolute cost barriers to entry are positively correlated with what I call Π_D barriers to entry and expansion and Bain's scale barriers to entry are highly correlated with what I call the scale barrier to entry and expansion, the profit-maximizing rate-of-return in a given market would also be positively correlated with the height of its barriers to entry in Bain's sense of this concept. Hence, if I let Π_L stand for the limit-pricing rate-of-return (which on Bain's assumption that limit pricing will always deter entry will be constant through time) and Π_M stand for the conventional-profit-maximizing rate-of-return—which will equal the weighted-average of the before-entry conventional-profit-maximizing rate-of-return (Π_M^B) and the after-entry conventional-profit-maximizing rate-of-return (Π_M^A), more specifically which will equal $(c\Pi_M^B + d\Pi_M^A)/(c + d)$ where "c" is the length of the before-entry period and "d" is the length of the after-entry period—the strong, positive correlation between Π_L and Π_M implies that there is no reason to believe that (Π_L) will be higher than $(c\Pi_M^B + d\Pi_M^A)/(c + d)$ when barriers to entry are moderate to substantial and lower than $(c\Pi_M^B + d\Pi_M^A)/(c + d)$ when barriers to entry are low.

¹¹³² These scholars have not provided an account of the determinants of the profitability of limit pricing for established firms that confront an effective potential competitor.

With one partial exception,¹¹³³ limit-price theorists all assume that limit pricing will always deter entry. As I have already noted, because Bain assumed that the fact that a market's established firms were practicing limit pricing pre-entry would not affect the impact that entry would have on their prices, he believed that one could establish the inevitable efficacy of limit pricing arithmetically (at least if one assumed that the relevant potential entrants were sovereign maximizers). However, in a world in which the fact that an ARDEPPS' established firms were charging limit prices pre-entry will affect the post-entry price-change that is most profitable for them, Bain's type of arithmetic proof of limit pricing's efficacy will no longer work. To be fair, limit-price theorists have offered four non-arithmetic explanations for the supposed efficacy of limit pricing, and I can think of at least two others that deserve some attention. However, even if one takes account of the possibility that individual acts of limit pricing could tend to deter entry in more than one way, such pricing will clearly be far less effective at deterring entry than the limit-price theorists suppose.

Bain offered the first explanation of the supposed ability of limit pricing to deter entry—that limit pricing would deceive potential investors into underestimating the price the ARDEPPS' established firms could have charged pre-entry and hence would charge post-entry¹¹³⁴ (in my terms but not his, into underestimating the height of the ARDEPPS' Π_E curve—*inter alia*, the OCAs, NOMs, and COMs the established firms enjoyed or could have obtained pre-entry). I think that the current literature exaggerates the extent to which limit pricing can function in this way. Although limit pricing might totally deceive some potential competitors, there are several reasons for doubting that such deception would often take place. Thus, since the best-placed potential entrants into many ARDEPPSes are already-established firms in closely-allied fields, they will often know too much about the shape of the ARDEPPS' demand curve and the intensity of its price competition to be fooled by limit pricing. Indeed, even if the potential entrants do not discover the ruse themselves, the character of the ARDEPPS' prevailing price might very well be revealed to them (for a price—perhaps a superior job-offer) by a knowledgeable employee of an established firm in the ARDEPPS in question. The existence of interlocking directorates, the mobility of top-level management, and the huge sums that are currently spent on intercompany spying also support the conclusion that such deception could not succeed for long.

A second possibility, which Bain and others have ignored, is related to the first: even if limit pricing does not deter entry or expansions by deceiving the potential investors in question into underestimating the height of the relevant ARDEPPS'

¹¹³³ The exception is Darius Gaskins, who assumes that limit pricing will always reduce the probability that entry will occur. See Darius Gaskins, *Dynamic Limit Pricing: Optimal Limit Pricing Under Threat of Entry*, 3 J. ECON. THEORY 306 (1971).

¹¹³⁴ See Joe S. Bain, *A Note on Pricing in Monopoly and Oligopoly*, 39 AM. ECON. REV. 448, 453 (1949).

$H\Pi_E$ curve, it may deter risk-averse potential investors from making a QV investment by increasing their uncertainty about the height of the $H\Pi_E$ curve at the ARDEPPS' pre-entry QV-investment level (by increasing the risk barrier to entry or expansion). However, the fact that the relevant potential investors will almost always be well-established firms in the ARDEPPS in question or in closely-allied ARDEPPSes reduces the ability of limit pricing to function in this way as well by reducing both its ability to create such uncertainty and the relevant investors' risk-averseness.

Milgrom and Roberts proposed a third possible basis for the supposed deterrent effect of limit pricing—*viz.*, that limit pricing would deter entry by deceiving potential competitors into underestimating the established firms' costs.¹¹³⁵ For two reasons, I doubt that limit pricing would have much of an impact on entry for this reason. First, I think that artificially-low prices would be more likely to deceive potential investors into underestimating the established firms' OCAs and attainable NOMs and COMs than to induce them to underestimate the established firms' MCs. Second, since potential investors' post-entry profits will be directly determined by their rivals' post-entry prices rather than by their rivals' post-entry costs, their entry decision will be affected by their rival-cost underestimates only to the extent that (1) they lead them to underestimate the prices that the established firms would find conventionally-most-profitable post-entry, (2) they lead them to overestimate the probability that the established firms will respond to entry by engaging in a fight to the finish by making the potential investors underestimate their own chances of survival in such a battle, and (3) they induce them to spend resources to determine why their predicted costs are so much higher than their rivals' apparent costs—how they could improve their planned production and distribution techniques. Once more, the fact that the relevant potential investors will usually be well-established firms in the same or allied ARDEPPSes reduces both the likelihood that limit pricing will induce them to underestimate the established firms' costs and the extent to which any such induced underestimates would deter them from investing.¹¹³⁶

Bain also suggested a fourth way that limit pricing might deter entry—*viz.*, by communicating a threat that the established firms would retaliate against any new entrant. Although limit pricing could deter entry in this way, the force of this argument is vitiated by two considerations (even if we ignore the fact that limit

¹¹³⁵ Paul Milgrom and John Roberts, *Limit Pricing and Entry Under Incomplete Information: An Equilibrium Analysis*, 50 *ECONOMETRICA* 443 (1982).

¹¹³⁶ Milgrom and Roberts' article induced a response that argued that an established firm whose potential competitors were uncertain of their own likely costs might be able to deter entry by charging prices above its inherently-most-profitable price. I regard the suggestion that such behavior would tend to deter entry by inducing the relevant potential competitors to overestimate their costs as essentially silly since the relevant pricing would also tend to make them overestimate their prospective rivals' post-entry prices. See Joseph Harrington, *Limit Pricing When the Potential Entrant Is Uncertain of Its Cost Function*, 54 *ECONOMETRICA* 429 (1986).

pricing is an extremely-expensive way of communicating such a threat). First, limit pricing cannot simultaneously (1) communicate a threat and (2) deceive a potential investor into underestimating the price the established firms could succeed in obtaining pre-entry and post-entry or the costs the established firms had to incur to produce and distribute their products. Second, the efficacy of this kind of threat will obviously be lower when the relevant potential investors are already-established firms that have the financial wherewithal to withstand retaliation and a stake in avoiding a reputation of being deterrable.

I can think of a fifth way in which limit pricing could deter entry or expansions that is related to this threat-possibility. Limit pricing could deter such investments by increasing the credibility of the established firms' threat of retaliation by reducing the law-related costs the sellers in question will have to incur to carry out the threats in question. Thus, to the extent that established firms that are limit pricing can retaliate against a new entrant simply by maintaining their original limit price—*i.e.*, without responding to entry by reducing their prices, the practice of limit pricing will reduce the probability that their retaliation will lead to their being tried and/or convicted under the antitrust laws (and concomitantly the certainty-equivalent cost to them of retaliating). Obviously, the lower the cost of retaliation, the more believable any related threats, and the less attractive actual entry, other things' being equal.

Sixth and finally, some limit-price theorists have argued that limit pricing will deter entry by protecting the goodwill of the established firms. According to this group of theorists, limit pricing will protect the established firms' goodwill and thereby deny the potential entrant the opportunity "to establish the essential connection in the market, which is the condition *sine qua non* of the efficient and continuing manufacturer."¹¹³⁷ More specifically, they argue that "the general situation...is that so long as its price is right, an established firm will have a more or less clearly defined market, and would be protected from the efforts of would-be competing businesses to cut into the market."¹¹³⁸ "But in the event that the price is *not* right—then experience suggests not only that new competition will appear but at least as often as not the new competitor will succeed,"¹¹³⁹ for "the resentment of the buyers the price now revealed to have been not warranted by costs provides a reservoir of ill-will which, properly exploited, will ensure the new entrant access to the market."¹¹⁴⁰ In short, these limit-price theorists (1) implicitly

¹¹³⁷ ROY HARROD, *ECONOMIC ESSAYS* 125 (Macmillan, 1952).

Harry R. Edwards, *Price Formation in Manufacturing Industry and Excess Capacity*, 7 *OX. ECON. PAPERS* 94, 96 (1955).

¹¹³⁸ P.W.S. ANDREWS, *MANUFACTURING BUSINESS* 148 (Macmillan, 1949).

¹¹³⁹ Harry R. Edwards, *Price Formation in Manufacturing Industry and Excess Capacity*, 7 *OX. ECON. PAPERS* 94, 96 (1955).

¹¹⁴⁰ *Id.* at 97.

define a seller's goodwill in terms of the satisfaction customers obtain from providing the seller with income, (2) argue that goodwill will be positive if buyers believe that their supplier has given them "fair" terms but will become negative if buyers discover that the seller has been charging more than a "reasonable" markup over costs, (3) assume that buyers will always draw the latter inference if a new entrant offers them more attractive terms, and therefore (4) conclude that limit pricing will deter new entry by precluding new entrants from turning goodwill into bad. I find this goodwill argument almost totally unpersuasive, at least in the more generalized industrial context in which it has been made. Thus, although village butchers might very well possess the kind of goodwill on which the theory focuses, I doubt that many consumers place a positive value on the profits their purchases generate for major industrial concerns. Indeed, even if such goodwill were more pervasive than I believe, I would not be persuaded by this hypothesis, for (1) it is not at all clear to me why shoppers who are offered more attractive terms by a newcomer would not attribute this fact to the newcomer's lower costs or promotional pricing rather than to their previous supplier's "excessive" margins, and (2) large new entrants that want to undermine their established rival's goodwill might be able to do so in the face of limit pricing simply by sustaining short-run losses in order to establish a market position.

In sum, I do not think that limit pricing would deter entry nearly so effectively as the limit-pricing theorists have assumed. I will now explain why I think that the limit-price theorists exaggerate the frequency with which—if limit pricing would always deter entry—it would be more profitable than allowing entry to occur. I have already indicated that in three sets of circumstances sellers may find a practice that could properly be labeled limit pricing not only an effective deterrent to entry but a method of deterring entry that is more profitable than allowing entry to occur or deterring entry in any other way. These three cases aside, however, I do not think that limit pricing would be more profitable than allowing entry to occur even if it would effectively deter entry. Even if the number of best-placed potential competitors the established firms faced was sufficiently large to create a situation in which the potential competitor that would make the last entry that would be executed absent limit pricing or established-firm expansions would face the same barriers to entry that confronted the first potential competitor to enter the ARDEPPS in question during the analysis-period, limit pricing that was effective would not be more profitable than allowing entry to occur unless it would reduce the relevant potential competitors' certainty-equivalent expected rates-of-return by more than it reduced the limit pricers' rates-of-return. If limit pricing that reduced the supernormal rate-of-return the established firms realized on each of their QV-investment projects by $X\%$ —*i.e.*, from $(Y + X)\%$ to $Y\%$ —deterred all entry by reducing their best-placed potential competitors' certainty-equivalent expected rates-of-return by $X\%$, it would have no effect on the established firms' long-run rates-of-return even if the potential competitor that was best-placed to make the last entry that would be

made absent limit pricing or established-firm expansion would face the same barriers as the potential competitor that would otherwise have made the first entry. And if an $X\%$ limit-pricing-induced reduction in the established firms' rates-of-return deterred all entry by reducing all potential competitors' certainty-equivalent expected rates-of-return by $X\%$, it would reduce the established firms' long-run rates-of-return if the last entry that would otherwise have been made would have been introduced by someone that faced higher barriers than those that confronted the first entrant in the analysis-period (because at least one of the potential competitors that would have to enter to establish equilibrium QV investment would face higher barriers to entry than the [original] best-placed potential competitor faced). Hence, outside the three exceptional cases described previously, limit pricing would not be more profitable than allowing entry to occur unless its practice would reduce the potential competitors' expected certainty-equivalent rate-of-return by more than it reduces the limit pricers' actual rates-of-return.

I doubt that this condition will ever be fulfilled. Clearly, if limit pricing works by deceiving the potential competitors into underestimating the height of the relevant ARDEPPS' $H\Pi_E$ curve, this condition is unlikely to be fulfilled. The most favorable assumption one could make on this issue from the perspective of those who claim that limit pricing would be more profitable than allowing entry to occur is undoubtedly that such deception will reduce the potential competitors' estimates of the height of the relevant $H\Pi_E$ curve by the same amount that it reduces its practitioners' rates-of-return. Nor do things look brighter for the profitability of limit pricing if we shift to the other ways in which it could deter entry. Thus, limit pricing seems unlikely to increase the risk barrier to entry by creating uncertainty about the height of the $H\Pi_E$ curve by as much as it would reduce the incumbent's short-run rate-of-return—much less to increase the relevant short-run rate-of-return sufficiently to compensate for the effects of any tendency of the relevant barriers to entry faced by the last entrant in the analysis-period to exceed those facing the first. Similarly, although limit pricing that communicates a threat or makes the threat more credible will raise the potential competitors' retaliation barrier to entry, I doubt that the practice will increase this barrier as much as it reduces the established firms' rates-of-return. Indeed, I suspect that the profit-difference in question will virtually always exceed the profits the threat will enable the limit pricer to realize in other ways—*i.e.*, by practicing predation in other contexts, by contriving oligopolistic prices, and by undercutting or undermining its rivals' contrived oligopolistic prices. This conclusion is crucial because, as already mentioned, these threat-effects are alternatives to the deception-effect first considered—*i.e.*, will not be present for any potential competitor that limit pricing deceives into underestimating the height of the relevant ARDEPPS' $H\Pi_E$ curve. Moreover, as I have already indicated, although the goodwill argument can be combined with any of the above possibilities, I doubt its empirical importance. Nor do I find it conceivable that limit pricing will decrease

the relevant potential entrant's expected supernormal rate-of-return by more than it will reduce the limit pricers' rates-of-return by performing any combination of the above functions that it could simultaneously perform.

In short, in my judgment, unless one is dealing with (1) a relatively inefficient producer in a business niche whose profit-potential is seriously underestimated, (2) a seller that fears that more accurate information about the profit-potential of its ARDEPPS will lead to a frenzy of QV-investment activity that will raise ARDEPPS QV investment above its equilibrium level, or (3) a seller that believes that, if its limit pricing deters an entry or expansion in the short run, it will raise the barriers faced by the best-placed potential entrant or expander in its ARDEPPS (and hence its limit price) because the potential competitor or expander that was originally best-placed to add a QV investment to the relevant ARDEPPS will become worse-placed to do so over time, perhaps because it will use elsewhere the financial, managerial, and/or non-managerial labor resources it would have used to execute its entry into or QV-investment expansion in the relevant ARDEPPS in the short run, limit pricing would virtually never be more profitable than allowing entry to occur even if it were effective. (Recall: I do not think that the practice in which a seller reduces its price to a buyer to deter the latter from integrating backwards should be called "limit pricing.")

I turn now to the possibility that, even if limit pricing would be both effective and more profitable than allowing entry, it would not be more profitable than other entry-detering strategies. In practice, I expect that limit pricing will almost never be as profitable as other means of deterring entry. Thus, even if limit pricing could successfully communicate a threat, sellers would probably prefer to communicate threats verbally or by reducing their prices for a short time in response to specific rumors that entry was being contemplated. Similarly, even if limit pricing could increase goodwill, sellers would probably find it more attractive to accomplish this result by providing superior service. Indeed, despite the risk of prosecution, established firms would probably find buying off or buying up a potential competitor preferable to limit pricing. Most important, however, I suspect that sellers will almost always find it more profitable to deter entry by making one or more QV investments themselves—*i.e.*, by making what I call limit investments, QV investments that would not be profitable but for their tendency to reduce the amount of QV investments others make in the ARDEPPS in question. Since many types of limit investments (for example, an investment in a new product variant or in capacity) are not really rescindable in the way in which limit-pricing price-cuts can be reversed, they clearly will tend to deter entry by reducing the potential entrant's prospective OCAs and increasing its costs by reducing its sales and hence its ability to take advantage of economies of scale in production and distribution. Since any potential entrant that is deterred by limit investments would have expected to realize at least a normal rate-of-return on its investment had the limit investment not been executed, an established firm will find it profitable to make a

limit investment of \$X that will deter someone else's QV investment of \$X unless the difference between the barriers to expansion it faced and the barriers to entry facing the potential competitor whose entry its expansion would deter exceed the sum of (1) the supernormal profit-rate the deterred potential competitor would otherwise have realized on its entry and (2) the amount by which the limit investment's actual rate-of-return was increased by the fact that its execution would reduce (in comparison with the *status quo ante*) the nominal profits the limit investor's pre-existing projects would generate in the future by less than those profits would otherwise have been reduced by the new entry (or rival expansion) it deterred. Unless one is dealing with an ARDEPPS in which demand is growing or costs are falling extremely rapidly, established firms will virtually always find limit investments that deter the same amount of QV investment that they create privately profitable.

In short, (1) limit pricing will be a far-less-effective deterrent of entry or expansion than the limit-pricing theorists claim; (2) except in three very special cases, limit pricing would almost certainly not be more profitable than allowing entry to occur even if it were as effective as its "supporters" assert; and (3) even if limit pricing were as effective as limit-price theorists claim and would be more profitable than allowing entry to occur, it would almost certainly not be so profitable as various alternative moves the relevant established firms could make to deter entry or expansion.¹¹⁴¹ Although these conclusions would be surprising if there were a substantial body of direct evidence that established firms threatened with entry did engage in limit pricing or if limit-price theorists had confirmed their theory through some other type of valid empirical procedure, no such direct evidence or sound empirical test exists. To my knowledge, no-one (no limit-price theorist and no-one else) has ever described a case in which an established firm practiced limit pricing: the historical stories that have been provided are all accounts of limit investing. Limit-price "theory" is a "theory" in search of a phenomenon. And the supposed empirical tests of limit-price theory—which claim to be testing the theory by demonstrating that, controlling for seller concentration, rates-of-return increase with barriers to entry¹¹⁴²—are no tests of the theory at all since the relevant relationship would obtain (assuming away the problematic character of any related market definitions and the somewhat related dubiousness of the relevance of seller concentration) regardless of whether the sellers in question limit priced or charged conventional-profit-maximizing prices.

¹¹⁴¹ Rather than confronting the deficiencies of limit-price theory, academic economists have tried to rescue it by building stochastic limit-pricing models (which claim that limit pricing reduces the probability of entry). See Darius Gaskins, *Dynamic Limit Pricing: Optimal Limit Pricing Under Threat of Entry*, 3 J. ECON. THEORY 306 (1971).

¹¹⁴² See BAIN BARRIERS at 182–204.

6. The Reasons Why It May Be More Profitable to Prevent Entry by Merging With the Potential Competitor Than by Bribing It Not to Enter and/or Threatening to Retaliate Against Its Entry, the Relevance of the Fact That a Conglomerate Merger Eliminates an Effective Potential Competitor to Its Legality Under the Sherman and Clayton Acts, Correctly Interpreted, and the U.S. Courts' and the Antitrust-Enforcement Agencies' Positions on This Legal Issue

A. The Reasons Why It May Be More Profitable to Prevent Entry by Merging With the Potential Competitor Than by Bribing It Not to Enter and/or Threatening to Retaliate Against Its Entry

Why might it be more profitable to eliminate an effective potential competitor by merging with it than by deterring its investment by paying it a bribe or threatening it with retaliation or allowing the entry to take place? The merger will be more profitable than deterring the new entry by paying the potential competitor a bribe (not accompanied by a threat of retaliation) if the following sum is positive:

- (1) the gains the merger will confer on the merger partners by generating efficiencies, by creating a merged firm whose buying power exceeds the sum of the MPs' buying power, by creating a merged firm that can earn more profits through contrivance and predation, and in the other ways that conglomerate mergers can yield profits than the MPs could have done *minus*
- (2) the loss the merger generates by creating a merged firm that is less efficient in specific ways than the MPs were and generating risk costs that are unrelated to the possibility that the potential competitor may accept the bribe and enter anyway *minus*
- (3) the certainty-equivalent cost the briber incurs because the potential competitor may accept the bribe and enter anyway *minus*
- (4) any positive difference between the mechanical transaction cost of the merger and the mechanical transactions cost of the bribe *minus*
- (5) any positive difference between the law-related cost of the merger and the law-related cost of the bribe.

The merger will be more profitable than deterring the new entry by threatening the potential competitor with retaliation and, if necessary, carrying out that threat if the following sum is positive:

- (1) the gains the merger will confer on the merger partners in the ways listed in item (1) of the immediately-preceding list *plus*
- (2) the gains that the threats and associated acts of retaliation will confer on the incumbent if they succeed in deterring the new entry by strengthening its reputation for engaging in successful strategic conduct *minus*

- (3) the loss the merger generated by creating a merged firm that is less efficient in specific ways than the MPs were and by generating risk costs that are unrelated to the possibility that the threats and acts of retaliation may fail to deter the new entry *minus*
- (4) the certainty-equivalent cost the incumbent incurs because its threats and acts of retaliation may not deter the new entry (which includes the cost it incurs because the episode weakens its reputation for engaging in successful strategic conduct) *minus*
- (5) any positive difference between the mechanical transaction cost of the merger and the mechanical transaction cost of the threats *minus*
- (6) the cost to the incumbent of any retaliation it must engage in (which includes both mechanical costs and the loss it would have to incur to retaliate even if the retaliation were mechanically transaction-costless) *minus*
- (7) any positive difference between the law-related cost of the merger and the law-related cost of the threat of retaliation and any associated acts of retaliation (a difference that might be negative).

The merger will be more profitable for the incumbent than allowing entry to occur if the following sum is positive:

- (1) the difference between the amount by which the potential competitor's entry would reduce the merger-partner incumbent's profits and the supernormal profits the new entrant would realize on its new entry *plus*
- (2) the gains the merger would confer on the merger partners by generating efficiencies, by creating a merged firm whose buying power exceeds the sum of the MPs' buying power, and by creating a merged firm that profits more from contrivance and predation than the MPs would have done *minus*
- (3) the loss the merger generates by creating a merged firm that is less efficient in specific ways than the MPs were and by generating risk costs *minus*
- (4) any supernormal profits the potential competitor would earn on the merger (the potential competitor might actually realize a loss on the merger if the incumbent threatened it with retaliation if it did not agree to the merger) *minus*
- (5) the transaction cost of the merger *minus*
- (6) the law-related cost of the merger.

Admittedly, it will often be more profitable to use a combination of anticompetitive offers (bribes) and threats of retaliation to deter the entry of a uniquely-effective potential competitor than to merge with or acquire it. Still, there clearly will be many situations in which the most profitable way to deter such a potential competitor's entry will be to merge with it or acquire it.

B. The Relevance of the Fact That a Conglomerate Merger Eliminates an Effective Potential Competitor to Its Legality Under the Sherman and Clayton Acts, Correctly Interpreted

Three points are salient. First, although the profits that a conglomerate merger yields its participants by eliminating an effective potential competitor of one or both of the MPs in question (in the latter case, when each MP was a potential competitor of the other [in different markets]) are Sherman-Act-illicit, the fact that a conglomerate yields Sherman-Act-illicit profits in this way will not cause it to violate the Sherman Act unless the MPs' *ex ante* perception that their merger was *ex ante* profitable was critically affected by their belief that it would or might yield them profits by eliminating one or both as a potential competitor of the other. This condition for "criticality" will not be satisfied if (1) the MPs believed *ex ante* that their merger would yield sufficient profits legitimately (e.g., by generating static and/or dynamic efficiencies, tax advantages, or benefits to an MP-owner who wanted to increase the liquidity of his assets and/or escape his managerial responsibilities) to be *ex ante* profitable on that account or (2) if the MPs believed *ex ante* that although their merger would not generate sufficient Sherman-Act-licit profits to be *ex ante* profitable on that account the Sherman-Act-licit profits it would yield and the Sherman-Act-illicit profits it would yield by enabling them to increase their COMs, to increase the retaliation barriers to QV investing they erected against their rivals, and to practice predation more profitably—even if it did not eliminate an effective potential competitor—would render it *ex ante* profitable.

Second, although the fact that a conglomerate merger eliminates an effective potential competitor of one or both MPs counts against its Clayton Act legality since the elimination of such a competitor will tend to inflict an equivalent-dollar loss on Clayton-Act-relevant buyers by reducing the absolute attractiveness of the best offer they respectively receive from any inferior supplier, it will not critically affect the Clayton Act legality of the merger in question unless it causes a merger that would not otherwise have inflicted a net equivalent-dollar loss on Clayton-Act-relevant buyers to do so. This criticality-condition is salient because even conglomerate mergers that eliminate an effective potential competitor can generate sufficient static and dynamic efficiencies for it not to inflict a net equivalent-dollar loss on Clayton-Act-relevant buyers.

Third, the "defendant-do-nothing" baseline for measuring the competitive impact and hence legality of conduct covered by the Clayton Act can also critically affect the Clayton Act legality of conglomerate mergers that eliminate one or more potential competitors. Thus, this feature of the Clayton Act approach to measuring a business choice's competitive impact implies that an effective-potential-competitor-eliminating conglomerate merger whose substitution for no conglomerate merger at all would not impose a net equivalent-dollar loss on Clayton-Act-relevant buyers by reducing the absolute attractiveness of the best offer they respectively received from any inferior supplier would not violate the Clayton Act even if the prohibition of the proposed or consummated merger in question would have conferred an

equivalent-dollar gain on Clayton-Act-relevant buyers by inducing the “acquiring” firm to execute a more procompetitive conglomerate merger with a different potential competitor (a more procompetitive merger that would have yielded more static and dynamic efficiencies but would have deterred an entry that would have been less competitive with the “acquiring” firm’s projects than the entry that was/would have been deterred by its consummated/proposed merger) or with a firm that was not one of its potential competitors.

C. The U.S. Courts’ and the DOJ/FTC’s Position on the Legal Relevance of the Fact That a Conglomerate Merger Eliminates an Effective Potential Competitor and on the Economic-Efficiency Issues and Failing-Company Issues That Have Arisen or Could Arise in Such Potential-Competition Conglomerate-Merger Cases

(1) The U.S. Courts’ Positions

U.S. courts seem to have fully accepted the limit-price theorists’ central claims that limit pricing will always deter entry, that limit pricing will be more profitable than allowing entry to occur in a broad range of circumstance, and that limit pricing will be the most profitable way for established firms to deter entry. In a series of cases in the 1960s and early 1970s, U.S. courts endorsed limit-price theory, which they denominated “wings theory” (the reference was to firms’ waiting just offstage in the theatrical “wings”) or “edge” theory (where the misleading reference is to firms’ waiting at the edge of a market, misleading because an ARDEPPS’ best-place potential competitor may not currently be operating at its edge).¹¹⁴³ Lower U.S.

¹¹⁴³ The first case in which the Supreme Court used the expression “potential competition”—United States v. El Paso Natural Gas Co., 376 U.S. 651 (1964)—actually involved a misuse of the expression to cover an actual rival that had already unsuccessfully bid against the acquiring firm. The Supreme Court used the expression correctly in *FTC v. Procter & Gamble Co.* (Clorox), which involved a merger between (1) a manufacturer of household products including laundry detergent but not bleach that was allegedly the best-placed potential entrant into the bleach market and (2) the leading manufacturer of bleach. The notion of potential competition also played a significant role in *United States v. Falstaff Brewing Co.*, 410 U.S. 526 (1973)—the geographic-diversification conglomerate-merger case discussed in Sect. 4C. Perhaps most importantly, limit-price theory (in fact, an even more dubious misperceived-potential-competitor variant of limit-price theory) played a critical role in the joint-venture case *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158 (1964). In that case, the Court found a joint venture to violate Section 7 of the Clayton Act (which actually does not apply to joint ventures) on the ground that, if it did not take place, one of the parents would have entered the market the joint venture would have entered (which, apparently, one parent would have done) while the other parent’s continuing presence as a potential competitor—indeed, as a potential competitor that the market’s established firms would have incorrectly believed would enter if they did nothing to prevent its entry—would have induced the established firms to limit price to keep it out. (The Court implicitly

courts have never given any indication that they are aware of the deficiencies of limit-price “theory”—*i.e.*, continue to appear to subscribe to it. However, post-1973, U.S. courts have been less willing to conclude that particular potential entrants were in fact effective¹¹⁴⁴ and have left the impression that they would recognize a potential competitor to be effective only if convincing evidence were introduced establishing that the potential competitor in question intended to act on well-developed independent-entry plans if it could not gain entrance to the target ARDEPPS through merger or acquisition.¹¹⁴⁵ I hasten to add, however, that post-1980, the government has sometimes won conglomerate-merger cases in lower courts on the ground that the merger in question would eliminate an effective potential competitor.¹¹⁴⁶

U.S. courts have never addressed the general issue of when potential competition will be effective or when limit pricing will be practiced. Nor have they ever focused on Bain’s contentions (1) that potential competition will not be effective when barriers to entry are high¹¹⁴⁷ or (2) that limit pricing will be practiced if but only if the best-placed potential competitor faces moderate to substantial barriers to entry. Relatedly, U.S. courts have not recognized that this latter claim—which, as I noted, is inconsistent with Bain’s claims about the efficacy and profitability of limit pricing—implies that horizontal mergers that would raise the conventional-profit-maximizing prices of the MPs and their *R*s will not reduce competition on that account if the barriers facing the best-placed potential competitor for the market in question are moderate to substantial since the incumbents in question will practice limit pricing in such situations and (on Bain’s account) the merger will not alter the limit price. U.S. courts have also not noticed that limit pricing would almost certainly be illegal if it were ever practiced. As described by the proponents of limit-price theory, limit pricing involves one or more sellers’ setting lower-than-conventionally-profitable prices to increase their profits in the long run by reducing the absolute attractiveness of the best offers against which they will have

assumed—probably correctly—that, if the joint venture had gone forward, the parents’ stake in it would have made it unprofitable for them to enter its market independently even if the joint-venture agreement did not prohibit them from doing so.)

¹¹⁴⁴ See, *e.g.*, *United States v. Marine Bancorporation*, 418 U.S. 602 (1974), where the cause of skepticism was state and federal regulations against branching in the banking industry, and *Tenneco, Inc. v. FTC*, 689 F.2d 346 (2d Cir. 1982), where the cause of skepticism was high barriers to entry.

¹¹⁴⁵ HOVENKAMP at 300.

¹¹⁴⁶ See, *e.g.*, *Yamaha Motor Co. v. FTC*, 657 F.2d 971 (9th Cir. 1981).

¹¹⁴⁷ Indeed, even those U.S. courts that recognize the possibility that a potential competitor that would face high barriers to entry for an independent entry might be able to reduce the barriers it faced by executing a toe-hold conglomerate merger do not seem to recognize that the effectiveness of a best-placed potential competitor depends not on the absolute height of the barriers to entry it faces but on the relationship between the height of the barriers to entry it faces and the sum of the barriers to expansion and QV-investment disincentives that would face the ARDEPPS’ best-placed potential expander at its entry-barred expansion-preventing QV-investment level. See *Tenneco, Inc. v. FTC*, 689 F.2d 346 (2d Cir. 1982).

to compete by deterring the entry of a potential competitor. As I indicated in Chap. 11, such pricing would appear to be a textbook example of predatory pricing, which is prohibited by the Sherman Act. Admittedly, one might contest this claim by pointing out that, unlike predatory price-cuts, which the predator can reverse after its target has exited, limit-pricing price-cuts cannot be profitably reversed post-deterrence or, at least, could not be profitably reversed if the effective potential competitor did not increase the $(\Pi_D + R)$ barriers it faced by allocating to some other project the resources it was originally going to use to enter the market in question. I am not persuaded by this counterargument (1) partially because in practice best-placed potential competitors will tend to allocate to other projects the resources they were planning to devote to entry but (2) primarily for the formalist reason that the asserted fact does not alter the reality that limit pricing satisfies all of the Sherman Act's formal requirements for illegality.

One 1962 Supreme Court potential-competition conglomerate-merger opinion—*Procter & Gamble*¹¹⁴⁸—did address the legal relevance of the “efficiencies” that the merger in question reputedly would generate and concluded that those efficiencies counted against the merger’s legality. However, I am confident that contemporary U.S. courts would reach the opposite conclusion about any real efficiencies that a potential-competition-eliminating conglomerate merger would generate. This element of the *P&G* opinion primarily reflected the now-outdated judicial view of the 1960s that the efficiencies that any type of conduct generated would tend to reduce competition by inducing the actor’s established competitors to exit (by worsening their array of competitive positions) and by deterring potential entrants to and potential expanders in the actor’s market from making a QV investment (by worsening such potential investments’ prospective arrays of competitive positions). It also reflected the *P&G* Court’s view that some of the “efficiencies” in question would be purely private (would reflect the fact that the merged firm would have more bargaining power than Clorox) and that the other efficiencies the merger would generate would stem from P&G’s ability to profit more than Clorox from engaging in misleading advertising (about the superiority of the Clorox product). (I should add that the latter fact would be irrelevant to the economic-efficiency impact of the efficiencies in question if the relevant private gain reflected the fact that the merged company could place the same quantity of advertising at lower private and allocative cost but would be relevant to the associated economic-efficiency gain to the extent that it reflected the fact that the profits in question reflected P&G’s finding it profitable to place more such advertisements than Clorox did.)

Finally, to my knowledge, no U.S. court has ever addressed the legal significance of the fact that a potential-competitor-eliminating conglomerate merger involved a failing company. The absence of opinions on this point partly reflects the fact that a failing company cannot be an effective potential competitor of its acquirer, but some

¹¹⁴⁸ *FTC v. Procter & Gamble Co. (Clorox)*, 386 U.S. 568 (1967).

cases in this category must involve a conglomerate merger in which the acquiring firm is a potential entrant into a failing company's market. I am confident that U.S. courts will handle the failing-company issue in such cases in the way that *Citizen Publishing Co.* and the 1992 and 2010 U.S. Horizontal Merger Guidelines recommend. My critique of this approach applies *mutatis mutandis* in the current context.

(2) The DOJ's and FTC's Positions

Six points are salient. First, in a substantial number of cases, including those cited in the preceding six footnotes, the DOJ or FTC argued that the fact that a conglomerate merger (or joint venture) would or did eliminate an effective potential competitor rendered it illegal under U.S. antitrust law. Second, in its 1997 review of Bell Atlantic Corporation's proposed acquisition of Nynex Corporation, the government was concerned that Philadelphia-based Bell Atlantic would enter the New York market independently if it were not allowed to merge with Nynex. Third, between 1996 and 2003, the FTC issued second requests in 12 potential-competition conglomerate-merger cases asking for information about the possibility that the mergers in question might reduce competition by eliminating an effective potential competitor. Fourth, the Agencies' arguments in several pre-1992 potential-competition conglomerate-merger cases accepted limit-price theory, and the DOJ's 1984 Conglomerate Merger Guidelines assumed that limit-price theory was correct as a matter of economics. Fifth, as I stated in Chap. 12, both the 1992 and the 2010 Horizontal Merger Guidelines seem to me to reject limit-price theory, and, to my knowledge, the Agencies have not made a limit-price-theory argument since the 1992 Guidelines' publication. Sixth, the 1984 Conglomerate Merger Guidelines make a number of other potential-competition-related assumptions and claims that the DOJ and FTC have never disavowed that are both wrong and undermine the Agencies' positions on a broader range of business conduct:

- (1) assume that potential competition will not be able to induce established firms to lower their prices unless the relevant ARDEPPS' seller concentration is conducive to monopolization and collusion—an assumption that ignores the fact that firms that could not be considered to be monopolists can find it profitable to charge supra-competitive prices even if they do not engage in predation or contrivance (because they can possess OCAs and obtain NOMs without engaging in predation);
- (2) assume that firms will be able to profit by engaging in predation or contrived oligopolistic pricing only if the ARDEPPS' concentration is high or its leading firm's market share is high;
- (3) assume that an individual potential competitor is unlikely to be effective if three or more other firms are better-placed or equally-well-placed to enter or if other firms that are worse-placed to enter will enter unless the evidence that the firm

in question will enter is “particularly strong”—assumptions that respectively ignore (A) the fact that more than three firms can be effective potential competitors (when actual QV investment is more than three QV investments below current or future equilibrium QV investment) and (B) the fact that a firm’s willingness to enter if it is not “eliminated” through merger or acquisition does not guarantee that it was effective; and

- (4) assume that an individual potential competitor will not be effective if another potential competitor would be willing to replace any QV investment the firm did not make (an assumption that will be wrong if the eliminated potential competitor would have executed its entry sooner than its entry would be replaced by the entry of a fellow potential competitor).

7. The Legality of Conglomerate Mergers Under E.C./E.U. Competition Law, Both as Correctly and as Actually Interpreted and Applied

A. The Legality of Conglomerate Mergers Under E.C./E.U. Competition Law as Correctly Interpreted and Applied

The various provisions of E.C./E.U. competition law that apply to horizontal mergers apply in precisely the same ways to conglomerate mergers. In particular, the EMCR and its Clayton-Act-type lessening-competition test are fully applicable to conglomerate mergers; now-Article 102 and both its Sherman-Act-type exclusionary-abuse test and its unique exploitative-abuse test apply to conglomerate mergers at least one of whose participants is individually or collectively dominant; and now-Article 101 and both its “*object* of preventing, restricting, or distorting competition” test and its “*effect* of preventing, restricting, or distorting competition” test apply to all conglomerate mergers if my interpretation of now-Article 101(1) is correct and to those conglomerate mergers that are requisitely likely to create a merged company that will engage in more contrived oligopolistic or predatory conduct than its participants would otherwise have done if, contrary to my view, it would be legally correct to read the “clause (a)–(e)” list in now-Article 101(1) to be comprehensive.

As I indicated in Chap. 4, although I am certain that—properly interpreted—the Clayton Act would be read to prescribe a do-nothing baseline for competitive-impact measurement, I am not certain whether it would be correct as a matter of the E.C./E.U. competition law to interpret now-Article 101(1) and the EMCR to prescribe the use of that baseline.

B. The Legality of Conglomerate Mergers Under E.C./E.U. Competition Law as Actually Interpreted and Applied

(1) The EC's and the E.C./E.U. Courts' Positions on the Ways in Which Conglomerate Mergers Can Lessen Competition and the Kinds of Procompetitive Economic Efficiencies That Conglomerate Mergers Can Generate

The discussion that follows takes into consideration the way in which, prior to 2008, the EC addressed and resolved cases about mergers and acquisitions it classified as conglomerate (see below), the CFI's and ECJ's review of those EC decisions on appeal, the relevant portions of the 2008 EC Guidelines on the Assessment of Non-Horizontal Mergers Under the Council Regulation on the Control of Concentrations Between Undertakings (hereinafter 2008 EC Non-Horizontal Merger Guidelines)¹¹⁴⁹—which the EC promulgated at least in substantial part to reconcile its position to the courts', and the post-2008 EC conglomerate-merger decisions.

Prior to 2008, the CFI and ECJ both agreed (1) that conglomerate mergers were far less likely than horizontal concentrations to impede effective competition significantly and (2) that mergers they classified as conglomerate could reduce competition in four different ways. I will initially list and then comment on the four ways in which the EC and the E.C./E.U. courts claimed and continue to believe that conglomerate mergers can lessen competition.

First, both the EC and the E.C./E.U. courts assert that mergers they classify as conglomerate because, at the time of the merger's proposed execution, its participants were not both well-placed to obtain the patronage of any individual buyer and were not in a vertical relationship with each other will reduce competition if foreseeable changes in buyer preferences and/or production and distribution marginal costs would cause both to be well-placed to secure the patronage of one or more individual buyers—*i.e.*, if for this reason the merger would reduce competition by eliminating future competition between the participants.¹¹⁵⁰ Although I agree with this conclusion, such mergers should be classified as horizontal mergers and would be so classified in the U.S.

Second, both the EC and the E.C./E.U. courts believed prior to 2008 and continue to believe that conglomerate mergers and acquisitions will tend to lessen competition to the extent that the business entity they create will be more able to use

¹¹⁴⁹ OJ C 265/07 (2008). The relevant portions are Section II—Overview (points 10–22), Section III—Market Share and Concentration Levels (points 23–27), and Section V—Conglomerate Mergers (points 91–121).

¹¹⁵⁰ See, *e.g.*, Tetra Laval/Sidel, M2416, OJ L43/13 (2004) and Commission v. Tetra Laval, C13/03, ECRI-1113 (2005). I am glad to say that no mention of this possibility is made in the 2008 EC Non-Horizontal Merger Guidelines.

tying agreements or engage in additional bundling to foreclose competition.¹¹⁵¹ Somewhat more specifically, both prior to 2008 and now the EC and the E.C./E.U. courts believe that, if the conglomerate merger creates an entity that has “a significant degree of market power, which does not necessarily amount to dominance in one of the markets concerned,”¹¹⁵² any additional tie-ins and bundling that the conglomerate merger causes their participants to use may enable the conglomerate both to “gain...market power in the tied goods market” and to “protect...[its] market power in the tying goods market.”¹¹⁵³ I consider this claim to be almost totally unwarranted for reasons that Chap. 14’s critique of the related leverage theory of tie-ins and reciprocity explains.

As I will argue then, the leverage theory is based on the clearly-false premise that a firm that enjoys competitive advantages when selling one product to a particular buyer (regardless of whether it is a dominant firm or the product in question is a “leading brand” or a “must stock item”) can somehow increase the profitability of inducing relevant buyers to make concessions to it by accepting disadvantageous terms of sale on other products or by accepting other disadvantageous obligations (say, not to deal with the seller’s rivals) by conditioning its sale of the first product to the buyer in question on the buyer’s accepting these other unfavorable terms of sale or other obligations—a premise that in essence assumes that the relevant sellers can have their cake and eat it too (can extract these concessions without making concession on the first product, on which they enjoy competitive advantages). As we shall see, tie-ins and bundling can perform many functions for their employers, will often increase economic efficiency, and will not generate the kind of leverage with which this theory is concerned even when the benefits they yield are purely private. Moreover, even if I grant that a few tie-ins (*viz.*, a few tie-ins that impose a long-term full-requirements obligation on the other party whose imposition is not inherently profitable) might be exclusionary, the probability that a given tie-in of the relevant type will fall into this category has little to do with the tying seller’s market power in or its share of the so-called tying-product market. This conclusion reflects the following facts: (1) the crucial question is whether the tie-ins in question leave “un-locked-up” enough suppliers or distributors to enable others to operate proficiently, (2) even if all suppliers and all distributors were fungible, the answer to this question would depend not on the percentage of them that are locked-up but on the quantity not locked-up relative to the quantity of inputs or distributorship-services the potentially-excluded firm requires, and (3) not all input suppliers or distributors are fungible, so that the actual answer depends on the relative quantities of available, appropriate (best-placed or well-placed) inputs and distributorship-services. Moreover, the preceding discussion implicitly assumed that potentially-excluded competitors would be restricted to purchasing inputs or distributive services from

¹¹⁵¹ See, *e.g.*, *General Electric v. Commission*, Case T-210/01, ECR II-000 ¶¶ 327, 362–63, 405 (2005); *GE/Amersham*, Case COMP/M. 3304, points 35 and 37 (2004); and *GE/Smiths Aerospace*, Case COMP/M. 4561, points 116–26 (2007), OJ C 133/02 (2007).

¹¹⁵² This position was reiterated by the EC in its 2008 Horizontal Merger Guidelines at point 99.

¹¹⁵³ This position was reiterated by the EC at *id.* at point 108.

extant independents. In reality, even if such a firm were prevented from using suitable extant independents, it might be able to overcome this problem by entering on its own, participating in a joint-venture entry, or inducing an independent entry (by providing information, direct monetary subsidies, and/or long-term full-requirements purchase or supply guarantees to independent entrants). Although the EC and the E.C./E.U. courts recognize the relevance of truly-independent entry and the possibility that a firm that would otherwise be foreclosed might be able to facilitate an entry by an independent firm, they do not devote appropriate attention to the possibilities that a firm that would otherwise be injured by foreclosure could reduce or eliminate the loss in question by entering itself or as a parent of a joint venture. Admittedly, the 2008 EC Non-Horizontal Merger Guidelines do mention other “counterstrategies” such as changing production processes to reduce dependence on a foreclosed input or deciding “to price more aggressively to maintain market share.”¹¹⁵⁴ However, I suspect that the first of these options will rarely be available and the second will rarely be efficacious. One final law-related point is relevant in this context. If the additional tie-ins and bundling that a conglomerate merger would cause its participants to use not only would have the *effect* of reducing competition but would have reducing competition as their *critical object* (i.e., would be exclusionary), that fact would reduce to the persuasiveness of the tie-ins/bundling arguments against the legality of conglomerate mergers in that the illegality of the feared merger-induced conduct (1) should call into question the assumption that the merger will create a merged firm that will engage in the conduct and (2) raises the possibility that the legally-appropriate response to the risk that a conglomerate merger will lead the resulting company to use additional exclusionary tie-ins is to bring cases against it if it does rather than to prohibit the merger.

So far, I have been critical of this tie-in/bundling leverage-argument against conglomerate mergers. I should admit that the EC’s and the E.C./E.U. courts’ discussions of this possibility gets some things right. In particular, the EC and the E.C./E.U. courts are correct in arguing that, for the tie-ins to foreclose there must be a “large common pool of customers for the products concerned,”¹¹⁵⁵ the products will usually have to be bought simultaneously by the same customers,¹¹⁵⁶ and the arrangements must be “lasting.”¹¹⁵⁷ The EC’s and the E.C./E.U. courts’ claim that for tie-ins to foreclose they must cover “a sufficiently large fraction of market output” to “significantly impede effective competition,”¹¹⁵⁸ *inter alia*, by precluding extant firms or potential competitors from taking advantage of economies of

¹¹⁵⁴ *Id.* at point 103.

¹¹⁵⁵ This position was reiterated by the EC at *id.* at point 100.

¹¹⁵⁶ This position was reiterated by the EC at *id.* at point 98, citing GE/Amersham, point 35 Case COMP./M. 3304 (2004).

¹¹⁵⁷ This position was reiterated by the EC at EC 2008 Non-Horizontal Merger Guidelines at point 102.

¹¹⁵⁸ This position was reiterated by the EC at *id.* at point 113.

scale or network effects¹¹⁵⁹ is less persuasive, given the non-fungibility of all input suppliers on the one hand and all resellers on the other.

Third, both prior to and after 2008, the EC and the E.C./E.U. courts claimed that conglomerate mergers and acquisitions can lessen competition by generating what they seem to regard to be two other, “exclusionary” “portfolio effects”—*i.e.*, will enable the resulting company to gain advantages by threatening to withdraw supplies of both participants’ products from buyers who want to purchase both participants’ products (particularly when at least one of the products in question is a “leading brand”) and will enable the resulting company to take advantage of economies of scale and scope whose realization will cause rivals to exit and/or reduce competition by raising barriers to entry.¹¹⁶⁰ It might have been appropriate for me to enquote the word “third” with which this paragraph began because the first of these “portfolio effects” fears is really just the negative counterpart of the tie-in/bundling concern—*i.e.*, the concern that a seller can obtain leverage by refusing to supply two or more products to a given buyer is the negative counterpart of the concern that a seller can obtain leverage by requiring buyers to purchase two or more products from it. Chapter 14’s critique of the leverage theory of tie-ins applies *mutatis mutandis* to this portfolio concern. I should add that, although neither the EC nor the E.C./E.U. courts have explained why the economies of scale and scope that a conglomerate merger or acquisition can generate can reduce competition by inducing one or more rivals to exit or deterring rival QV investments, such economies can reduce competition both in these ways by worsening an established firm’s competitive-position array and by critically raising the barriers to QV investment facing one or more otherwise-effective potential QV investors by worsening their prospective competitive-position arrays. However, not only have the EC and the E.C./E.U. courts failed to delineate the conditions under which either such outcome would eventuate, their assumption that any tendency of a conglomerate merger or acquisition to generate such effects counts against its legality is inconsistent with their general insistence that E.C./E.U. competition law does not prohibit even dominant firms from competing on the merits. (I have not said that this assumption is inconsistent with the EC’s and E.C./E.U. courts’ assertion that the economic efficiencies a conglomerate merger or acquisition yields favor its legality because that assertion may reflect an implicit premise that the efficiencies in question will benefit relevant buyers.)

Fourth, the EC and the E.C./E.U. courts are also concerned that conglomerate mergers can increase competition-lessening coordination (contrivance in my terms) in the areas of product-space in which their participants operate (1) by reducing the number of effective competitors¹¹⁶¹ (presumably by leading to additional,

¹¹⁵⁹ This position was reiterated by the EC at *id.* at point 101.

¹¹⁶⁰ See, *e.g.*, Commission v. Tetra Laval, C-13/03, ECR I-1113 (2005) and Tetra Laval v. Commission, Case T-502, ECR II-4381, ¶¶ 150–55 (2002). See also General Electric v. Commission, Case T210/01, ECR II-5575, 65–76 (2005).

¹¹⁶¹ 2008 EC Non-Horizontal Merger Guidelines at point 120.

exclusionary tie-ins and bundling, by generating analogous portfolio effects, and by yielding economies of scale and scope)—*i.e.*, the number of rivals a contriver must induce to comply with its wishes, (2) by rendering some rivals whose compliance is required “more vulnerable,”¹¹⁶² and (3) by increasing the extent to which contrivance can take place across markets.¹¹⁶³ The concern that conglomerate mergers will increase contrivance by reducing the number of firms in the relevant areas of product-space piggybacks on the exclusionary-leverage/portfolio-effect claims but would be relevant if those were justified and the legally-appropriate response to the behavior in question were not to attack it when it occurs—in particular, would be relevant on the above assumptions because any such secondary effects that should be considered might critically influence the net equivalent-dollar impact of a merger that generated some economic efficiencies that benefitted relevant consumers. However, if I am right that conglomerate mergers will rarely if ever reduce the number of sellers in a relevant area of product-space, the concern that conglomerate mergers will increase contrivance by reducing the number of relevant competitors is unwarranted. I also disagree with the EC’s and E.C./E.U. courts’ claim that conglomerate mergers will tend to increase contrivance by making some sellers “more vulnerable” in a way that affects their willingness to oppose contrivance, though I doubt that the EC and the E.C./E.U. courts understand when and why this will occur—*viz.*, that the merger may make the merged firm less willing to undercut its rivals from a position of inferiority than the MPs were both by increasing the merged firm’s (OCA + NOM)s by generating static marginal efficiencies and by spreading the merged firm’s defenses when it faces conglomerate rivals that operate in both MPs’ ARDEPPSes. As the preceding sentence indicates, I also agree with the Guidelines’ claim that conglomerate mergers can facilitate cross-market contrivance.

Having listed and discussed the various ways in which the EC and the E.C./E.U. courts believe conglomerate mergers may lessen competition, I should point out various ways in which conglomerate mergers can lessen competition that the EC and the E.C./E.U. courts have ignored and the specific reasons why conglomerate mergers can facilitate cross-market contrivance—*viz.*, by

- (1) creating a merged firm that engages in more single-market price contrivance and QV-investment contrivance (generates more L barriers) than its antecedents would have done by increasing the profits it can realize by doing so because the firm the merger creates inherits the reputation for contrivance of the merger participant that has a stronger reputation for contrivance, because the merged firm will tend to have more retained and current earnings to invest in contrivance, because there are company-wide economies of scale in contrivance (in building a reputation for contrivance), and because in some circumstances

¹¹⁶² *Id.*

¹¹⁶³ *Id.* at point 121.

(see below), the conglomerate merger will increase the profitability of contrivance in other ways,

- (2) reducing QV-investment competition by creating a firm that is less willing to expand than one or both antecedents were by increasing the $(\Pi_D + R)$ barriers the resulting firm faces by leading it to devote to consolidation resources that the antecedents would have devoted to executing a QV investment and by increasing the L barriers the resulting firm faces above those the antecedents faced by increasing the resulting firm's average OCAs (by generating static marginal efficiencies), NOMs, and COMs above those of its antecedents and spreading the resulting firm's defenses when the resulting firm faces a conglomerate R that was a rival of both antecedents,
- (3) reducing price and QV-investment competition by creating a firm that engages in more predation than the participants would have practiced in all the ways that the merger in question could increase the amount of contrivance the merged firm practiced above the combined amount its participants would have, perhaps¹¹⁶⁴
- (4) reducing QV-investment competition directly and price competition indirectly by eliminating an effective potential competitor, and
- (5) when the merged company faces one or more conglomerate rivals that operate in one or more of the markets in which each merger participant operated, by creating a merged firm that engages in more price and QV-investment contrivance than its antecedents would have done by enabling the merged firm to make one anticompetitive communication when each of its antecedents would have had to make one, by enabling the merged firm to take advantage of any excess reciprocity power that one of its participants had in its relations with a conglomerate rival in relation to which the other participant did not have sufficient reciprocity power to secure collaboration on that basis alone, by enabling the merged firm to reduce the loss it had to incur to inflict any given amount of harm on such a conglomerate rival through retaliation by enabling it to execute more retaliation through one of the participant's products and less through the other's than the participants would have found necessary and optimal as separate entities, and relatedly and conceivably (but doubtfully) by making it profitable for the merged firm when it would not have been for the merger participants to retaliate against non-cooperators by inducing buyers/

¹¹⁶⁴ I say "perhaps" because the evidence for the claim is weak since (1) it consists solely of the fact that (at least to my knowledge) neither the EC nor any E.C./E.U. court has even considered the possibility that a conglomerate merger that eliminated or would eliminate a potential competitor might reduce competition because the potential competitor in question was effective (would have entered had the market's established firms done nothing to prevent it from doing so) and (2) that "fact" may reflect nothing more than their never having been presented with such a case. The fact that in a series of cases the EC considered the possibility that likely entry from potential competitors might prevent a merger it would otherwise have concluded would decrease competition from doing so is beside the point. See, e.g., *Mercedes-Benz/Kässbohrer*, Case IV/M. 477, OJ L211/1 (1995); *Gubain/Wacker Chemie/NUM*, Case IV/M. 744, J L247/1 (1996); *Aerospatale-Alenialde Havilland*, Case IV/M. 53, OJ L334/42 (1991); and *Boeing-McDonnell-Douglas*, Case IV/M. 877, OJ L 336/16 (1997).

suppliers of both participants' products to boycott a non-cooperator by threatening the buyers/suppliers with retaliation.

The EC and the E.C./E.U. courts recognize that conglomerate mergers that would tend to impose an equivalent-monetary loss on relevant buyers by lessening competition might not do so if they generate economic efficiencies.¹¹⁶⁵ Three economic-efficiency-related points are relevant at this juncture. First, although, as previously indicated, the EC and the E.C./E.U. courts do recognize that the economies of scale and scope that conglomerate mergers and acquisitions generate may lessen competition, they agree that the economic efficiencies that such transactions generate will normally benefit relevant consumers. Second, the EC and the E.C./E.U. courts have no more idea of the factors that determine whether and by how much the economic efficiencies that conglomerate mergers/acquisitions generate will benefit relevant consumers than they (or their U.S. counterparts) have of the counterpart factors for horizontal mergers. Third, although the 2008 EC Guidelines do explain how conglomerate mergers can generate various "economies of scope",¹¹⁶⁶ and do allude to the possibility that conglomerate mergers involving producers of complementary products may facilitate the coordination of their pricing to prevent privately-unprofitable and perhaps-presumptively-economically-inefficient substitutions among them,¹¹⁶⁷ their discussion of the latter possibility ignores the ability of firms to prevent such substitutions by using tie-ins, reciprocity agreements, and endproduct-royalty schemes (see Chap. 14), and their more general comment about the relationship between the economic efficiencies that can be generated respectively by conglomerate and vertical mergers/acquisitions¹¹⁶⁸ does not instill confidence about the EC's understanding of the economic efficiencies that vertical but not conglomerate mergers and acquisitions can generate.

(2) The Probability That the EC Must Establish That a Conglomerate Merger Will Reduce Competition to Be Justified in Declaring It Illegal on That Account and Various Kinds of Evidence That the EC Must Consider When Calculating the Probability in Question: Two Issues on Which the EC and the E.C./E.U. Courts Originally Disagreed

The preceding discussion focused on abstract theoretical issues on which the EC and the E.C./E.U. courts seem largely to have agreed. However, my impression is that, although the EC and the E.C./E.U. courts agreed that "conglomerate mergers

¹¹⁶⁵ 2008 EC Non-Horizontal Merger Guidelines at points 13, 92, and 115.

¹¹⁶⁶ *Id.* at point 118.

¹¹⁶⁷ *Id.* at point 117.

¹¹⁶⁸ *Id.* at point 116.

in the majority of circumstances will not lead to any competition problems”¹¹⁶⁹ and agreed as well about the ways in which conglomerate mergers and acquisitions can lessen competition and the general conditions under which they pose a risk to competition, the E.C./E.U. courts believed that one factor that could influence the competitive impact of conglomerate mergers was more important than the EC recognized and also believed that stronger evidence of possible reductions in competition must be supplied to warrant the prohibition of a conglomerate merger than the EC thought was necessary.

The factor that the CFI and ECJ found more important than the EC did was the possibility that the competition-reducing conduct in which the EC and the E.C./E.U. courts feared conglomerate mergers might induce the resulting entity to engage would be illegal under E.C./E.U. law or the laws of its member states. In particular, the ECJ has required the EC to devote considerable attention to the possibility that E.C./E.U. and member-nation prohibitions of leveraging and exclusionary conduct may deter the firm created by a conglomerate merger from engaging in such conduct (though, unlike the CFI, the ECJ did not require the EC to execute an exhaustive analysis of the applicable laws and actual enforcement-practices).¹¹⁷⁰ On other matters of required proof, the CFI and ECJ have (1) stated that the EC should take account of whether the merged company’s management has made statements indicating their intention to engage in relevant leveraging or exclusionary conduct post-merger (which I suspect they will rarely do once such evidence is utilized),¹¹⁷¹ (2) noted that evidence on an MP’s use of reciprocity or tie-ins involving one set of products in one time-period has only limited bearing on the probability that the firm would engage in such conduct on other paired products in a different time-period,¹¹⁷² (3) called into question the EC’s reliance on studies by one or more academic economists of the possible effects of a conglomerate merger it was considering when other economists challenged those studies’ conclusions by questioning their empirical premises,¹¹⁷³ and (4) stated that “where the Commission takes the view that a [conglomerate] merger should be prohibited because it will create or strengthen a dominant position within a foreseeable period, it is incumbent on it to produce convincing evidence thereof.”¹¹⁷⁴

The EC is bound by the ECJ’s judgments. It is therefore not surprising that both the relevant portions of the 2008 EC Non-Horizontal Merger Guidelines (in particular, point 46, which addresses the relevance for the legality of a conglomerate merger of the fact that the competition-decreasing conduct that the EC would otherwise find conglomerate mergers might generate was illegal under E.C./E.U.

¹¹⁶⁹ *Id.* at point 92.

¹¹⁷⁰ See *Commission v. Tetra Laval*, Case C-13/03, ¶ 89 (2005) and *Tetra Laval BV v. Commission*, Case T-5/03, ECR II-4381 (2002).

¹¹⁷¹ See *General Electric v. Commission*, Case T210/01, ECR II-5575 (2005).

¹¹⁷² *Id.*

¹¹⁷³ *Id.*

¹¹⁷⁴ *Tetra Laval v. Commission*, Case T-5/02, ¶¶ 150–55, ECR (2002) II-4381 (2002).

or member-country national laws) and the EC's more-recent decisions appear to conform to the ECJ's substantive, "burden of proof," and evidentiary conclusions.¹¹⁷⁵

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The conglomerate-merger analyses of academic economists, antitrust-enforcement agencies, and courts are disappointing. All of these actors have ignored the ways in which conglomerate mergers can reduce competition by increasing contrived oligopolistic pricing, $(\Pi_D + R)$ barriers, and predation. Many economists and the courts continue to subscribe to a limit-price theory whose premises are unrealistic, whose specific conclusions do not follow from its premises, and that cannot be tested in the way that they have attempted to test it.¹¹⁷⁶ The EC and E.C./E.U. courts continue to subscribe to a leverage theory and a theory of exclusion that, as Chap. 14 will show, cannot bear scrutiny. And at least the lower U.S. courts seem to be committed to a "toe-hold merger" doctrine that is incorrect both as a matter of economics and independently as a matter of law. Given the current empirical importance of conglomerate mergers and the fact that they are likely to become even more common if horizontal-merger regulation is tightened, these deficiencies of the applicable economic and legal analyses are likely to have significant social consequences.

¹¹⁷⁵ See Peder Christensen, Kyriakos Fountoukakos, and Dan Sjöblom, *Mergers in the EC Law of Competition* 421 at 505 (Jonathan Faull and Ali Nikpay, eds.) (Oxford Univ. Press, 2d ed., 2007), citing GE/Amersham, Case COMP/M. 3304.

¹¹⁷⁶ See Sect. 2B of Chap. 10 and Sect. 4 of Chap. 12.

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