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Financial Crisis And Merger Review Standards

Law360, New York (April 30, 2009) -- The current financial crisis has ushered in a discussion of possible changes to the implementation of antitrust law enforcement policy applicable to mergers.

Suggestions have included the addition of a "too big to fail" criterion in merger reviews and an "economic crisis" addendum to the antitrust agencies' current use of the failing firm defense. These proposals should be approached very cautiously.

The first proposal, addressing the creation of entities which might later fail, appears to present issues far outside current parameters of Section 7 of the Clayton Act, 15 U.S.C. Section 18, and suggests industrial policy concerns more properly left to Congress or some other regulatory regime.

At a minimum, Section 7 (and Section 5 of the Federal Trade Commission Act) could require legislative amendment and, for transparency purposes, the agencies should provide detailed guidance before such industrial policy concerns are considered by the antitrust agencies.

The second proposal may well reflect a solution in search of a problem, given the substantial discretion currently afforded antitrust regulators to consider the financial strength of acquisition targets under accepted competitive effects analysis on a case-by-case basis, even if one or more criteria of the traditional failing firm analysis are not satisfied.

Crisis Breeds Innovative Thinking

FTC Chair Jon Leibowitz and U.S. Department of Justice Antitrust Division AAG Christine Varney are now both officially in charge of their respective antitrust agencies.

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Mr. Leibowitz’s appointment to the position of FTC chairman did not require Senatorial approval; Ms. Varney's nomination was confirmed on April 20, 2009. Both have promised a reinvigoration of antitrust enforcement, including merger enforcement.

This reinvigoration may include not only greater scrutiny of deals using well-established concepts for identifying potential competitive injury, but also the introduction of new analytical concepts.

For example, some antitrust enforcement officials have acknowledged publically a willingness to consider "too big to fail" arguments in merger reviews. At her confirmation hearing of March 10, 2009, Ms. Varney responded to a question from Sen. Herb Kohl, D-Wis., by wondering aloud whether "antitrust law has failed if we allow institutions to be created that are too big to fail?"

Similarly, FTC Commissioner J. Thomas Rosch suggested in a speech in January that "if a merger creates a firm whose failure is likely to have a catastrophic effect on the market as a whole, because it is so integral to the market, the end result may be a substantial lessening of competition."

Commissioner Rosch has reportedly asked FTC staff lawyers to consider "too big to fail" arguments in the review of the two major pharmaceutical mergers currently under review at FTC: Pfizer's proposed acquisition of Wyeth, and Merck's proposed acquisition of Schering-Plough.

The reviews of these two transactions will provide an early indication of whether and how the agencies apply this novel approach to antitrust law enforcement decision making.

Innovative Thinking Carries Risk

Section 7 of the Clayton Act, the primary legislative basis for merger challenges, proscribes only those combinations where "the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

While Section 7 does not provide an analytical roadmap for predicting when such a lessening of competition may occur, the agencies’ Horizontal Merger Guidelines of 1992 do, with the primary indicium of anti-competitive effect defined as "the ability profitably to maintain prices above competitive levels for a significant period of time."

While the potential "failure" of a business is relevant under these guidelines, that analysis is limited to whether a party (typically the target) would, absent the merger, likely fail, thus causing its assets to exit the market anyway.

The guidelines do not, and the agencies (at least in recent memory) do not, inquire into whether the combined firm will achieve some capability, scale or macroeconomic significance that should be avoided for public policy purposes unrelated to immediate

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competition concerns — if the surviving firm is otherwise unable to raise price, reduce output, create barriers to new entry or disadvantage consumers in some way as the result of the combination.

Although there has been no meaningful articulation by enforcement officials as to how a "too big to fail" concept would (or could) be applied in merger enforcement, a number of possibilities come to mind. For example, in theory, a combined entity could be deemed "too big" if:

- Competitors could not, within some defined period, replace the output and other competitive attributes (such as research and development capabilities) of the combined firm were it to fail.

The guidelines' current test for entry, that entry be "timely, likely and sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern," could be applied in some form to evaluate remaining competitors and potential competitors, not only to assess whether the market would defeat a small but significant nontransitory increase in price resulting from enhanced market power post-merger, but also defeat supply disruption and price increases resulting from some hypothetical exiting of the combined firm from the market due to failure.

Under this scenario, the market structure of an industry operating at near or full capacity, and without an ability to add capacity within the defined period, could be frozen.

- Because of public policy concerns, such as unemployment, industrial base preservation or systemic significance, the combined firm would not be allowed by the government to fail, with the result that, upon failure, the combined firm would require federal subsidies, receivership or other intervention to stay afloat.

Under this scenario, the antirust agencies would serve as a "first line" of regulatory defense to prevent the creation of institutions the government may later choose (or not choose?) to rescue.

- The government has already invested in the equity or debt of a business to keep it afloat, such that the failure of the business would cost the government (and thus the taxpayers) some or all of that investment.

Under this scenario, the agencies would seek to preserve the government's investment, and disapprove an acquisition that did not maximize the value of the government’s investment.

In the case of multiple suitors, this agenda could actually result in the antitrust agencies favoring a less competitive outcome, if the preferred suitor was able to offer greater consideration for the business as a result of anticipated enhanced market power post-merger.

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While any of these possibilities could be couched as relating to the agencies' traditional goal of "promoting competition for the benefit of consumers," it is easy to see a slippery slope toward less than efficiency-optimal merger review outcomes.

"Too big to fail" is hardly a competitive effects issue, at least as most antitrust practitioners use that concept. It is, more accurately, an industrial policy issue more properly left to other political or regulatory regimes.

Implementation Hurdles are High

Moreover, as a practical matter, by injecting industrial policy issues into to what is currently a well refined and relatively transparent merger review process driven by economic and factual analysis, a "too big to fail" criterion would force antitrust staff and decision makers into issues far outside their current merger review expertise.

- How would staff determine the likelihood of failure of the combined firm? If failure is unlikely, the risks posed by failure would have to discounted accordingly. Otherwise, a competitively neutral or even pro-competitive, efficiency-enhancing merger could be blocked unnecessarily.

But since the current financial crisis — caused at least in part by a serious underestimation of the economic risks created by the real estate bubble and the leveraged acquisition of collateralized debt obligations by banks and other institutions — was a very big surprise to many of the "best and the brightest" on Wall Street, at the Federal Reserve, and among other banking regulators, how is it conceivable that antitrust lawyers and economists within the agencies will somehow develop comprehensive expertise in risk of failure assessment?

- Does “failure” even imply an anti-competitive outcome? To the extent the combined firm can reorganize under Chapter 11, or its assets are redeployable in the same relevant geographic and product markets in the event of a liquidation, failure may be competitively neutral or even pro-competitive. Will antitrust lawyers and economists within the agencies try to assess reorganization risks and timing?

- How would the agencies possibly balance the myriad of public policy concerns that might cause the government to intervene to prevent failure? These concerns are inherently political judgments and, at least historically, the agencies have affirmatively disavowed such issues as non-germane to merger analysis.

How many times have trade groups or labor associations, for example, pitched the agencies that a particular transaction should be blocked because some efficiency enhancing integration of rivals would result in job losses, plant closings and related dislocations?

The agencies routinely listen to, but ignore, such arguments, since these issues are (quite properly) beyond the mandate or purview of Section 7 of the Clayton Act.

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- Washington Post columnist Charles Krauthammer (and others) have described the Obama administration's interventions into the financial services and auto industries as an exercise in "large scale industrial policy."

If that characterization is correct, at least such policy-making is taking place in the political arena, as opposed to the law enforcement arena in which the antitrust agencies are supposed to operate. It is important, for the continued legitimacy of the agencies' law enforcement function, that their mission not expand to include (or even be tainted by) political decision-making.

- Finally, the antitrust agencies cannot reasonably consider the government's investment or potential investment in a business or industry in formulating and implementing merger policy. The government, for various reasons, may choose to intervene or not in particular situations.

Lehman Brothers was permitted by the Federal Reserve and U.S. Treasury Department to collapse and file bankruptcy. In contrast, many other banks and financial institutions have received large injections of public capital or were "encouraged" to merge rather than collapse. The wisdom and long-term economic effects of this and future federal intervention will be analyzed and debated for years.

In the meantime, it is hardly the role of the antitrust agencies to try to predict how or when such intervention might occur in the effort to identify and challenge violations of Section 7 of the Clayton Act. And whether or not the government holds an interest in a party to a proposed merger seems quite unrelated to the analysis of the competitive effects of that merger.

A Better Path

At least for the moment, antitrust law enforcement authorities in the United States are considering new theories and new law enforcement approaches in response to serious industrial policy concerns better left to the administration, Congress and other political bodies such as the Treasury Department and the Federal Reserve. Otherwise, antitrust law enforcement authorities could lose their image of objectivity and credibility.

One could view the current "too big to fail" discussions in the same vein as many other efforts over the past 40 years to ascertain whether the scope of antitrust law enforcement should be expanded.

These have included investigations and litigation involving, for example, conglomerate merger theory, reciprocity, shared monopolies and facilitating practices. None of those are on antitrust practitioners' radar screens currently, nor (I suspect) will be "too big to fail" arguments in the long-term.

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We will, no doubt, emerge from the current financial crises at some point. Whether government intervention in businesses and industries accelerates or slows that recovery is an interesting question.

However, it is hard to see how the introduction of a new theory of competitive risk — that the combined entity is somehow deemed "too big to fail" — is appropriate under Section 7 of the Clayton Act, consistent with the Horizontal Merger Guidelines or even workable at the antitrust agencies absent a fundamental and risky redefinition of their merger review mission.

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