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This volume contains articles and panel discussions delivered during the Twenty-ninth Annual Fordham Corporate Law Institute Conference on International Antitrust Law & Policy in New York City on October 31 and November 1, 2002.

Editor

Barry E. Hawk

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Chapter 13

THE ROLE OF EFFICIENCIES IN M&A GLOBAL ANTITRUST REVIEW: STILL IN FLUX?

Ilene Knable Gotts and Calvin S. Goldman, Q.C.†

> "[I]t needs to be remembered that the goal is efficiency, not competition."[1]

> "Merger analysis is, by its nature, an uncertain art form. Predicting the future, while required under the law, is never an easy task."[2]

I. INTRODUCTION

The focus of competition policy on the promotion of efficiency has not always been clearly understood and is still controversial. Historically, United States ("U.S.") competition authorities – and U.S. courts – were hostile to mergers and acquisitions ("M&A") that significantly increased market share concentration, regardless of whether they produced efficiencies. In the 1960s and mid-1970s, U.S. enforcement agencies and U.S. courts viewed the creation of efficiencies as even potentially anticompetitive. Nor was the opposition to efficiencies limited to the

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1. Lawrence H. Summers, Perspectives on Competition: Competition Policy in the New Economy, 69 Antitr. L.J. 353 (2001).

2. Andrew Kleit and Margaret Sanderson, The Perfect is not the Enemy of the Good: A Response to Roy Davidson's Article, When Merger Guidelines Fail to Guide, 13:2 Canadian Comp. Pol. Rec. 48 (June 1992).

economically unsophisticated: a quarter of a century ago, the leading proponents of the Chicago School of Law & Economics opposed incorporating efficiencies into the competitive effects analysis, believing that it was simply too difficult for courts to assess the merits of efficiencies arguments.[3]

Although U.S. courts and agencies embraced the benefits of efficiencies in the non-M&A context by the early 1980s, there remains — even today — hesitancy toward recognizing efficiencies in judicial challenges to mergers in all but close cases. Moreover, the debate over a number of outcome determinative factors continues, including: (1) what welfare standard should be applied; (2) what standard of proof should be imposed; (3) how efficiencies should be factored into the analysis; (4) what type of efficiencies should count; and (5) whether firms should, ex post facto, be accountable for failing to achieve efficiencies. At the core of all of these issues — and influencing the attitude of antitrust enforcement agencies and, where applicable, courts — are the underlying normative perspectives toward redistribution policies.

A transaction that provides a firm with market power (or results in a coordinated price increase or output restriction among market participants) generally results in a deadweight loss — which is a reduction in society's total welfare — due to potentially mutually beneficial transactions not occurring. Efficiencies may increase consumer and/or producer welfare due to the ability of the merged firm to offer the relevant product or service post-merger at a lower price (or better quality) and/or lower cost. Some commentators and scholars suggest that, so long as the combined consumer and producer surplus exceeds the deadweight loss, the transaction is net beneficial.[4] Such a view is blind as to whether the transaction benefits producers at the expense of consumers so long as it saves resources in the relevant market by more than consumers lose. In this "consumer-centric" approach, a transaction would be prohibited if consumers suffer at all. Thus, a consumer-centric approach significantly limits the types of efficiencies that will "count." Under such a policy, only those types of efficiencies that will "pass-through" to consumers will count. Moreover, proponents of the consumer-centric approach frequently require that the transaction parties demonstrate that there is no alternative means for achieving those cost savings and will seek to limit the time horizon for which such consumer benefits will be counted. This shortened time horizon discounts long-term efficiencies, and, again, can cause potentially net beneficial transactions, as well as transactions that would even benefit consumers, to be blocked.

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3. Judge Richard Posner still retains this view. See Richard A. Posner, Antitrust Law: An Economic Perspective (2d ed. 2001). See discussion infra, Section II.B.

4. An approach that focuses on whether a transaction is net beneficial is consistent with the Kaldor-Hicks view of efficiency, which ignores wealth transfers.

The limitations on the types of efficiencies that will be accepted, however, represent only one of the hurdles a consumer-centric approach creates for the treatment of efficiencies. Inherent in a consumer-centric focus is a low tolerance for the risk that a transaction will produce anticompetitive effects. As a result, merger parties may find themselves faced with a presumption of illegality in transactions involving high concentration levels and an often insuperable burden of proof to overcome this presumption. This increased burden is inconsistent and unwarranted as it ignores the overall effects of a merger and does not treat all transactions the same. In short, antitrust authorities must approach their assumptions of what types of efficiencies should count and what burdens should be imposed with caution, applying reasonable and consistent economic and legal principles; anything less may have significant deleterious effects in the M&A arena. Section II of this article discusses each of these assumptions in turn.

To focus exclusively on merger review and the treatment of efficiencies in a single jurisdiction is myopic in today's global economy. Indeed, the treatment of efficiencies is extremely varied among industrialized nations. As discussed in more detail below, this divergence in efficiency policies among enforcement regimes can adversely affect the ability of firms to compete, or for that matter, to merge or undertake acquisitions, on an international basis.[5] Increasingly, markets are

5. In May 2001 the European Commission's Directorate-General for Economic and Financial Affairs published the following series of commissioned studies as part of a report entitled The Efficiency Defence and the European System of Merger Control: (1) Fabienne Ilzkovitz and Roderick Meiklejohn, European Merger Control: Do We Need an Efficiency Defence? ("Ilzkovitz & Meiklejohn"); (2) Lars-Hendrik Röller, Johann Stennek, and Frank Verboven, Efficiency Gains from Mergers ("Röller, Stennek & Verboven"); and (3) Johann Stennek and Frank Verboven, Merger Control and enterprise competitiveness: Empirical analysis and policy recommendations ("Stennek & Verboven"). A copy of the report is available at <<http://europa.eu.int/comm/economy.finance/-publications/european_economy/2001/eer50501 _en.pd.f>>. See also Ilzkovitz & Meiklejohn at 10-11 ("Some critics argue that a merger control policy which takes no account of efficiency gains may be harmful to European competitiveness, in particular in high-tech industries. . . . The [European] Commission points out that the E[uropean] U[nion] is underperforming in high-technology industries, such as the information technology industry. . . European companies are less dynamic than the U.S. ones. . . . [The European Commission] communication makes no explicit reference to an efficiency defence but rather a general plea in favour of a modernisation of competition policy to keep up with globalisation. However, an earlier parliamentary report on the competitiveness of European industry specially advocates that competition policy must encourage the regrouping of European companies in so far as that influences their competitiveness on world markets.") But see Robert Pitofsky, Proposals for Revised United States Merger Enforcement in a Global Economy, 81 Geo. L. J. 195, 198 (1992) ("Pitofsky Georgetown Article") ("[F]ew would argue that the failure of United States enforcement agencies and courts to take into account efficiency, productivity and innovation considerations in merger analysis was the principal cause of American firms' difficulties in international trade.").

operating on a global scale – or at least with the same multinational firms trading or operating in some or all of the Organization for Economic Cooperation and Development ("OECD") countries. The globalization of industry has served as a strong impetus for competition authorities from the various developed (and some less developed) jurisdictions to begin meeting to discuss substantive and procedural best practices. The International Competition Network ("ICN"), the OECD and the World Trade Organization ("WTO") each are meeting to promote convergence of competition policy.[6] In order to deal with this subject more judiciously, we focus on the current status and best practices in the United States, the European Union (the "EU"), and Canada.[7] The focus on these three jurisdictions also is particularly timely because the role of efficiencies in M&A review is being reevaluated as a result of high-profile and contentious decisions in each of these jurisdictions.

The role of efficiencies in the EU has been highly controversial. Although the EU appears to have recognized the advances made in economic and financial theory during the latter half of the 20th century in drafting the European Community Merger Regulation ("ECMR"), to date, it appears that efficiencies have been more of a detriment than a benefit to merging entities. In contrast, in Canada, the government has not only adopted legislation that expressly authorizes the consideration of efficiencies, but also, thus far, Canada's leading decisions seem to apply the legislation so as to permit full consideration of efficiencies. As the marketplace continues to evolve globally, convergence among the major enforcement authorities on fundamental competition principles, such as the role of efficiencies, will be critical.

This article is divided into two parts. The first section focuses on the historical treatment of efficiencies, while the second section looks forward at how efficiencies may (and should) be treated in the future. In that regard, the second section also suggests how efficiencies can be more appropriately included within the analysis by the enforcement agencies and, where applicable, the courts.

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6. See William J. Kolasky, Can the International Competition Network Help Tame the Growing Multinational Merger Thicket? Presentation before the 2002 American Bar Association ("ABA") Annual Meeting, Section of Antitrust Law, Washington, D.C. (Aug. 12, 2002).

7. As a starting point, focusing on these three jurisdictions, which have the most developed economies and competition laws, should provide a good foundation. The United States, the EU, and Canada, combined, constitute almost 60% of the global economy (as measured by GDP). Moreover, from the perspective of impact on the United States, the EU, and Canada are among the largest trading partners.

II. HISTORY

A. *United States*

1. *Early Precedent*

The governing substantive statute for U.S. M&A review is Section 7 of the Clayton Act.[8] Clayton Section 7 prohibits transactions in which the effect may be "substantially to lessen competition" or to tend to create a monopoly. The language of Clayton Section 7 is silent on the question of efficiencies. The legislative history of Clayton Section 7, as amended by the Celler-Kefauver Act in 1950, is not much more illuminating on the issue of whether there is an efficiencies defense. At best, "Congress may have contemplated recognition of an efficiencies defense in the circumstances in which the merger involved inefficient small rivals and the claimed efficiencies would bring their costs in line with the costs that larger firms already enjoyed."[9]

Early U.S. Supreme Court precedent in the merger context applied a formulaic market share driven structural approach to decide a transaction's fate, with very little else counting in the analysis.[10] Purportedly, based on Congressional intent (or the lack thereof), these decisions were hostile to efficiencies and treated them as a strike against a merger.[11] As former Federal Trade Commission ("FTC") Chairman Robert Pitofsky noted:

> [T]he most emphatic Supreme Court statement on the point is FTC v. Procter & Gamble Co. . . . , where the court said "possible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition." In fact, Congress

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8. 15 U.S.C. § 18 (2002).

9. Steven M. Edwards, Robert D. Joffe, William J. Kolasky, John J. McGowan, Carlos E. Mendez-Penate, Janusz A. Ordover, Phillip A. Proger, Louis M. Solomon, and Utz P. Toepke, Proposed Revisions of the Justice Department's Merger Guidelines, 81 Colum. L. Rev. 1543, 1564 (1981) ("Task Force Article"); accord IVA Phillip E. Areeda, Herbert Hovenkamp, and John L. Solow, Antitrust Law: An Analysis of Antitrust Principles and their Application (1998) ("Areeda") ¶ 970c at 28.

10. FTC v. Brown Shoe Co., Inc., 384 U.S. 316 (1966); FTC v. Procter & Gamble Co., 386 U.S. 568 (1967); United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963).

11. See Brown Shoe, 384 U.S. at 344 (Congress resolved competing considerations of occasional higher costs and prices in favor of decentralization); Procter & Gamble, 386 U.S. at 580.

really never addressed the question of possible tradeoffs between anticompetitive effects and possible efficiencies.[12]

Although subsequent "lower courts were uncomfortable with absolute preclusion of efficiency claims in merger cases[13] ... no case can be cited where an otherwise illegal merger [has been] ... declared legal because of the presence of substantial efficiencies."[14] Even as late as 1989, a federal district court treated efficiencies as an "offense" rather than a defense.[15] The treatment of efficiencies during this era is aptly characterized by Commissioner Thomas Leary as being one in which there was a "conscious hostility by the Federal Trade Commission" to efficiencies.[16]

In the late 1960s through at least the mid-1970s, the U.S. enforcement agencies and economists were somewhat schizophrenic in their treatment of efficiencies – perhaps reflecting a slow recognition of the potential benefits from efficiencies in some instances. Eight FTC decisions issued during the 1970s suggested that efficiencies support a holding of illegality.[17] At the same time, there were some signs of hope in the general recognition of efficiencies.

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12. Robert Pitofsky, Efficiencies in Defense of Mergers: 18 Months After, George Mason Law Review Antitrust Symposium: The Changing Face of Efficiency, Washington, D.C. 1998 ("Pitofsky George Mason Remarks"), at n. 6, quoting P&G, 386 U.S. at 580. See also Dennis A. Yao and Thomas N. Dahdouh, Information Problems in Merger Decision Making and Their Impact on Development of an Efficiencies Defense, 62 Antitr. L.J. 23, 30 (1993) ("Yao & Dahdouh"); Alan A. Fisher and Robert H. Lande, Efficiency Considerations in Merger Enforcement, 71 Cal. L. Rev. 1582, 1592 (1983) ("Fisher & Lande").

13. See, e.g., FTC v. United Health Inc., 938 F.2d 1206 (11th Cir. 1991); United States v. Country Lake Foods, Inc., 754 F. Supp. 669, 680 (D. Minn. 1990); United States v. Carilion Health Sys., 707 F. Supp. 840, 849 (W.D. Va.), aff'd, 892 F.2d 1042, 1084-85 (4th Cir. 1989).

14. Pitofsky George Mason Remarks at 1.

15. FTC v. Imo Indus., 1992-2 Trade Cas. (CCH) ¶ 69,943 at 68,560 (D.D.C. 1989) (enjoined a merger that would make the firm more cost effective).

16. Thomas B. Leary, Efficiencies and Antitrust: A Story of Ongoing Evolution, ABA Section of Antitrust Law 2002 Fall Forum, Washington, D.C. (Nov. 8, 2002) ("Leary Fall Forum Remarks") at 2. Leary cites Foremost Dairies, 60 F.T.C. 944 (1962), modified 67 F.T.C. 282 (1965), as the most conspicuous example of conscious hostility. In Foremost Dairies, the FTC challenged Foremost's acquisition of a dairy in an adjacent market, indicating that a Clayton Section 7 violation could be established by proof that "the acquiring firm possesses significant power in some markets or that its overall organization gives it a decisive advantage in efficiency over small rivals." 60 F.T.C. at 1087.

17. Beatrice Foods Co., 86 F.T.C. 1 (1975), modified and aff'd, 540 F.2d 303 (7th Cir. 1976); Budd Co., 86 F.T.C. 518 (1975); United Fruit Co., 82 F.T.C. 53 (1973); Sterling Drug Inc., 80 F.T.C. 477 (1972); Papercraft Corp., 78 F.T.C. 1352 (1971); Stanley Works, 78 F.T.C. 1023 (1971), aff'd, 469 F.2d 498 (2d Cir. 1972), cert. denied, 412 U.S. 928 (1973); Kennecott Copper Corp., 78 F.T.C. 744 (1971); Bendix Corp., 77 F.T.C. 731 (1970), vacated and remanded, 450 F.2d 534 (6th Cir. 1971), settled, 84 F.T.C. 1291 (1974). See Wesley J. Liebeler, Antitrust Law and the New Federal Trade Commission, 12 S.W.U.L. Rev. 166, 225 (1981).

First, in 1968, then-U.S. Department of Justice ("DOJ") economist Oliver E. Williamson (later, a university professor) advanced the idea of an efficiency defense.[18] The first Merger Guidelines issued by the DOJ in 1968 ("1968 Guidelines"),[19] which were issued during Assistant Attorney General ("AAG") Donald Turner's tenure, reflected Williamson's research by including a narrow efficiencies defense, only to be recognized "in exceptional circumstances."

Second, in 1974, Professor Harvey Goldschmid edited a conference volume on industrial organization that provided evidence on efficiencies in concentrated industries and disputed the common belief that increases in concentration were always a problem. Rather, Professor Goldschmid indicated that a nontrivial increase in efficiency could rebut an anticompetitive implication derived exclusively from market concentration theory.[20] Faced with increased evidence regarding the potential benefits of efficiencies, the FTC in 1975 indicated in its *Beatrice Foods*[21] decision that "improved efficiencies and price reductions are certainly no reason to condemn a merger not otherwise shown to be anticompetitive."

2. 1980s-Present

In 1981 an informal task force of lawyers and economists proposed to the DOJ certain changes to the 1968 Guidelines, including endorsing a positive role for efficiencies.[22] The task force, for instance, recognized that there might be instances where a merger between two small firms in a concentrated industry will produce substantial efficiencies and not lead to interdependent pricing.[23] Moreover, in a horizontal merger, the task force urged that the enforcement agencies consider the potential efficiencies that would be achieved as a result of the merger and that might enhance performance of the market, including, without limitation, manufacturing, distribution, marketing, service, administrative, and R&D economies.[24]

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18. See Oliver E. Williamson, Economies as an Antitrust Defense: The Welfare Tradeoffs, 58 Am. Econ. Rev. 18 (1968); Oliver E. Williamson, Economies as an Antitrust Defense: Correction and Reply, 58 Am. Econ. Rev. 1372 (1968); Oliver E. Williamson, Allocative Efficiency and the Limits of Antitrust, 59 Am. Econ. Rev. Papers & Proc. 105 (1969); Oliver E. Williamson, Economics as an Antitrust Defense Revisited, 125 U. Pa. L. Rev. 699 (1977) ("Williamson 1977 article").

19. U.S. Dep't of Justice, Merger Guidelines (1968), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,101.

20. Harvey J. Goldschmid, Industrial Concentration: The New Learning. FTC Chairman Muris described Professor Goldschmid's book as "the most influential book in the history of the economics of antitrust." See Timothy J. Muris, The Government and Merger Efficiencies: Still Hostile After All These Years, 7 Geo. Mason L. Rev. 729 (1999) ("Muris 1999 Article").

21. FTC v. Beatrice Foods, 86 FTC 1, 66 (1975), aff'd, 540 F.2d 303 (7th Cir. 1976).

22. See Task Force Article.

23. Task Force Article at 1564; accord Areeda at ¶ 970b.

24. Task Force Article at 1561.

The task force specifically indicated that the analysis should not be limited to particular types of economies. Even though some commentators argued that only certain types should be considered, the task force could not find any empirical support for that position. Also, the task force believed that, although there are a number of formulas that could be used to attempt to quantify economies, the better approach would be to look at the economies from a "qualitative" viewpoint.

The task force recommended a threshold concentration level under which the DOJ would consider efficiencies:

> In a case where evidence of an anticompetitive effect is speculative (and the task force believes that the lower the aggregate share is below 30% the more speculative the inference of anticompetitive effect that can be drawn from the market share alone), the merger parties ought to be permitted to demonstrate that nontrivial economies exist.[25]

Indeed, the task force thought that the "cost of making a mistake in this area is likely to be far greater when a beneficial merger is prohibited than when a merger that has some adverse effect on competition is erroneously permitted." Finally, in the context of a horizontal transaction, the task force noted that special attention should be given to the effect that economies might have on enhancing competition by turning a weak competitor into a strong competitor.[26]

The task force also endorsed the role of efficiencies in vertical and conglomerate mergers. Specifically, the task force recognized that vertical mergers have the potential to enhance competition through the achievement of certain efficiencies, and indicated that "where increased barriers [are created as a result of a vertical merger and] are simply the result of increased economies, they should not give rise to a negative inference."[27]

Throughout the early 1980s, the enforcement agencies remained unwilling to embrace fully the task force's recommendations. Indeed, while the DOJ Guidelines issued in 1982 ("1982 Guidelines")[28] significantly altered most aspects of merger analysis,[29] they left unchanged the

25. Id.; see also Williamson 1977 Article at 728-31; compare Pitofsky test discussed infra in Section II.C.

26. Compare FTC v. H.J. Heinz Co., 116 F. Supp. 2d 190 (D.D.C. 2000), rev'd, 246 F.3d 708 (D.C. Cir. 2001), discussed infra, pp. 214-218.

27. Task Force Article at 1566.

28. U.S. Dep't of Justice, Merger Guidelines (1982), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,102.

29. Economists, such as George Stigler, significantly influenced the 1982 Guidelines. See George Stigler, A Theory of Oligopoly, 72 J. Pol. Econ. 44 (1964).

treatment of transaction-specific efficiencies.[30] The FTC Statement concerning Horizontal Mergers issued in 1982 ("FTC Statement")[31] was slightly more favorable in the types of efficiencies recognized: it included "measurable" operating efficiencies. On the other hand, the FTC Statement suggests that efficiencies will be taken into account for internal deliberations only – not in litigation. In that regard, the FTC (in a 3-2 vote) relied on efficiencies (including some benefits, such as innovation, that were not clearly tied to variable cost) to clear the proposed GM/Toyota production joint venture.[32] While the FTC Statement indicated that the FTC would not take efficiencies into account in litigation, the FTC did expressly conclude separately that the U.S. Supreme Court's decisions did not foreclose an "efficiencies defense."[33] Later, in *Cargill v. Monfort*, the U.S. Supreme Court eliminated all doubt by considering efficiencies as part of the analysis.[34]

The Merger Guidelines issued by the DOJ in 1984 ("1984 Guidelines"), however, perceptibly shifted the treatment of efficiencies from a defense to an integral part of the competitive effects analysis.[35] In announcing the 1984 Guidelines, the DOJ noted that "the efficiency enhancing potential of mergers can increase the competitiveness of firms and can result in lower prices to consumers."[36] The introduction of the 1984 Guidelines also added that "the primary benefit of mergers to the

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30. Presumably, the new thresholds were set at a level designed to reflect the fact that transactions generally produce efficiencies.

31. FTC, Statement concerning Horizontal Mergers (1982), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,200.

32. General Motors, 103 FTC 374 (1984). The rationale for the joint venture "was not the potential for scale economies but rather a mutual education process in which one partner (Toyota) would gain experience producing vehicles with a U.S. labor force and the other partner (GM) would become familiar with Japanese lean production techniques. The experience was apparently successful for both parties, as Toyota subsequently built its own assembly plant in Georgetown, Kentucky and General Motors applied the lessons learned in the venture to the design of its own Saturn division." Leary Fall Forum Remarks at 5.

33. American Medical International Inc., 104 FTC 1, 216-20 (1984).

34. 479 U.S. 104 (1986). In Cargill, the plaintiff-competitor argued that the merger was anticompetitive because it would create "multiplant efficiencies" that would enable the merged entity to reduce prices and increase its market share. The Court indicated that such means of increasing business is often "the very essence of competition." Id. at 122 n.17.

35. U.S. Dep't of Justice, Merger Guidelines (1984), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,103. This change in approach perhaps in part reflected the philosophy and influence of then-FTC Bureau of Competition Director (now FTC Chairman) Timothy Muris, who wrote an article in 1980 criticizing the government's harsh treatment of efficiencies. Timothy J. Muris, The Efficiency Defense under Section 7 of the Clayton Act, 30 Case W. Res. L. Rev. 381 (1980) ("Muris 1980 Article").

36. Oliver E. Williamson, The Merger Guidelines of the U.S. Department of Justice – In Perspective, Presented at The 20th Anniversary of the 1982 Merger Guidelines, at 11 (June 10, 2002).

economy is their efficiency enhancing potential, which can increase the competitiveness of firms and result in lower prices to consumers."[37] The efficiencies discussion itself retained the standard of proof of "clear and convincing evidence,"[38] but the DOJ replaced the requirement that the efficiencies not be achievable through internal expansion or another transaction with a lesser "reasonably necessary" test.[39] Moreover, the DOJ eliminated the "close cases" limitation and formulated a sliding scale under which transaction parties were required to establish a higher level of expected net efficiencies the more significant the competitive risks posed by the transaction. Finally, the 1984 Guidelines broadened the type of efficiencies recognized to include manufacturing, servicing, and distribution operations, as well as those efficiencies resulting from reductions in general, selling, administrative, and overhead expenses.[40]

The DOJ also actually began to recognize the potential benefits of efficiencies in its decisionmaking process. In perhaps the most politically charged merger during the Reagan Administration – the LTV/Republic merger – the DOJ initially concluded the merger would lessen competition in three markets, and that the efficiencies claimed were insufficient to overcome the serious potential effects.[41] After the DOJ commenced litigation, the transaction parties entered into settlement with the DOJ pursuant to which Republic was required to divest two of its steel mills. AAG Paul McGrath, upon acceptance of the settlement, noted that the transaction parties provided very persuasive evidence that the combined operation of several plants would result in substantial cost savings, a factor taken into account in approving the merger.[42] The DOJ also noted the weakened and deteriorating condition of the U.S. steel industry, and found it would be in the public interest to approve the settlement as the cost savings achieved through efficiencies would permit

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37. 1984 Merger Guidelines at § 3.5.

38. Id. In Yao & Dahdouh at 30-34, the authors appropriately question the desirability of this heightened evidentiary standard.

39. The prior "merger-specific" test was nearly impossible for transaction parties to meet. See Yao & Dahdouh at 41. But see Heinz, discussed infra, pp. 214-218.

40. One of the first transactions challenged under the 1984 Guidelines was United States v. Archer-Daniels-Midland Co., 781 F. Supp. 1400 (S.D. Iowa), which was a consummated transaction in which the judge permitted the parties to present a full-fledged efficiencies defense, although he ultimately permitted the transaction on other grounds. For a discussion of this case's efficiencies arguments, see F.M. Scherer, Some Principles for Post-Chicago Antitrust Analysis, 52 C.W.L.R. 5, 19-23 (2001) ("Scherer 2001 Article").

41. United States v. LTV Corp., 1984 WL 21973*14 (D.D.C. 1984).

42. See David Balto, The Efficiency Defense in Merger Review: Progress or Stagnation? Antitrust, Fall 2001, at 74, 75 ("Balto Article") ("The merger enabled the combined company to substantially reduce shipping costs by shipping unfinished steel to closer finishing plants.").

Republic to compete more effectively, both domestically and in the export markets.[43]

The joint DOJ/FTC Guidelines issued in 1992 ("1992 Guidelines")[44] further shifted the analysis away from structural presumptions based on concentration and market shares to provide a qualitative competitive effects analysis once a transaction fell outside the specified concentration "safe harbors." The only change in the efficiencies section, however, was the elimination of the sentence regarding "clear and convincing evidence."

In 1995 the FTC held Global Competitive Hearings on, inter alia, the role of efficiencies in M&A antitrust review.[45] The resulting report ("FTC Global Report") endorsed integrating further efficiencies into the competitive effects analysis. Following issuance of the FTC Global Report, the FTC and the DOJ formed a joint task force to examine the role of efficiencies: the task force adopted the 1997 Efficiencies Amendment to the 1992 Guidelines (the new Section 4 of the 1992 Guidelines)[46] ("1997 Revisions"). The 1997 Revisions tied efficiencies directly to the competitive effects analysis, indicating that the task force recognized that lower costs may reduce the likelihood of coordinated interaction or the incentive to raise price unilaterally. The agencies expanded the list of recognized efficiencies to include improved quality, enhanced service or new products, and specifically excluded efficiencies arising from anticompetitive reductions in output, service, or other competitively significant categories, such as innovation.

Pursuant to the 1997 Revisions, efficiencies must be cognizable, i.e. they must be: (1) merger specific;[47] (2) verified;[48] and (3) not the result of

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43. Andrew R. Dick and William J. Kolasky, The Merger Guidelines and the Integration of Efficiencies Into Antitrust Review of Horizontal Mergers, Presented at The 20th Anniversary of The 1982 Merger Guidelines at 17-18 (June 10, 2002) ("Dick & Kolasky"). But note, the LTV/Republic transaction was included in The Best and Worst Deals of the '80s, Business Week (Jan. 18, 1990) at 57 – since the combined company filed for bankruptcy two years later because it did not achieve enough efficiencies to survive.

44. U.S. Dep't of Justice and FTC, Merger Guidelines (1997), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,104.

45. The Pitofsky Georgetown Article advocated a broader use of efficiencies in merger review for the United States to become more competitive globally. As FTC Chairman, Pitofsky advocated permitting a transaction with clear and convincing evidence of productive efficiencies unachievable through less restrictive alternatives, so long as the merger involved a market that is only moderately concentrated and the merging firm would have less than 35% of the market post merger.

46. 4 Trade Reg. Rep. (CCH) ¶ 13,104.

47. As FTC Chairman Muris wrote in the Muris 1999 Article, the focus should not be on whether another method might exist to lower costs, but, instead, on whether: (1) the method is more or less costly than the merger; and (2) it can be implemented as rapidly as the merger. Muris 1999 Article at 732.

48. The 1997 Revisions require "the merging firms to substantiate efficiency claims so that the [a]gency can verify by reasonable means the likelihood and magnitude

anticompetitive reductions in output. The change in the first element is significant because: "[I]nstead of requiring proof that claimed efficiencies could not be achieved through some hypothetical alternatives such as unilateral expansion or competitor collaborations, the agencies committed to evaluate claimed efficiencies against other practical alternatives."[49] There may be a number of reasons why firms do not pursue efficiencies internally. For instance, a firm may not want to build a new plant to take advantage of new technological efficiencies because the industry already has excess capacity or the associated costs would be prohibitive, but, alternatively, could benefit from substantial efficiencies by merging with a competitor and consolidating production in the competitor's newer facility. Similarly, firms simply may not want to enter into a joint venture or contract due to high transaction costs associated with allocating the benefits of the arrangement between the firms. Finally, the 1997 Revisions incorporate a sliding scale approach under which the agencies will require proof of greater efficiencies as the likely anticompetitive effects of the transaction increase. Thus, the 1997 Revisions embrace the principle that efficiencies almost never justify a merger to monopoly or near monopoly.

Today, it is clear that the U.S. antitrust authorities, as a matter of the agencies' prosecutorial discretion, will consider efficiencies in close cases.[50] The stronger the case for potential anticompetitive effects of a transaction, the greater the burden on the parties to demonstrate cognizable efficiencies. In a transaction suggesting strong anticompetitive potential (usually existing in a transaction that will result in a reduction in the number of participants from three to two in a well-defined market and where there is a strong unilateral or coordinated interaction effect presumed or alleged), the parties shoulder a very high burden of proof that credible efficiencies will overcome the potential anticompetitive effects. Cognizable efficiencies also can impact the choice of remedies acceptable to the agencies. To this effect, the agencies will consider remedies that are crafted to address the competitive issues raised by the transaction, but, at the same time, minimize the diminution of efficiencies.

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of each asserted efficiency, how and when each would be achieved (and the costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific."

49. Pitofsky-George Mason Remarks at 2.

50. See, e.g., Press Release, FTC, Federal Trade Commission Votes to Close Investigation of Proposed Merger of Amerisource Health Corporation and Bergen Brunswig Corporation, Aug. 24, 2001, available at http://www.ftc.gov/opa/2001/amerisourcebergen.htm. (four-to-three merger permitted to proceed, at least in part, due to efficiencies). See Ilene Knable Gotts, FY 2002 -- All Quiet on the Antitrust Front in M&A Review? (Forthcoming Antitrust Report, Feb. 2003). Timothy J. Muris, "Understanding Mergers: Strategy and Planning, Implementation , and Outcomes" FTC Roundtable, (Dec. 9, 2002 at 1 ("Muris FTC Roundtable Remarks").

In the courts, however, the agencies still appear to be arguing that efficiencies cannot, and do not, trump high concentration levels.[51] Since 1990, four U.S. Courts of Appeals (6th, 8th, 11th, and D.C.) have considered the role of efficiencies in an M&A context.[52] In addition, in about a half dozen M&A challenges, the district court considered whether efficiencies rebutted the government's prima facie showing of anticompetitive effects based solely on market share and concentration.[53] In almost all court proceedings, the government won on its prima facie case because the very high concentration levels asserted resulted in an insurmountable level of reluctance, if not hostility, against acceptance of the efficiencies proffered by the parties. As Leary indicates, a broader range of less tangible efficiencies is considered "internally and informally but discount[ed] ... altogether in a contested transaction because they are often difficult to quantify. We should do more to reconcile [the] ... public and ... non-public practice."[54]

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51. See, e.g., FTC v. University Health, Inc., 938 F.2d 1206, 1223 (11th Cir. 1991); United States v. Archer-Daniels-Midland Co., supra.

52. FTC v. University Health, Inc., supra; FTC v. Butterworth Health Corp., 121 F.3d 708 (6th Cir. 1997); FTC v. Tenet Health Care Corp., 186 F.3d 1045 (8th Cir. 1999) (efficiencies not merger-specific and too speculative); FTC v. H.J. Heinz Co., supra.

53. United States v. Country Lakes Foods, Inc., 754 F. Supp. 669, 674 (D. Minn. 1990) (only litigated non-hospital case in which efficiencies due to scale economies of product were expressly recognized); United States v. United Tote, Inc., 768 F. Supp. 1064 (D. Del. 1991) (assuming that merger would result in valid efficiency gains for the combined entity, the Court finds them insufficient to offset anticompetitive aspects and no guarantee savings would be passed-through); United States v. Long Island Jewish, 983 F. Supp. 121 (E.D.N.Y. 1997) (efficiencies must be significant and must be demonstrated to benefit consumers; as a nonprofit hospital, likely to pass on cost savings); FTC v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997) (parties claimed that combined entity would save between $4.9 and $6.5 billion over five years, including savings as a result of being able to extract better prices from vendors; the Court rejected efficiencies as largely unverified from internal documents, failed to establish merger-specificity since both parties were expanding rapidly on their own and Staples had passed through only 15-17% of past cost-savings); FTC v. Tenet Healthcare Corp., 1998-2 Trade Cas. (CCH) ¶ 72,227 (E.D. Mo. 1998), rev'd on other grounds, 186 F.3d 1045 (8th Cir. 1999) (district court rejected claimed efficiencies primarily due to underutilization of hospitals as speculative and any savings were unlikely to be passed on to consumers absent competitive pressure from each other to lower prices); FTC v. Cardinal Health, Inc., 1998-2 Trade Cas. (CCH) ¶ 72,226 (D.D.C. 1998) (anticipated cost savings from increased economies of scale, due to distribution center consolidation, elimination of corporate overhead, better purchasing practices, and increased volume buying power could be achieved without merger; because of the high market concentration, the efficiencies were not enough to outweigh the costs of foregoing competition); FTC v. Swedish Match, 131 F. Supp. 2d 151 (D.D.C. 2000); Heinz, supra.

54. Leary Fall Forum Remarks at 11.

3. Heinz

Heinz illustrates the judicial deference to concentration levels and concomitant hostility towards efficiencies.[55] As Kolasky wrote before becoming Deputy AAG, "[t]o advocates for integrating efficiencies into the competitive effects analysis, the Heinz/Beech-Nut merger appeared to be a nearly ideal case."[56] In February 2, 2000, Heinz, the number two baby food producer in the U.S., proposed acquiring rival baby food manufacturer Beech-Nut,[57] claiming that the merger would produce variable cost savings that would lead to greater competition and lower prices by permitting the combined firm to compete more effectively against baby food market leader, Gerber. In *Heinz,* it was established that supermarkets typically do not carry all three of these major baby food brands. Gerber, which accounted for 65% of U.S. sales, is sold in virtually every supermarket, and Heinz and Beech-Nut competed to be the number two baby food brand through the provision of trade spending incentives to grocers. Heinz and Beech-Nut each had its specific limited area of geographic strength due to its relative scale economies in distribution and promotion; Heinz was being distributed primarily in the Midwest and Beech-Nut in the Northeast and Far West.

Heinz and Beech-Nut reportedly intended to cut prices and improve products by transitioning all products to the Beech-Nut label and producing the products in Heinz's production facility. Unlike Beech-Nut's old, high-cost labor-intensive production facility (which could not be expanded cheaply, particularly given the declining demand for prepared baby food), Heinz's plant was modern and operated at 40% of its dedicated baby food capacity; it could easily add Beech-Nut's volume and still have ample capacity for growth. Heinz also had six regional distribution centers that could handle both firms' products, and, thereby, achieve scale and scope economies of distribution. The expected variable cost savings for Beech-Nut products were expected to be approximately 15%.

Despite very high concentration levels nationally and in many cities, both the FTC's legal and economic staffs, as well as two of five FTC Commissioners, recommended against challenging the merger.[58] The majority of the FTC, however, authorized commencing an action to block the transaction in July 2000. FTC Commissioner Leary justified the suit (at

55. For an excellent detailed analysis of *Heinz,* see Jonathan B. Baker, Efficiencies and High Concentration: Heinz Proposes to Acquire Beech-Nut (Publication forthcoming in John E. Kwoka, Jr. and Lawrence J. White, eds., The Antitrust Revolution (4th ed., New York: Oxford Press 2004)) ("Baker Article").

56. William J. Kolasky, The Role of Efficiencies in Merger Review, Antitrust 82, 83 (Fall 2001) ("Kolasky Antitrust 2001 Article").

57. Although Heinz lagged significantly behind Gerber in the U.S., it was the leading seller of baby food in Europe.

58. See Baker Article at 9.

least in part) on the basis that the merger would be harmful even if there had not been much competition between Heinz and Beech-Nut because the high level of post-merger concentration suggested that the firms had been at least tacitly coordinating their lack of competition and it "would be perverse to permit parties to merge just because they have not chosen to compete hard in the past" (a theory that the FTC did not allege in *Heinz*).[59]

Judge James Robertson of the U.S. District Court for the District of Columbia held a trial in August and September 2000. The entire focus of the case-in-chief was the loss of wholesale competition between the two companies for shelf space; the second brand would have both unilateral and coordinated effects on competition.[60] The FTC argued that the efficiency claims: (1) were unproved and overstated, and could be achieved short of merger (e.g., through investment of brand reputation by Heinz, plant modernization by Beech-Nut or sale of Beech-Nut to another buyer); (2) would result from an anticompetitive reduction in consumer choice (i.e. the loss of the Heinz brand); and (3) even if cognizable, were insufficient in magnitude to outweigh the likely harm to competition.

The merger parties won at the district court on all three points. First, they established that Beech-Nut alone could not increase its output. After all, its variable costs of manufacturing were 43% higher than Heinz, and also likely higher than Gerber, and its overall variable costs of production and distribution were 15% higher than Heinz. Second, they showed that Heinz could not expand cheaply because it sold a value brand of limited attractiveness to many consumers. Third, the parties argued that both firms were limited in their ability to expand due to the difficulty in obtaining distribution on shelves where their brand was not already carried, the high costs of restocking stores, and the advertising and promotional costs involved in developing and maintaining brand reputation. Finally, they presented evidence that the limited distribution of Heinz and Beech-Nut products reduced the profitability of investments to develop significant innovations, thereby forestalling each firm's efforts to expand by introducing major new products. The merging parties also argued that the cost savings would be passed through to consumers due to competition from Gerber.

The district court found that the merger parties had rebutted the presumption created by the high and increasing market concentration by proving "extraordinary" efficiencies. However, the FTC sought, and obtained, from the D.C. Circuit a stay of the district court's decision and an injunction of the merger pending appeal.

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59. Thomas B. Leary, An Inside Look at the Heinz Case, Antitrust 32, 33 (Spring 2002).

60. The merger parties introduced extensive econometrics to establish that both Heinz and Beech-Nut priced against Gerber rather than against each other.

Following oral argument, a unanimous panel of the Circuit Court found the efficiencies evidence insufficient, both as a defense and as a basis for showing post-merger coordination unlikely, thereby effectively killing the transaction. As Kolasky aptly characterized it, in "reversing, the court of appeals stepped well outside the usual role of an appellate court and engaged in a remarkable degree of appellate fact-finding."[61]

The Circuit Court pointed to three problems with the district court's factual findings: (1) the district court should have considered the reduction in total variable costs rather than just the variable costs of manufacturing (which, according to the evidence, still would have created cost savings, a fact that the D.C. Circuit overlooked); (2) the district court should have analyzed the magnitude of the cost reductions over the merged firms' combined output rather than Beech-Nut's output alone (again, the evidence suggested that a significant cost savings would result under this measure, particularly if the improved quality was included in the equation)[62] and (3) the district court did not explain satisfactorily why the efficiencies could not be achieved through reasonable and practical alternative means with less competitive risk than would arise from the merger. On the last point, the district indicated that Heinz could have achieved the same results by investing the money it was spending on the acquisition on internally improving recipes and promoting a premium brand name. Yet, it appears that Heinz rejected making some new product investments prior to the transaction on the basis that, absent national distribution, such investments would be unprofitable.[63]

Finally, although the D.C. Circuit exhibited extreme skepticism and hostility to efficiencies due to the concentration levels that would exist post-merger, it did leave open the possibility that, at least in some cases, an efficiencies defense could succeed. The D.C. Circuit held that the high market concentration levels present in *Heinz* required, in rebuttal, proof of "extraordinary" efficiencies. As Kolasky pointed out, however:

> The principal support the court cites for this principle is Areeda & Hovenkamp. But in the very section of their treatise the court cites, Areeda & Hovenkamp say they "would permit the proof to be relaxed somewhat when neither of the merging firms is the largest firm in the market and the evidence shows that prior to the merger the merging firms both had higher costs than at least one larger rival, and that the merger will bring the costs of

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61. Kolasky Antitrust 2001 Article at 83.

62. The D.C. Circuit cites to Areeda, but overlooks an important qualification on such an approach when an efficient firm is acquiring an inefficient firm and the acquisition will significantly reduce the cost of producing the inefficient firm's output and that enables efficient production to be carried over a larger output. Kolasky Antitrust 2001 Article at 85, citing IVA Areeda ¶ 976b2.

63. Baker Article at 24.

the post-merger firm more into line with those of the rival." They note, in addition, that the case for an economics defense is particularly strong where market demand is declining, stable or growing very slowly. Areeda & Hovenkamp could not have better described the situation faced by Heinz and Beech-Nut.[64]

In sum, the *Heinz* decision illustrates that courts remain highly skeptical of efficiency claims, and transaction parties continue to face an insurmountable presumption of illegality created by high concentration levels. It appears to be the preference of the enforcement agencies and courts to condemn such transactions even in the face of likely significant efficiencies rather than chance the possibility of permitting a transaction with potential adverse competitive effects to proceed (even though there is no statute of limitations to a Clayton Section 7 claim). Although we agree there are transactions that should be viewed as "unthinkable," even though they may create some efficiencies, it is in the closer calls that care must be taken not to prejudge prematurely a transaction as "good" or "bad" due to the disparity between the burdens imposed on the government and on the transaction parties. In those transactions killed by such insurmountable presumptions, there will never be an opportunity for society to potentially benefit from the associated efficiency gains. Muris recently recognized the "chicken and egg" problem resulting from adverse court decisions that have led some antitrust attorneys to advise their clients not to make the effort necessary to put forward their best efficiencies case.[65] He indicates, however, that "internally we take substantial well-documented efficiencies arguments seriously; and we recognize that mergers can lead to variety of efficiencies beyond reductions in variable costs."[66] Moreover, Muris indicates that efficiencies can be important in cases that result in consent decrees, and in the formulation of remedies that preserve competition while allowing the parties to achieve most , if not all, efficiencies.[67] It is, therefore, appropriate to focus on how the consideration of efficiencies as part of the competitive effects analysis might be improved so that beneficial transactions are not prohibited. Chairman Muris reassured antitrust counsel that well-presented credible efficiencies will be given due consideration by the FTC merger review:

> I want to encourage the presentation of solid, credible efficiencies evidence. I also want to reassure antitrust counsel that such evidence will be taken seriously. That requires some

64. Kolasky Antitrust 2001 Article at 84.
65. Muris FTC Roundtable Remarks at 2.
66. Id.
67. Id.

leap of faith from counsel, but the Commission cannot move first in this area. We necessarily take the arguments as presented to us- although we evaluate them independently. We do not make them up for the parties. As Commissioner Leary recently detailed, when the arguments presented to us are strong, we will give them detailed attention.[68]

B. European Union

1. EU Precedent Generally Not Favorable to Efficiencies

To date, the EU has not viewed favorably efficiencies in its merger review. In 1989 the Counsel of the European Communities issued the ECMR,[69] which sets forth a comprehensive procedure pursuant to which the European Commission ("EU Commission") reviews the potential competitive impact of a transaction pre-consummation to determine whether to block the transaction. Under the ECMR procedures, transaction parties file a notification with the EU Commission. If the notification is deemed complete, the EU Commission has 30 days ("Phase I") to decide whether to initiate a "Phase II" inquiry.[70] Before the end of Phase I, the EU Commission staff may inform the transaction parties of concerns it has, and the transaction parties may, if they desire, offer undertakings to resolve those concerns (typically before the end of the third week).[71] If the EU Commission staff decides the commitments offered during Phase I clearly appear to exclude serious doubts of competitive concerns, it will extend Phase I from the original 30-day

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68. Id. Comissioner Leary stated that "[antitrust] agencies today regularly clear mergers without requiring that plausible efficiencies be quantified, absent very high concentration levels or other factors that raise particular concerns. Also, likely efficiencies also can serve as a plus factor to help resolve close cases unrelated to concentration." Leary Fall Forum Remarks at 11.

69. Council Regulation No. 4064/89, O.J. L395/1 (1989) on the control of concentrations between undertakings, as amended by Council Regulation No. 1310/97, O.J. L180/1 (1997). Interestingly, the various member states appear to differ in their treatment of efficiencies, with France, Sweden, and the United Kingdom considering a wide set of factors including efficiencies. On August 11, 2002 the Irish Competition Authority, which took responsibility for merger review in Ireland on January 1, 2003, published its draft merger analysis guidelines that incorporate an efficiency defense. Irish regulator adopts stance on efficiency defences (Aug. 11, 2002), available at www.legalmediagroup.com.

70. Article 6(1)(c) of the EMCR provides the EU Commission with the authority to open a Phase II investigation.

71. The EU Commission's jurisdiction to accept remedies to solve competitive problems raised by M&A arises under Articles 6(2) and 8(2) of the ECMR, which state, in relevant part, that "following modification [of the notified transaction] by the undertakings," the EU Commission may declare the concentration compatible with the common market.

period to a six-week period to permit market testing of the proposed undertaking.[72] Similarly, before the conclusion of the 120-day Phase II period, the EU Commission will indicate to transaction parties any remaining concerns regarding the transaction and transaction parties have the opportunity to proffer undertakings that address those concerns. If the EU Commission concludes, at the end of Phase II, that a transaction should not be permitted to proceed, then it will issue a decision to prohibit the transaction in its entirety.[73] Once a transaction is cleared, the EU Commission does not retain jurisdiction over the transaction. The ECMR, however, assigns to the EU Commission exclusive jurisdiction over concentrations having a "Community dimension."[74]

The ECMR focuses on the notion of market dominance:

> A concentration which creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the Common Market or in substantial part of it shall be declared incompatible with the Common Market.[75]

Thus, the ECMR has a two-prong test: (1) creation or reinforcement of a market dominance position; and (2) resulting market power capable of significantly impeding effective competition in a relevant market. "A firm is dominant if it has a large degree of market power -- a monopoly-like situation."[76] In a series of European Court of Justice decisions under Article 82 (similar to Sherman Section 2 in the U.S.), the Court has indicated that market shares of 50% may result in a legal presumption of dominance, and market shares in the 40-50% range can be enough to be considered dominant if coupled with other factors.[77] The ECMR, itself, is silent regarding what concentration levels constitute dominance, but suggests in its non-binding preamble that a market share of less than 25% is unlikely to cause antitrust concern.[78] More recently, the EU Commission has broadened the concept of dominance to include collective dominance.[79]

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72. Art. 10(1) ECMR.

73. Art. 8(3) ECMR.

74. The Community dimension is determined on the basis of turnover thresholds realized worldwide and within the EU.

75. Art. 2(3) ECMR.

76. See Röller, Stennek & Verboven at 37 for a discussion of dominance.

77. See Akzo Chemie BV, [1993] 5 C.M.L.R. 215, ¶ 60. In his book Postgraduate Diploma in EC Competition Law 2001-2002, Module 6 – Merger Regulation, at 6-39, edited by The Centre of European Law, School of Law, King's College London, Professor Daniel Goyder indicates that the EU Commission has not relied on this presumption in its M&A reviews, but, rather, has conducted a full factual analysis.

78. Recital 15 ECMR.

79. See Kali und Salz/MdK/Treuhand, O.J. C209/2 (1998) and Airtours plc, O.J. C191/24 (2002).

Article 2(1) of the ECMR contains a detailed list of the factors that the EU Commission must consider in its analysis. Pursuant to Article 2(1) of the ECMR, the EU Commission is required to take into account "the development of technical and economic progress provided that it is to consumers' advantage and does not form an obstacle to competition."[80] Thus, the ECMR, on its face, appears to require the EU Commission to take into account efficiencies as a factor in determining whether the transaction creates or strengthens a dominant position so long as (1) consumers benefit; and (2) the efficiencies do not become an obstacle to competition. Because of this second criterion, "it was widely believed . . . that the Commission would not treat efficiencies as a defense to a merger that created or strengthened a dominant position, and that it might even view efficiencies as an additional reason for prohibiting a merger on the ground that they would further entrench the merged firm's dominant position."[81] In the explanatory notes to the ECMR, the EU Commission further indicated that "the concept of technical and economic progress must be understood in light of the principles enshrined in Article 81(3) of the European Community treaty, as interpreted by the case law of the European Court of Justice."[82] The wording of Article 81(3), however, differs from the ECMR in that, under Article 81(3), the EU Commission only can authorize agreements if they contribute "to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the possible benefit." Thus, under Article 81, efficiencies are not a defense, but a requirement.[83]

Other important differences arise from the language of Article 81 and the ECMR. First, in contrast to Article 81, the ECMR excludes the more general reference to improvements in production and distribution, which suggests that only efficiency gains resulting from innovation might count.[84] Second, although Article 81 requires only a "fair share" of benefit to flow to consumers, the ECMR does not expressly provide whether (and to what extent) consumers must benefit.[85] Finally, and, perhaps, most importantly, the ECMR's requirement that the technical and economic progress should not form an obstacle to competition makes it unlikely that a dominant firm will be able to assert efficiencies as a defense since any

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80. Art. 2(1)(b) ECMR.

81. William J. Kolasky, North Atlantic Competition Policy: Converging Toward What? before the BIICL Second Annual International and Comparative Law Conference, London, England, May 17, 2002 ("Kolasky London Speech") at 3, citing, Frederick Jenny, Competition and Efficiency, in Antitrust in a Global Economy, 1993 Corporate Law Institute, Fordham U. School of Law (B. Hawk, ed., 1994).

82. Notes on Council Regulation (EEC) No. 4064/89, published in Merger Control Law, European Commission, Brussels-Luxembourg, 1998.

83. Ilzkovitz & Meiklejohn at 13.

84. Id. at 14.

85. Id.

improvement in efficiency may enhance its market power.[86] This view is illustrated by the EU Commission's actions in *Du Pont/ICI*[87] and *Shell/Montecatini*,[88] two transactions in which the EU Commission required undertakings that sought to provide comparable or shared efficiency benefits for competitors before allowing the transactions to proceed. In *Du Pont/ICI*, the EU Commission was concerned that the merger of two top-ranking research and development facilities in the nylon fiber business would grant to the merged entity a dominant position. The EU Commission permitted the Du Pont/ICI merger to occur only after Du Pont agreed to transfer to a third party a freestanding research and development facility of comparable quality to those operated by Du Pont and ICI.[89] Similarly, in *Shell/Montecatini*, the transaction parties were required to proffer undertakings that would preserve a second independent source of polypropylene technology licensing before the EU Commission permitted the concentration to proceed.[90]

Even in a joint venture context, the EU Commission has, at times, treated efficiencies as an offense rather than a defense.[91] In *MSG Media Service*,[92] the EU Commission rejected a proposed concentrative joint venture between Kirch and Bertelsmann to provide technical and administrative support for German digital pay-TV services. The EU Commission summarily questioned the joint venture's likelihood of achieving the economies claimed once it determined that the full function joint venture would create a dominant position in pay-TV markets.[93] Similarly, the EU Commission blocked the formation of Nordic Satellite Distribution,[94] a proposed concentrative joint venture for satellite TV transponder services between two Scandinavian telecom operations and a major Swedish content provider for TV programs. The EU Commission expressed concerns regarding both market shares for transponder services and possible spillover effects in the upstream market where the parents enjoyed market power.[95] The EU Commission did not view vertical

86. Id.

87. Du Pont/ICI O.J. L7/13 (1993) (Comm'n).

88. Shell/Montecatini O.J. L332/48 (1994) (Comm'n).

89. Du Pont/ICI O.J. L7/13 (1993) (Comm'n) at ¶¶ 33-34.

90. These undertakings were later withdrawn by the EU Commission as no longer necessary in light of the FTC consent and subsequent sale of all of Shell's polypropylene technology assets. See Decision of 24 April 1996 amending Decision 94/811/EC declaring the compatibility of a concentration with the common market O.J. L294/10 (1996) (Comm'n).

91. But see Gian Luca Zampa, The Role of Efficiency Under the EU Merger Regulation, (Nov. 2000), at Section III.A.3 (manuscript on file with the author).

92. MSG/Media Service O.J. L364/1 (1993) (Comm'n).

93. Id. at ¶¶ 23-24.

94. Nordic Satellite Distribution O.J. L53/20 (1996) (Comm'n).

95. Id. at ¶¶ 93 and 109.

integration of the operation of the transponders and content as necessary for a satellite operation to promote the satellite's operations.[96]

The debate over the role of efficiencies has existed from the very outset of the ECMR regime. In its first decision prohibiting a merger under the ECMR, *Aerospatiale-Alenia/de Havilland*,[97] the EU Commission found that, while the merger would produce some (albeit negligible) efficiencies from cost savings and one-stop shopping, those efficiencies only would enhance the merged firm's power to behave independently of its competitors.[98] Moreover, the EU Commission determined that the cost savings could be achieved through other means. Similarly, in *AT&T/NCR*,[99] the EU Commission rejected the transaction parties' contentions that the merger would achieve important synergies in the development of more advanced communications technologies, and noted that the potential advantages flowing from such synergies may create or strengthen a dominant position.

Subsequent EU Commission decisions continued to exhibit hostility towards efficiencies. For instance, a few years after *AT&T/NCR*, in *Accor/Wagons-Lits*,[100] the EU Commission considered whether the transaction would create a dominant position in the French motorway catering market. The EU Commission rejected Accor's claims of scale economies, indicating that: the combined firm "would have no interest to pass on assumed gains to consumers;" there might be potential diseconomies of scale; the cost reductions were not merger specific; and the concentration would form a significant obstacle to efficient competition.[101]

The EU Commission adopted a very different approach towards efficiencies, however, in its 1996 *Saint Gobain/Wacker-Chemie/NOM* decision, applying a genuine balancing test that weighed the advantages of potential synergies against the curtailment of competition:

> The possibility of a price increase of SiC, as a consequence of the operation, will outweigh the potential synergies. In assessing the potential efficiencies of the merger, therefore, it is important also to take into account the competitiveness of the downstream EU producers of abrasive and refractory products.[102]

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96. Id. at ¶ 146.

97. Aerospatiale-Alenia/de Havilland O.J. L334/42 (1991) (Comm'n) (parties argued that combined entity would have been able to reduce production costs substantially through rationalization of parts procurement, marketing, and product support; EU Commission rebutted argument and said not merger-specific).

98. Id. at ¶ 69.

99. AT&T/NCR O.J. C16/00 (1991) (Comm'n) at ¶ 30.

100. Accor/Wagons-Lits O.J. L204/1 (1992) (Comm'n).

101. Id. at ¶ 26,2(f).

102. Saint Gobain/Wacker-Chemie/NOM O.J. L247/1 (1996) at ¶ 246.

Regrettably, subsequent EU Commission merger decisions have not deployed this balancing test. Efficiencies have, however, in some cases, been an important basis for the EU Commission's decision to clear a transaction.[103]

One of the clearest rejections of an efficiency defense in a merger resulting in "dominance" occurred in the EU Commission's March 1999 decision in *Danish Crown/Vestjyske Slagterier*:

> As far as those efficiencies are concerned, it should be noted that under Article 2(1)(b) of the merger regulation the Commission may take account of the development of technical and economic progress only to the extent that it is to consumers' advantage and does not form an obstacle to competition. The creation of a dominant position in the relevant markets . . . therefore means that the efficiencies argument put forward by the parties cannot be taken into account in the assessment of the present merger.[104]

Perhaps the most promising role for assertion of efficiencies has been in a situation in which the industry involved is declining or one of the companies involved is financially distressed. Although the EU Commission did not cite to "efficiencies" per se as its basis for permitting the BASF/Eurodiol/Pantochim transactions[105] (but, rather, approved the transactions under a rescue merger approach) despite a finding that the transactions would create a dominant position in the relevant markets for three butanediol products, the same reasoning should apply. As the relevant markets were facing declining demand, the EU Commission determined that the transactions were necessary to permit the parties to lower production costs by deploying the Eurodiol plant systems to produce the entire outputs of the parties. Although such consolidation provided BASF with market dominance, the EU Commission recognized that the market conditions would otherwise have deteriorated to a greater extent, and to the greater detriment of consumers, if the transactions did

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103. Alcatel/Telettra O.J. L122/48 (1991) (Comm'n); American Cyanamid/Shell O.J. C273/1 (1993) (Comm'n); Mercedes-Benz/Kassbohrer O.J. L211/1 (1995) (Comm'n); ABB/Daimler-Benz O.J. L11/29 (Comm'n); Mannesmann/Valourec/Ilva O.J. L102/15 (Comm'n); and Agfa-Gevaert/DuPont O.J. L211/22 (1998) (Comm'n). In The Explicit Efficiency Defense in Merger Control: Does It Make the Difference?, 20(1) Eur. Comp. L. Rev. 25 (1999), Professor Peter Camesca indicates that the EU Commission relied upon efficiencies to clear these mergers.

104. Danish Crown/Nestivske Slagtenor O.J. L20/1 (2000) (Comm'n) (parties' arguments that the merger would permit substantial cost savings, enable the merged entity to supply customers with a full range of products, and enable the parties to maintain their market position in the Japanese market in face of strong U.S. competition were rejected by the EU Commission as "not merger-specific").

105. BASF/Eurodiol/Pantochim O.J. L132/45 (2002) (Comm'n).

not occur.[106] Moreover, the EU Commission found that prices would have risen much faster absent the combination.

2. GE/Honeywell

The EU's decision in *GE/Honeywell*[107] provides a stark example of the potential divergence between the United States and the EU in the treatment of efficiencies in merger review.[108] According to GE's and Honeywell's press releases, a key purpose of the merger was the desire of the firms to combine their complementary product lines in the civil aerospace industry. GE was the leading producer of jet engines for large commercial aircraft and large regional jets; Honeywell was a leading producer of engines for small regional and corporate jets, as well as avionics and many major nonavionics systems. GE and Honeywell faced different rivals in several of their lines of business. The EU Commission believed that the transaction raised serious competitive issues because it enabled GE to make bundled offerings, while the DOJ apparently considered this ability to be an efficiency of the transaction.[109]

The EU had two theories of competitive harm with respect to bundling: (1) the merger would strengthen GE's already dominant position in the market for aircraft engines for large commercial aircraft — higher prices to consumers eventually would occur as rivals would be forced out of business; and (2) the merger would enable GE to gain a dominant position in small engines, avionics, and other aircraft systems. In other words, the EU found that the merger would permit GE/Honeywell to engage in "mixed bundling" by offering a package of GE engines and Honeywell products at discounted prices. Although the EU found that buyer power was an effective constraint in *Allied Signal/Honeywell*,[110] the EU rejected this argument in *GE/Honeywell*, apparently finding that, due to the unique circumstances in *GE/Honeywell*, countervailing buyer power did not exist.

GE's so-called market "dominance tool kit" included GE Capital, which, according to the EU Commission, offered GE significant financial

106. Id. at ¶¶ 157-163.

107. General Electric/Honeywell, Case No. COMP/M. 2220 (2001) (Comm'n). See Donna E. Patterson and Carl Shapiro, Transatlantic Divergence in GE/Honeywell: Causes and Lessons, Antitrust 18 (Fall 2001) ("Patterson & Shapiro").

108. The transaction was cleared in the United States, as well as in Canada.

109. This article earlier focuses solely on the dispute between the EU and the United States in connection with the so-called "bundling theory." The EU decision also found a competitive concern in connection with GE Capital Aviation Services ("GECAS"). The debate between the United States and the EU in connection with the GECAS concern, however, relates to differing views regarding the significance of GECAS' aircraft purchases rather than efficiencies, and, thus, is not discussed in this article.

110. Allied Signal/Honeywell O.J. L152/1 (1999) (Comm'n) at ¶ 118.

means, enabling it to take more risk in product development than its rivals and to offer customers heavy discounts on the initial sale of engines, later recouping those discounts through sale of spares and repairs. In contrast, rivals had to rely on external financing. The EU Commission also found that GE would have lower financing costs (with its AAA bond rating) and the merger would extend this competitive advantage to Honeywell.[111] Together, the EU Commission found that these tools created a unique advantage for a combined GE/Honeywell entity that could not be replicated by competitors through teaming or otherwise. In the EU Commission's view, the merger would provide incentives for the merged entity to discount prices to customers through mixed bundling, thereby restricting the ability of Honeywell's rivals to compete, leading to increased marginalization and eventually elimination of the competitors. In turn, competitor exit from the marketplace, ultimately, would lead to higher prices and lower quality products. Indeed, the EU's mixed bundling theory is crucially dependent on its predictions that rivals would eventually be forced to exit the marketplace, with high entry barriers and a very long industrial cycle making re-entry or new entry unlikely.[112]

Whereas the EU Commission considered the effects of near-term lower prices resulting from mixed bundling as part of one of its theories of competitive harm, the DOJ disagreed strongly with this approach, expressing the view that any such price discounts would be beneficial to customers (and akin to the passing on of the traditional types of efficiencies that may arise in a merger).[113] Further, the DOJ considered that these near-term price discounts only would present a problem if they led to "competitor exit" and subsequent price increases that, on a net present value basis, would make customers worse off. EU Commissioner Mario Monti stated that, in any event, the parties did not, in his view, "provide a

111. See generally Gotz and Drauz, European Union Law: Unbundling GE/Honeywell: The Assessment of Conglomerate Merger Under EC Competition Law, 25 Fordham Int'l L.J. 885, 897-900 (2002) ("Drauz Article").

112. Drauz Article at 903.

113. "In our view, the so-called 'portfolio effects' analysis employed by the [EU Commission] is antithetical to the goals of antitrust law enforcement." Charles A. James, Assistant Attorney General, Antitrust Division, U.S. Department of Justice, "International-Antitrust in the Bush Administration," Canadian Bar Association, Annual Fall Conference on Competition Law, Ottawa (Sept. 31, 2001). *See also* "International Antitrust in the 21st Century: Cooperation and Convergence," OECD Global Forum on Competition, Paris (Oct. 17, 2001) where Mr. James stated, "We concluded that the merged firm would have offered improved products at more attractive prices than either firm could have offered on its own, and that the merged firm's competitors would then have had a great incentive to improve their own product offerings. This, to us, is the very essence of competition, and no principle is more central to U.S. law than that antitrust protects competition, not competitors."

clearly articulated and quantified defense in terms of efficiencies."[114] Notwithstanding the contrary opinion of the DOJ, the EU Commission has maintained that price cuts resulting from mixed bundling are not the type of real efficiency that should be taken into account in a merger analysis, but, instead, constitute a form of "strategic pricing" by the merged firm.[115]

The divergent views of the U.S. and European authorities have stirred considerable debate within the antitrust community. The Fall 2001 issue of Antitrust focussed on the GE/Honeywell merger with a lively roundtable discussion among Carl Shapiro, Francisco-Enrique Gonzalez-Diaz, and John DeQ. Briggs.[116] Citing what he saw as a fundamental doctrinal divergence between the U.S. and Europe, Shapiro stated:[117]

> Let me speak to the doctrinal question rather than the process issues. I think the *GE/Honeywell* case exposes very deep and fundamental differences of approach on doctrine between the United States and the European Union. The core of the case brought by the EU was based on the concern that the merged entity would engage in package discounting. I think we see in the EU hostility towards large firms that are perceived as powerful becoming more efficient, whereas in the United States efficiencies are welcomed, even if they mean strengthening a company that is already a leader. That's a fundamental difference.[118]

In response and in defense of the EU's decision, Mr. Gonzalez-Diaz replied:[119]

> Although I am not going to discuss the details of the case, I can tell you that I completely disagree with Carl Shapiro's characterization of the Commission's approach in *GE/Honeywell*. The Commission opposed the GE/Honeywell deal because, in our view, and this view might be right or wrong -- we will have the opportunity to check that before the European Court of

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114. Mario Monti, Antitrust in the U.S. and Europe: A History of Convergence, Prepared Remarks before the General Counsel Roundtable of the ABA (Nov. 14, 2001).

115. Drauz Article at 906-907.

116. Transatlantic Antitrust: Convergence or Divergence — Roundtable Discussion, Antitrust 18 (Fall 2001) ("Roundtable") at 7.

117. Professor Shapiro, Transamerica Professor of Business Strategy, Haas School of Business, was an economic expert for GE in *GE/Honeywell*.

118. Roundtable at 8.

119. Mr. Gonzalez-Diaz is the Head of Unit of the Merger Task Force, DG Comp, EC, and was lead EC attorney in *GE/Honeywell*.

Justice in the next few months – it was likely to lead to foreclosure effects and ultimately to damage consumer welfare.

The Commission has nothing against efficiencies, and has never prohibited or interfered with a deal that was shown to be likely to lead to significant efficiencies. We do not have an efficiencies offense doctrine in Europe, and I completely disagree with anyone who claims that the heart or the core of our concerns in *GE/Honeywell* or in any other case was that the transaction was going to be procompetitive, in the sense that consumers were going to be better off.[120]

As alluded to by Mr. Gonzalez-Diaz, GE and Honeywell have appealed the decision to the European Court of Justice in Luxembourg.[121]

3. *Signs of Possible Change in Perspective in the Near Future*

As mentioned above, critics argue that a merger policy that does not take into account efficiency gains (including cost savings that are passed on to consumers in the form of lower prices) may be harmful to European competitiveness, especially in high-tech industries.[122] Indeed, following the debates in the European Parliament on the EU Commission's competition policy report for 1999, the European Parliament issued resolutions that call for "efficiency and other pro-competitive elements" to be taken into account.[123]

Accordingly, the EU Commission recently has indicated that it is examining its views on efficiencies, and may view efficiencies more favorably in the future. A debate on the role of efficiencies under the ECMR was launched on December 11, 2001, with the publication of a green paper addressing EU merger policy and practices.[124] In July 2002, EU Commissioner Monti stated, "We are not against mergers that create more efficient firms. Such mergers tend to benefit consumers, even if

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120. Roundtable at 8.

121. While the European Court of Justice will not re-open questions of fact, it can review whether the EU Commission's legal arguments relating to the "portfolio effect" and "mixed bundling" were within the scope of the EU Commission's merger review. The Court's judgment in this case is not expected before late 2002.

122. Ilzkovitz & Meiklejohn at 11.

123. European Parliament Minutes of Oct. 24, 2000 (reported as 0290/2000/ Point 15).

124. See Green Paper on the Review of Council Regulation (EEC) No. 4064/89 (Nov. 12 2001), available at www.europa.eu.int/comm/competition/mergers/review/ green_paper/en.pdf. Indeed, a broader philosophical discussion also is underway regarding whether to replace the dominance test with the substantial lessening of competition test in existence elsewhere, including in the U.S., and Canada.

competitors might suffer from increased competition."[125] EU Commissioner Monti has offered further guidance as to the likely direction of certain pending changes. Most notable from a substantive standpoint, EU Commissioner Monti (1) expressed support for an efficiencies defense;[126] (2) noted that reform will be accompanied by the issuance of interpretative market power guidelines to assist in proving market definition and how efficiency considerations should be taken into account; and (3) indicated that the EU will not stop mergers simply because they reduce cost and allow the combined firm to offer lower prices, thereby reducing or eliminating competition. EU Commissioner Monti concluded, however, that "it is appropriate to maintain a touch of 'healthy skepticism' with regard to efficiency claims, particularly in relation to transactions which appear to present competition problems."[127]

On November 7, 2002, EU Commissioner Monti gave a major address in which, among other things, he explained further the evolving role of efficiencies.[128] Monti expressed that an explicit recognition of merger-specific efficiencies is possible within the mandate of Article 2(1)(b) of the treaty.[129] Monti further indicated that in the horizontal merger guidelines:

> [T]he Commission intends to carefully consider any efficiency claim in the overall assessment of the merger, and may ultimately decide that, as a consequence of the efficiencies the merger brings about, the merger does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded.

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125. Mario Monti, The Future for Competition Policy in the European Union, Address at Merchant Taylor's Hall, London (July 9, 2001), n. 4.

126. EU Commissioner Monti is the first economist to be EU Competition Commissioner. In his June 4, 2002 speech, Monti indicated that "the Commission does not rely on the fact that efficiencies resulting from a merger are likely to have the effect of reducing or eliminating competition in the relevant market (e.g., by enabling lower prices to be charged to customers) as a ground for opposing a proposed transaction . . . too bad if competitors do go out of business. . . . That's okay if the monopolist is more efficient." Mario Monti, European Competition Commissioner, Review of the EC Merger Regulation-Roadmap for the Reform Project Conference on Reform of European Merger Control, British Chamber of Commerce, Brussel (June 4, 2002) ("Monti British Chamber Speech"), at ¶ 26, available at http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=SPEECH/02/252|0|RAPID&lg=EN&display=; see also Brandon Mitchner, Monti Plans to Reform EU's Merger-Review Regime Wall S.J. Eur. (June 4, 2002).

127. Monti British Chamber Speech at ¶ 31.

128. Mario Monti, Merger Control in the European Union: A Radical Reform, European Commission/IBA Conference on EU Merger Control, Brussels, Belgium (Nov. 7, 2002) ("Monti IBA Conference Speech"). This formulation of the efficiencies defense by EU Commissioner Monti is similar to that contained in the U.S.'s 1997 Revisions. It will be interesting to see how the EU will apply this framework in practice.

129. Id. at p. 4.

> A note of caution, however: efficiency claims should only be accepted when the Commission is in a position to conclude with sufficient confidence that the efficiencies generated by the merger will enhance the incentive of the merged entity to act pro-competitively for the benefit of consumers, because the efficiencies generated by the merger will either outweigh any adverse effects on consumers or make these effects unlikely. For the Commission to reach such a conclusion, the efficiencies would have to be of direct benefit to consumers, as well as being merger-specific, substantial, timely, and verifiable. The burden of proof should moreover clearly rest on the parties, including the burden of demonstrating that the efficiencies are of such a magnitude as to outweigh the negative effects of the merger on competition. The draft guidelines will also indicate that it is very unlikely that efficiencies could be accepted as sufficient to permit a merger leading to monopoly or quasi-monopoly to be cleared.[130]

The formulation of the efficiencies defense by EU Commissioner Monti resembles that contained in the 1997 Revisions issued by the FTC and DOJ. The EU Draft Guidelines[131] issued in December 2002 similarly indicates that:

> The Commission welcomes corporate reorganizations...[and] takes into account... the development of technical and economic progress provided that it is to the consumers' advantage and does not form an obstacle to competition. The Commission considers any substantiated efficiency claim in the overall assessment of the merger. It may decide that, as a consequence of the efficiencies that the merger brings about, the merger does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded. This will be the case when the Commission is in a position to conclude on the basis of sufficient evidence that the efficiencies generated by the merger are likely to enhance the incentive of the merged entity to act proactively for the benefit of the consumers, by counteracting the effects on competition which the merger might otherwise have.[132]

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130. Id.

131. *See* Commission of the European Communities, Commission Notice on the Appraisal of Horizontal Mergers under the Council Regulation on the Control of Concentrations Between Undertakings 9dec. 11, 2002) ("EU Draft Guidelines") Para. 20.

132. EU Draft Guidelines ¶¶ 88-89.

The EU Draft Guidelines further require that "the efficiencies have to be of direct benefit to consumers and to be merger-specific, substantial, timely, and verifiable."[133] It will be interesting to see how the EU will apply this framework in practice.

C. *Canada*

Both the United States and the EU may find the treatment of efficiencies in Canada, which has statutorily embraced an efficiency defense, pertinent to their consideration of efficiencies. This defense has been subject to extensive litigation and interpretation before the Canadian Competition Tribunal ("Tribunal")[134] and the Canadian Federal Court of Appeal in *Superior Propane*, discussed in detail below.

The Canadian Competition Act[135] is administered by the Commissioner of Competition ("Canadian Commissioner"), who is appointed by the federal Cabinet, and oversees the Competition Bureau ("Canadian Bureau"). After the Canadian Bureau assesses a proposed merger, the Canadian Commissioner decides whether to challenge the merger before the Tribunal or proceed with a consent agreement filed with the Tribunal. The Tribunal, a quasi-judicial body comprised of judges drawn from the Federal Court, Trial Division, and lay members, who typically are economists or individuals with business experience.[136] The Tribunal acts independently from the Canadian Commissioner and the Canadian Bureau, and has exclusive jurisdiction to adjudicate mergers and the other non-criminal provisions of the Canadian Competition Act. Under the Canadian Competition Act, the Canadian Commissioner may file a notice of application with the Tribunal to challenge a transaction any time within three years from the date the transaction is substantially completed.

The overall analytical framework adopted in Canada for M&A review is similar to that adopted by the United States. The Canadian Bureau focuses on market power by adopting a hypothetical-monopolist approach to market definition and a generally similar approach to the

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133. Id. at ¶ 90.

134. The Tribunal's statutory authority is defined in the Competition Tribunal Act. R.S., 1985, c. 19 (2d Supp.), s. 3.

135. R.S.C. 1985, c. C-34.

136. "The specialized nature of the Tribunal provides the greatest potential for developing expertise in such complex issues as efficiency considerations and the effects of anticompetitive practices." Calvin S. Goldman: Corporate Concentration and Canada's New Competition Act in R. S. Khemani, D. M. Shapiro and W. T. Stanbury (eds. 1988) Mergers, Corporate Concentration and Power in Canada, Institute for Research in Public Policy, Halifax 489 at 492. For example, Dr. Lawrence Schwartz, a Canadian professor of economics, currently sits on the Tribunal. See the Tribunal's website at http://www.ct-tc.gc.ca/english/tribunal.htm, for Dr. Schwartz's biography.

analysis of barriers to entry and other qualitative assessment criteria. Two key historical differences between the Canadian and the U.S. approach to M&A review are: (1) the reduced weight given to high market shares or concentration; and (2) the statutory efficiency defense set forth in Section 96 of the Canadian Competition Act. In particular, in recognition of the efficiencies to be gained from economies of scale and Canada's smaller economy, the Canadian approach tolerates higher post-merger market shares than might be accepted in the United States.[137] In recent years, however, the current Canadian Commissioner has taken a more structuralist and less qualitative approach to merger review, which generally has narrowed the degree to which the treatment of market shares has differed between Canada and the United States.[138]

1. The Statutory Defense

The Canadian Parliament enacted the efficiency defense in 1986 as part of a series of amendments to the Combines Investigation Act, Canada's then antitrust statute and the predecessor to the current Competition Act.[139] The defense, in theory, permits a merger that prevents or lessens, or is likely to prevent or lessen, competition substantially in any market in Canada, so long as the efficiency gains resulting from the merger exceed the anticompetitive effects of the merger. In practice, merging parties may raise the defense, both in the initial assessment phase before the Canadian Bureau, and, again, if necessary, when the Canadian Commissioner has brought an application before the Tribunal challenging the merger.

Section 96 of the Canadian Competition Act expressly mandates the efficiency defense:

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137. To some extent, the adjustment upward of the market shares to take into account efficiencies is consistent with the approach favored by Judge Robert Bork. See Robert H. Bork, The Antitrust Paradox: A Policy at War with Itself, 126-27 (1993 Ed.) ("Bork").

138. For example, in the bank and retail grocery store merger contexts, the Canadian Commissioner established market share categories to determine the effect of a merger on competition (i.e. market shares of 45% or more fall in the category "will result in a substantial lessening of competition," market shares between 35% and 45% fall into the category "may result in a substantial lessening of competition," and market shares below 35% fall into the category "will not result in a substantial lessening of competition." See, e.g., the Canadian Bureau's Fact Sheet: The Competition Bureau and the Proposed Merger of Toronto-Dominion Bank and Canada Trust (Appendix B – Criteria Used for Local Market Classification and Backgrounders "Loblaw Companies Limited – Acquisition of Provigo Inc. in Quebec and Ontario" and "Sobeys Inc. Acquisition of Certain Assets of The Oshawa Group Limited").

139. Calvin Goldman headed the Canadian Bureau when the efficiency defense amendment was introduced as part of the Competition Act.

(1) The Tribunal shall not make [a consent order] under section 92 if it finds that the merger or proposed merger in respect of which the application is made has brought about or is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger and that the gains in efficiency would not likely be attained if the order were made.

(2) In considering whether a merger or proposed merger is likely to bring about gains in efficiency described in subsection (1), the Tribunal shall consider whether such gains will result in
  (a) a significant increase in the real value of exports; or
  (b) a significant substitution of domestic products for imported products.

(3) For the purposes of this section, the Tribunal shall not find that a merger or proposed merger has brought about or is likely to bring about gains in efficiency by reason only of a redistribution of income between two or more persons.

While Section 96 of the Canadian Competition Act recognizes that mergers may be both anticompetitive and efficiency enhancing, it appears, on balance, to favor efficiency enhancement.

a. History of the Canadian Efficiency Defense

The Economic Council of Canada's 1969 Interim Report on Competition Policy formed the genesis of the efficiency defense when it advocated that the principal goal of Canadian competition policy was "economic efficiency:"

> Essentially, we are advocating the adoption of a single objective for competition policy: the improvement of economic efficiency and the avoidance of economic waste, with a view to enhancing the well-being of Canadians. . . .[140]

Following the Economic Council's report, the efficiency defense evolved in several draft bills, culminating in Bill C-91,[141] which included

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140. Interim Report on Competition Policy (Ottawa: Queen's Printer, 1969) at 19.

141. 1st Sess., 33rd Parl., 1984-85. The first attempt to table reform legislation made by the then-Liberal government in 1971 was met with strong opposition and harsh criticism from business groups. Following a series of further unsuccessful attempts to advance similar legislation, the Conservative government passed Bill C-91, successfully and expeditiously in June 1986.

an efficiency defense that was almost identical to the final text of Section 96 of the Canadian Competition Act.

In applying the efficiency defense, one of the issues that arose concerned the goals of Section 96 of the Canadian Competition Act and whether they included the protection of consumer welfare. While the Canadian Federal Court of Appeal has considered the introduction of Bill C-91 to incorporate a "consumer protection" measure,[142] the Tribunal has taken a different view of the objective of Bill C-91, stating that the policy goal of Bill C-91 was the creation of dominant firms able to compete successfully, with consumers and small businesses being among the prime beneficiaries of such an effective competition policy as they would be better protected from anticompetitive conduct by these firms and would have a greater ability to compete.[143]

The Tribunal concluded that the Parliamentary Committee had determined that efficiency was the paramount objective of the merger provisions of the Canadian Competition Act, and was, therefore, of the view that the primary reason for Bill C-91 was the need to strengthen Canadian business and provide an incentive for productivity in the face of aggressive international competition, which productivity would ultimately benefit consumers.[144]

Since its inception in 1986, the efficiency defense has been considered in only two cases brought before the Tribunal: *Superior Propane* and *Hillsdown*.[145]

Notwithstanding the limited number of Tribunal deliberations invoking the efficiency defense,[146] efficiencies have (at least until more recently) played a significant role in several earlier merger reviews involving relatively high post-merger market shares,[147] and have been considered a part of the Canadian Bureau's assessment considerations.

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142. The Commissioner of Competition v. Superior Propane and ICG Propane Inc. (2001), 199 DIL.R. (4th) 130 ("Superior Appeal Decision").

143. The Commissioner of Competition v. Superior Propane Inc., 2000 Comp. Trib. 16, File No. CT1998002 (April 4, 2002) ("Superior Redetermination Decision") at ¶ 60.

144. Id. at ¶¶ 80-81.

145. Director of Investigation & Research v. Hillsdown Holdings (Canada) Ltd., [1992] 41 C.P.R. 3d 289. Although the Tribunal reviewed and interpreted the efficiency defense in some detail in *Hillsdown*, such discussion was obiter dictum since the Tribunal did not find that a substantial lessening or prevention of competition was likely to result from the merger.

146. In Canada (Director of Investigation & Research) v. Imperial Oil Ltd. (Jan. 26, 1990), Doc. CT-89/3 (Competition Trib.), the Tribunal was prepared to accept, as legitimate potential sources of productive efficiency gains, lower inventories and distribution costs, savings in marketing and overhead expenditures, and output gains from specialization of production.

147. For example, efficiencies were a significant factor in the early years of the Canadian Competition Act in the approval of the following mergers, notwithstanding their high post-merger market shares:

b. Anticompetitive Effects

Section 96(1) of the Canadian Competition Act requires efficiency gains to be balanced against "the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger." It is commonly understood that transactions that substantially prevent or lessen competition may have two basic adverse economic or anticompetitive effects that flow from the increased price and reduction in output and consumption: (1) an adverse allocation of resources resulting from the distortionary effects of prices above marginal costs and output below competitive (a societal loss known as "deadweight loss"); and (2) a transfer of wealth from buyers to sellers and their shareholders flowing from the creation of higher prices and/or lower product quality (known as "redistributive effects").[148]

Transaction	Product Market	Year	Types of Efficiencies Considered
Fletcher and Challenge/B.C. Forest Products	Newsprint	1987	Production and distribution efficiencies.
Rothmans and Benson & Hedges	Tobacco products	1987	Production and distribution efficiencies.
Nabisco-Interbake	Snack crackers	1987	Production, marketing and distribution efficiencies.
Trailmobile and Fruehauf	Trailer vans	1988	Production efficiencies from the full merger of manufacturing operations.
Wolverine and Noranda	Seamless copper tubing	1988	Significant efficiency gains for Wolverine.
Dofasco and Algoma	Hot rolled sheet and strip	1988	Capital expansion and operating savings.
Consumers Packaging/Domglas	Glass containers	1988	Annual savings estimated to be $54 million
Molson/Carling O'Keefe	Beer	1989	Considerable efficiency gains that would assist international competitive position.

Source: Annual reports of the Canadian Director of Investigation and Research, Bureau of Competition Policy, for the years ended March 31, 1987, 1988, 1989 and 1990; News releases of Consumer and Corporate Affairs Canada: "D.I.R. accepts revised undertakings from Trailmobile" (July 11, 1988). DIR announces decision on InterBake acquisition" (Feb. 1, 1988); Calvin S. Goldman, Director of Investigation and Research, Bureau of Competition Policy, "The Impact of the Competition Act of 1986," speech delivered to the National Conference on the Centenary of Competition Law in Canada, Toronto, Canada (Oct. 24, 1989); Calvin S. Goldman Director of Investigation and Research, Bureau of Competition Policy, "Merger Review Under Canadian Competition Law: The Quest for Balance," speech delivered to the Canadian Bar Association, Vancouver, Canada 9 Aug. 23, 1989).

148. In addition to these anticompetitive effects, there can be both quantitative misallocation effects and qualitative redistributive effects arising from independent and coordinated pricing or other behavior by competing firms (e.g., reductions in levels of

In practice, the anticompetitive effects of a transaction may be difficult to determine accurately, in particular with respect to the calculation of losses due to the reduction in service, quality, variety, innovation and other non-price dimensions of competition. Insofar as such losses are not quantifiable, they should be assigned a qualitative weight.

c. Types of Efficiencies Permitted

The Canadian Merger Enforcement Guidelines[149] (the "Canadian Merger Guidelines") prescribe two classes of efficiency gains that will be assessed under the efficiency defense: (1) production efficiencies; and (2) dynamic efficiencies. Production efficiencies generally are the focus of the evaluation because they can be quantifiably measured, objectively ascertained, and supported by engineering, accounting or other data.[150]

Dynamic or "Schumpeterian" efficiencies include gains attained through the optimal introduction of new products, the development of

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service, product quality, and consumer choice), and the loss of potential dynamic efficiency gains resulting if the combined entity decides to abandon one or more of a party's new technologies or projects. Indeed, the Canadian Commission argued, albeit unsuccessfully, for the consideration and inclusion of these anticompetitive effects in *Superior Propane*, but had not included any evidence of such in the record.

149. While the Canadian Merger Guidelines are not sacrosanct nor legally binding, they provide important enforcement guidelines reflecting the Canadian Commissioner's view on how the Canadian Competition Act should be interpreted. They were prepared to inform the business community and the public as to how the Canadian Bureau analyzes the competitive impact of mergers including how it considers efficiencies. (Superior Initial Decision at ¶ 394.)

150. Production efficiencies include product-level, plant-level and multi-plant-level operating and fixed-cost efficiencies, savings associated with integrating new activities within the combined firms, and savings attributable to the transfer of superior production techniques and know-how from one of the merging parties to the other. Plant-level savings refer to those savings that flow from specialization, elimination of duplication, reduced downtime, smaller inventory requirements, or the avoidance of capital expenditures that would otherwise be required. Multi-plant-level savings include those savings associated with plant specialization, rationalization of administrative and management functions, and the rationalization of R&D activities. Further, efficiencies also may be attained in respect of distribution, advertising, and capital raising. Finally, a reduction in transaction costs associated with the integration of activities previously performed by third parties (e.g., contracting for inputs, distributions, and services) also may constitute production efficiencies. For example, in *Hillsdown*, the parties claimed three areas of cost savings: (1) administrative cost savings resulting from a reduction in the number of administrative positions post-merger (including salaries and associated benefits and expenses after having subtracted severance costs); (2) transportation cost savings achieved through the rationalization of various truck routes (allowing for a reduction in the trucking fleet, drivers, and fuel costs post-merger); and (3) manufacturing cost savings arising from one party reducing its input purchases, relying, instead, on the existing production of its merger partner.

more efficient productive processes, and the improvement of product quality and service.[151] However, claims that a transaction will lead to dynamic efficiencies ordinarily are more difficult to measure. Accordingly, the weight given to claims regarding such efficiencies generally will be qualitative in nature.[152]

2. *The* Superior Propane *Decisions*

Clearly the most comprehensive (and perhaps confusing) analysis of the treatment of efficiencies in Canada arises in the three *Superior Propane* decisions: (1) the Tribunal's first decision following a lengthy hearing under which the Canadian Commissioner challenged the merger of two Canadian propane companies[153] ("Superior Initial Decision"); (2) (the Superior Appeal Decision); and (3) the Tribunal's second decision following a subsequent redetermination hearing ordered by the Federal Court ("Superior Redetermination Decision"). The Canadian Commissioner again has brought an appeal of the Tribunal's the Superior Redetermination Decision to the Canadian Federal Court of Appeal. The *Superior Propane* decisions have, to this point, confirmed the use of the efficiency defense to permit the combination of two national propane companies, notwithstanding clear evidence that the combination would create near monopolies in several geographic areas in Canada.

a. Background

On July 16, 1998 Superior Propane Inc. ("Superior") announced its intention to acquire all of the issued and outstanding shares of ICG Propane Inc. ("ICG"). Shortly thereafter, the Canadian Bureau, which had competition concerns regarding the merger, announced that it would challenge the transaction before the Tribunal. After a two-day hearing, the Tribunal dismissed the Canadian Bureau's application for an injunction, and Superior and ICG closed their transaction the following day.[154]

On December 22, 1998 the Canadian Commissioner applied to the Tribunal for a post-merger order compelling Superior to divest its ownership of ICG because the transaction, in the Canadian Commissioner's view, would lead to a likely substantial lessening, and

151. Canadian Merger Guidelines, Appendix II.

152. Id.

153. Commissioner of Competition v. Superior Propane Inc., 2000 Comp.l Trib. 15, File No. CT1998002 (Aug. 30, 2002) (the "Superior Initial Decision").

154. On December 11, 1998, the Tribunal issued a consent interim order that permitted the transaction to close but required Superior to hold separate-the overlapping ICG assets to preserve ICG's business pending the Tribunal's determination.

prevention of, competition in a large number of local markets and one national market in Canada.

b. The Superior Initial Decision

Following 48 days of hearing involving 74 fact and 17 expert witnesses (including ten with Ph.D. degrees in economics), the Tribunal rendered its decision on August 30, 2000, finding that the Superior/ICG merger was likely to prevent competition substantially in Atlantic Canada and likely to lessen competition substantially in the coordinated services offered to the national account market, as well as in a number of local markets across Canada. In particular, the Tribunal determined that the merged entity would have a combined market share of at least 70% on a national basis and a near monopoly in a number of local markets.[155] The Tribunal further acknowledged the high level of market concentration, the high barriers to entry, the lack of effective remaining competition; and the absence of foreign competition in the propane industry in Canada. Based on the above factors, the Tribunal would have ordered a remedy involving the total divestiture by Superior of all of ICG's shares and assets,[156] but for the efficiency defense raised by the merger parties and, ultimately, allowed by the Tribunal.

Superior and ICG argued that their merger would bring about substantial efficiency gains that would far outweigh any post-merger anticompetitive effects, primarily through the rationalization of their distribution networks, head office functions, and other duplicative operations. The Tribunal agreed with the merger parties, finding that the proposed merger would result in some (Canadian) $29.2 million in efficiencies per year, i.e. in economic resources freed up by the more efficient organization of the two businesses into a single business,[157] primarily in three major areas of operation: corporate centre,[158] customer support,[159] and field operations.[160]

With respect to the anticompetitive effects of the merger, the Tribunal accepted the Canadian Commissioner's evidence that the deadweight loss to the Canadian economy caused by the substantial lessening of competition stemming from the merger would unlikely exceed (Canadian)

155. Superior Initial Decision at ¶¶ 306-313.

156. Id. ¶ 314.

157. Id. at ¶ 383.

158. Corporate centre cost savings were expected from a reduction in head office employees, rent, and legal and marketing expenditures. Id. at ¶ 320.

159. Customer support functions cost savings would arise from the elimination of duplication of facilities and redundant personnel in areas where both merging companies operate, and from the adoption of Superior's decentralized "business model." Id. at ¶ 321.

160. Field operations cost savings were anticipated from removal of redundancies due to overlapping geographic markets; and from the larger delivery volumes in each territory, allowing the merged entity to reduce supply and transportation costs. Id. at ¶ 322.

$3 million per year (and even that estimate was noted by the Tribunal to be probably overstated). In its decision, the Tribunal adopted the total surplus standard (thereby assuming that the transfer of wealth from consumers to sellers and their shareholders was neutral), rejecting the Canadian Commissioner's arguments that the Tribunal should adopt the "balancing weights approach" (which requires the consideration of the wealth transfer or redistributive effects by assigning relative weights to the loss by consumers and corresponding gains by sellers/shareholders).[161]

In its treatment of the efficiency defense, the Tribunal rejected the claim of the Canadian Commissioner that, as a matter of law, a "merger to monopoly" could "never" be saved by the efficiency defense, holding that a merger that leads to a monopoly does not necessarily require the Tribunal to make an order under Section 92 of the Canadian Competition Act.[162] Following the issuance of the Tribunal's decision, the Canadian Commissioner promptly appealed to the Canadian Federal Court of Appeal, arguing that the Tribunal had erred in law by applying the wrong standard (i.e. the total surplus standard) in its balancing analysis.

c. The Superior Appeal Decision

In the Superior Appeal Decision released on April 4, 2001, the Federal Court of Appeal accepted the Canadian Commissioner's argument that the Tribunal had erred in law by not giving any consideration to transfers of wealth or redistributive effects from consumers to sellers/shareholders. However, the Court declined to prescribe the correct methodology and to provide any specific guidance on how the Tribunal should weigh wealth transfers against expected cost savings, including the appropriate methods for taking redistributive effects into account, or even when to take them into account.[163]

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161. The Tribunal expressly rejected the application of the balancing weights approach based on, inter alia, the following reasons:

(1) the members of the Tribunal were not qualified to make assessments on the social merit of competing societal interests;

(2) redistributional concerns did not fall within the ambit of the merger provisions of the Canadian Competition Act;

(3) since, in the Tribunal's view, merger review must be predictable, the adoption of the balancing weights approach would result in decisions that vary from case-to-case, depending on the individual, and, perhaps subjective, views of the sitting members of the Tribunal regarding the groups affected by the mergers (i.e. consumers and seller/shareholders); and

(4) as the deadweight loss resulting from a price increase is typically quite small when compared to the transfer of wealth, the inclusion of the transfer of wealth as an effect to be considered under the efficiency defense would effectively vitiate the availability of the defense. Id. at ¶¶ 431-437.

162. Id. at ¶ 418.

163. Superior Appeal Decision at ¶ 139.

While the Court agreed with the Tribunal that efficiency was the paramount objective of the merger provisions of the Canadian Competition Act, it ultimately held that the Tribunal must consider all anticompetitive effects of a merger.[164] In addition, while refraining from prescribing the "correct methodology," the Court suggested that the balancing weights approach may be an appropriate test under the defense.[165]

The Court remanded the case to the Tribunal for a rehearing on the adverse economic effects of the merger, directing the Tribunal to formulate the "correct methodology" for determining how all the anticompetitive effects of the merger (including the redistributive effects) should be weighed against its expected efficiency gains.

d. The Superior Redetermination Decision

In the Superior Redetermination Decision, the Tribunal, with express reluctance, applied the balancing weights approach suggested by the Court, and, based on the evidence before it, determined that the expected efficiencies resulting from the merger still would outweigh the combined effect of the deadweight loss and the redistributive effects.

The Canadian Commissioner submitted that the creation of monopolies in 16 different geographic markets for retail propane and the creation of a monopoly in the "national accounts coordination services" market were qualitative effects that must be considered under the review of the efficiency defense. The Tribunal reiterated that, under Section 92 of the Canadian Competition Act, it must decide whether a merger "lessens or prevents competition substantially," and cannot so find solely on the basis of evidence of market share or concentration. Accordingly, the Tribunal concluded that even a merger to market share of 100% did not automatically violate Section 92 of the Canadian Competition Act, and, only after consideration of other factors, could it conclude that such merger would "lessen or prevent competition substantially."[166]

Based on its review of the existing evidence provided in the first hearing, the Tribunal concluded that the redistributive effects were not completely neutral, i.e., the gains and losses were not completely offsetting, ,and that there existed a social loss that required consideration. While the evidence supported the socially adverse redistributive effects relating to

164. The Court stated, "Thus, although section 96 requires the approval of an anticompetitive merger where the efficiencies generated are greater than, and offset, its anticompetitive effects, the ultimate preference for the objective of efficiency in no way restricts the countervailing 'effects' to deadweight loss. Instead, the word, 'effects' should be interpreted to include all the anticompetitive effects to which a merger found to fall within section 92 in fact gives rise, having regard to all of the statutory purposes set out in section 1.1." Id. at ¶ 92.

165. Id. at ¶¶ 139-141.

166. Id. at ¶ 272.

low-income households that used propane for essential purposes and had no good alternatives, the number of such households was determined to be small, i.e. representing less than 20% of all propane consumers. The Tribunal stated that, while in theory, the interests of low-income households should be weighed more heavily than the interests of the shareholders of the merged firm, such higher weight was not determinable based on the evidence on the record. Further, the Tribunal viewed the interests of all other households and business owners equal with the shareholders of the merged firm, particularly since all sellers were, in a sense, consumers as well. Based on the foregoing, the Tribunal found that the adverse redistributive effects of the merger (i.e. those from lower-income consumers to shareholders) would be only approximately (Canadian) $2.6 million.[167]

Having assessed the quantum of adverse redistributive effects, the Tribunal still had to decide how to combine them with the total estimated deadweight loss. Noting that there was no statutory basis under the Canadian Competition Act for assuming the relative weighting, the Tribunal was unable to determine a proper weight to assign to the redistributive effects. In any event, the Tribunal observed that it was clear that the adverse redistributive effects were, based on the evidence, quite small. Accordingly, the Tribunal concluded that, under any reasonable weighting scheme, the (Canadian) $29.2 million in efficiency gains would be far greater than, and would offset all of, the effects of lessening and prevention of competition attributable to the merger.[168]

3. Aftermath

Superior Propane is a very important case in Canada as well as outside of Canada as a guide to efficiency considerations in merger review. It makes clear that Canadian competition law will not block horizontal mergers leading to high market shares, provided that the synergies achieved as the result of the merger, including rationalizing capacity and streamlining operations, exceed the merger's anticompetitive effects.

Notwithstanding the decisions of the Court and Tribunal in *Superior Propane*, the Canadian efficiency defense, as it stands, is not free from ambiguity in its application or execution. As Mr. Justice Létourneau observed in the Superior Appeal Decision, "Section 96 is broadly worded and provides no guidance as to the meaning of efficiency found in the section, the effects of the lessening of competition which are to be weighed against the efficiency gains, and the test, standard or trade-off to be applied in weighing the elements."

On April 17, 2002 the Canadian Bureau announced that it had filed a notice of appeal with the Canadian Federal Court of Appeal of the

167. Id. at ¶ 368.
168. Id. at ¶ 371.

Superior Redetermination Decision, submitting that it raised fundamental questions about the purpose of the Canadian Competition Act and how it is to be interpreted by the Tribunal.[169] The Canadian Commissioner's appeal of the Tribunal's redetermination decision is scheduled to be heard on November 26-28, 2002.[170]

In addition, the House of Commons Standing Committee on Industry, Science and Technology has recommended in its report, A Plan to Modernize Canada's Competition Regime, that:

> The Government of Canada immediately establish an independent task force of experts to study the role that efficiencies should play in all civilly reviewable sections of the Competition Act, and that the report of the task force be submitted to a parliamentary committee for further study within six months of the tabling of this report (Recommendation 28).[171]

Legislatively, draft amendments to Section 96 of the Canadian Competition Act are before Canadian Parliament in Bill C-249.[172] Bill C-249 proposes that gains in efficiency from a merger would not be permitted to offset the effects of a lessening or prevention of competition unless the majority of the benefits derived therefrom are being or are likely to be passed on to customers within a reasonable time in the form of lower prices. Bill C-249 also contains provisions that preclude the efficiency defense in situations where, after the transaction has been completed, the merger will result or is likely to result in the creation or strengthening of a dominant market position. Professor Donald McFetridge observes that this proposed

169. Speaking for the Canadian Bureau, the Canadian Commissioner stated that the principal reason for the appeal was the Tribunal's determination that it was not within its mandate to consider the public interest in its review of the merger. In addition, the Canadian Commissioner could not accept the Tribunal's interpretation that efficiencies are the paramount objective of the merger provisions of the Canadian Competition Act, noting that the Court directed the Tribunal to consider other objectives of the Canadian Competition Act, such as the impact on consumers and small- and medium-sized businesses. Competition Bureau, News Release, "Competition Bureau Appeals Tribunal Decision in Superior Propane Case" (April 17, 2002).

170. Please note that Blake, Cassels & Graydon LLP was, and continues to be, counsel for Superior Propane in the litigation now under appeal in the Canadian Federal Court of Appeal. Superior's legal team, led by Neil Finkelstein of Blakes, is likely to rely on well-established principles of judicial deference, and, indeed, the Federal Court of Appeal's own reasons in the Superior Appeal Decision, as well as the Tribunal's reasons in the Superior Redetermination Decision, in support of submissions that the Canadian defined Commissioner's second appeal should be dismissed.

171. The Standing Committee on Industry, Science and Technology, A Plan to Modernize Canada's Competition Regime (Eighth Report), Walt Lastewka, M.P., Chair (House of Commons, April 2002).

172. Bill C-249, An Act to amend the Competition Act, 2nd Sess., 37th Parl., 2002 (1st reading Oct. 24, 2002).

dominance exclusion is a variant on the Canadian Commissioner's argument (already rejected by the Tribunal) that Section 96 of the Canadian Competition Act cannot apply in cases of merger to monopoly and reflects the misapprehension that a successful defense for mergers to dominance is routinely available under a total surplus standard. He states that:

> The creation or strengthening of dominance is simply a way of describing an increase in market power. The anticompetitive effects of an increase in market power depend on the [factors considered by the Canadian Bureau in a merger review]. While some of these factors may be more important in some instances than in others, it is the resulting increase in market power rather than the label attached to it that matters. Once the anticompetitive effects of an increase in market power have been established, there is no reason to allow for an efficiencies defense in some cases and not in others.[173]

D. *Comparison of Efficiency Defense in the United States, the European Union and Canada*

It is clear that the antitrust authorities of the United States, the EU, and Canada have followed their own legislation and guiding policies in the treatment of post-merger efficiencies, resulting, at times, in markedly different approaches and principles. The following table illustrates what appear to be the current differences among these three jurisdictions.

Canada	United States	EU
Statutory efficiency defense (Canadian Competition Act)	No separate statutory efficiency defense; efficiency gains considered as part of total assessment	Still some debate whether there is an efficiencies defense or offense
Efficiency gains must be "greater than and offset" anticompetitive effects (Canadian Competition Act)	Efficiency gains must show that transaction is not likely to be anticompetitive	Efficiency gains not yet explicitly recognized as a basis to permit an otherwise anticompetitive transaction

173. Donald G. McFetridge, Efficiencies Standards: Take Your Pick, 21:1 Canadian Competition Record 45, 54 (Spring/Summer 2002) ("McFetridge Article").

Canada	United States	EU
Efficiency gains must be greater than and offset the aggregate anti-competitive effects (*Superior Propane*)	Efficiency gains in one market may be weighed against anticompetitive effects in another market as a matter of prosecutorial discretion	No explicit precedent permitting offset
Small businesses afforded an "equitable opportunity" to participate in economic activity (*Superior Propane*)	Antitrust laws protect competition not competitors (*Cargill*)	Concerns about obstacles created and competitive advantages
Efficiencies must be merger-specific (Canadian Competition Act)[174]	Efficiencies must be merger-specific	Efficiencies must be merger-specific
Efficiencies are paramount in Canadian competition policy (Canadian Competition Act, *Superior Propane*)	Efficiency is a goal of U.S. antitrust law; the ultimate goal is consumer welfare	Technical and economic progress among principles listed in the EC Treaty and ECMR
Balancing weights approach (*Superior Propane*)	Consumer surplus standard or modified price standard or price standard	Consumer surplus standard
Efficiencies may trump a merger to monopoly or near-monopoly (*Superior Propane*)	Efficiencies almost never justify a merger to monopoly or near-monopoly "Extraordinary" efficiencies required where there are high market concentration levels (*Heinz*)	Efficiencies unlikely to trump the creation or strengthening of a dominant position

174. In practice, the Canadian Bureau may, if not seeking to block an entire merger, use the "merger-specific" test, which can be tied to partial divestitures through the "order to be made" language, in order to look at efficiencies in other markets in which there is no substantial lessening of competition.

Canada	United States	EU
No clear methodology for how loss to consumer surplus should be balanced against gains to sellers/shareholders (*Superior Propane*)	D.C. Circuit Court did not address whether efficiencies would be passed on in lower prices to consumers (*Heinz*) D.C. Circuit Court was silent on what are "extraordinary" efficiencies (*Heinz*)	Must be to the benefit of consumers

III. LOOKING FORWARD – UNRESOLVED QUESTIONS AND POLICY DECISIONS

Deputy AAG Kolasky indicated last year:

> We value competition, not as an end in itself, but because it promotes both types of efficiency [productive and transactional]. Recognizing that efficiency is the ultimate goal should make us very cautious about adopting a merger policy that sacrifices short-term efficiencies in the name of maintaining competition. At a minimum, we should make certain we have a high degree of confidence that the trade-off we are making will ultimately benefit consumers. . . . In the United States, we have very little confidence in our ability to make these judgments. . . .[175]

Given the integral role of economics in antitrust analysis and the sentiments of enforcement officials, such as Kolasky, it is surprising that: (1) efficiencies continue to be treated with skepticism and hostility; and (2) fundamental issues regarding how to evaluate and factor efficiencies into the analysis remain. Over two decades ago, (now FTC Chairman) Muris pondered:

> Upon which foundation do merger rules that ignore efficiency lie? . . . First, economic theory might dictate that efficiency should be ignored. This argument does not withstand scrutiny of the costs and benefits possible from mergers . . . Second, we

175. Kolasky George Mason Speech at 5-7. See Gregory J. Werden, A Robust Test for Consumer Welfare Enhancing Mergers Among Sellers of Differentiated Products, 44 J. Indus. Econ. 409 (1996); Gregory J. Werden and Luke M. Froeb, A Robust Test for Consumer Welfare Enhancing Mergers Among Sellers of Homogeneous Products, 58 Econ. Letters 367 (1998); Gregory J. Werden, An Economic Perspective on the Analysis of Merger Efficiencies, Antitrust (Summer 1997) ("Werden 1997 Article").

> could ignore efficiency if economic fact indicated that mergers were not a source of efficiency. . . . If mergers can reduce costs, then ignoring efficiency cannot be justified as preventing search for a nonexistent benefit. Many scholars contend, and evidence supports the conclusion, that mergers are a source of lower costs. . . . The third basis that could bring the concentration-only rule within the rule of reason is that concentration rules might sufficiently protect efficiency. This, however, is not the case. . . . If the merger does lower costs, it is likely to be pro-competitive even at higher concentrations.[176]

Even today, this debate continues due to differences in belief regarding which welfare standard – and redistribution policy objectives – should be followed. The consumer-oriented bias evidenced in the United States and EU to date also arises from the zero-tolerance for Type I errors (i.e. no enforcement action taken to block anticompetitive transactions) by enforcement officials and the presumptions existing against transactions in highly concentrated markets. The remainder of this article will focus on issues raised by antitrust officials and scholars, and will suggest how these issues should be resolved.

A. *What Welfare Standard Should Be Applied?*

The debate continues regarding whether "allocative efficiency" (sometimes referred to as the "total surplus standard" or the "total welfare standard") or consumer surplus should be the ultimate goal of competition laws.[177] Even within the consumer surplus standard, some scholars favor limiting the cognizable efficiencies to those that lead to lower prices ("price standard"), on the grounds that those savings are the most concrete and easily measured. In addition, for political reasons, some scholars advocate assigning different weights to consumer surplus and producer surplus as part of the total surplus standard. As mentioned above, the debate over the proper standard is part of the greater political debate over whether the ultimate goal of antitrust laws is consumer welfare or efficiency maximization. There are several models available to antitrust authorities when comparing efficiencies to anticompetitive effects, some of which are described below.

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176. Muris 1980 Article at 427-429. Some point out, however, that most transactions are in fact "failures" and do not achieve the efficiencies promised. See discussion infra, Section II. F.

177. Paul L. Yde and Michael G. Vita, Merger Efficiencies: Reconsidering the "Passing-on" Requirement, 64 Antitr. L.J. 735, 736 (1996) ("Yde & Vita"); Conrath & Widnell. For an interesting perspective on this debate see Peter J. Hamner, Antitrust Beyond Competition: Market Failures, Total Welfare, and the Challenge of Intramarket Second-Best Tradeoffs, 98 Mich. L. Rev. 849 (2000).

Whether this issue remains open to debate, however, is in itself questioned. For example, although FTC Commissioner Leary recognizes "that academics and a court in Canada have argued that a better index than [consumer welfare] is total welfare. . .,"[178] he does "not believe this is a fruitful policy debate, for the simple reason that no endorsement of an overall welfare standard is politically viable in [the United States]; The assumption that sellers are already much richer than buyers is just too deeply entrenched, even though it obviously is not always true."[179] Nevertheless, it is useful at a minimum to understand the merits and limitations of the full range of standards — regardless of whether or not one particular jurisdiction has the political appetite for adoption of the standard.

1. Price Standard and Consumer Surplus Standard

Under the price standard, proven efficiencies must prevent price increases in order to reverse the potential harm to consumers. Efficiencies are considered as a positive factor in merger review, but only to the extent that they restrain post-merger price increases. This means that at least some of the cost-savings must be passed on to consumers in the form of lower prices.[180]

The consumer surplus standard is a refined variation of the price standard. Under the consumer surplus standard, a merger will be permitted to proceed where the consumer gains in efficiency (i.e. the resource savings in costs) exceed the total loss of consumer surplus. However, while the lost consumer surplus is taken into account, the corresponding profit gain to seller/shareholders is not, and, therefore, does not offset the loss in consumer surplus. In other words, a zero weight is assigned to seller/shareholder profits, even when society may benefit from such profits.[181]

Advocates of the total surplus standard argue that the consumer surplus standard is not consistent with traditional welfare theory by assigning a zero weight to seller/shareholder profits; the standard, in effect, disregards the maximization of social welfare, i.e. that gains to seller/shareholders can be socially positive. As Professor Townley[182] points out, by assigning the same weight to all consumers, the consumer surplus standard treats all consumers alike, therefore protecting all consumers, even when some consumers may be better off than the shareholders:

178. Leary Fall Forum Remarks at 9.

179. Jaret Seiberg, FTC Redefines Merger "Efficiency," The Daily Deal (Nov. 11, 2002) at 3.

180. Superior Redetermination Decision, at ¶¶ 87-89.

181. Superior Redetermination Decision, at ¶ 94.

182. Professor Townley of Arcadia University was retained by the Canadian Commissioner to provide an applied welfare economics perspective on the analysis of mergers in general and in respect of the Superior/ICG merger in particular.

> From a welfare perspective, assigning distributional weights according to the Consumer Surplus Standard may be appropriate if consumers of the product in question are relatively poor. However, what if those who consume the product of the merged firms are relatively wealthy? That is, what if the commodity in question is a luxury produced by firms owned by relatively poor individuals? (This is akin to legislating rent controls on luxury apartments when the tenants are wealthier than the landlords.) I have no notion as to how likely this situation may be, but a Consumer Surplus Standard does not allow the discretion to deal with this type of case.[183]

In the United States, to date, case law appears to reject the total surplus standard in favor of a form of consumer surplus standard.[184] In Canada, at least for the time being, a balancing weights approach (discussed below) has been adopted.[185] In the EU, to the extent efficiencies have been recognized, it has been under this consumer surplus standard (otherwise objectionable) for the transaction to be permitted. Monopoly overcharges, after all, represent a real harm to consumers. Consumer surplus proponents believe that "[a]llocative efficiency claims are seldom to be advanced in justification of a merger."[186] Under the consumer surplus standard or the price standard, there must be direct welfare of

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183. Report of Peter G.C. Townley (August, 1999), Exhibit A to the Expert Affidavit of Peter G.C. Townley (Aug. 16, 1999) at 31-32, cited in Superior Redetermination Decision at ¶ 93.

184. Although the 1997 Revisions do not expressly incorporate the requirement, the 1994 Health Care Guidelines do, and the U.S. antitrust authorities continue to argue in litigation that passing on is an element of cognizable efficiencies. The 1997 Revisions state that "the Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market." Yet, a footnote in the 1997 Revisions provides that "[t]he Agency also will consider the effects of cognizable efficiencies with no short-term, direct effects on price in the relevant market." See U.S. Dept. of Justice and FTC, Statements of Enforcement Policy and Analytical Principles Relating to Health Care and Antitrust, Statement 9, at 104 (Sept. 27, 1994).

185. See, e.g., AMI, 104 F.T.C. at 213-20 (FTC rejected efficiencies defense because, among other things, "AMI does not establish that they will necessarily inure to the benefit of consumers . . . it is unlikely that AMI can show that 'market forces will oblige [AMI] to pass [cost savings] on to consumers.'"); FTC v. Butterworth, supra; FTC v. University Health, Inc., 938 F.2d at 1222-23 (must show that economies would ultimately benefit competition and hence consumers); United States v. United Tote, Inc., 768 F. Supp. at 1084-85 (rejected efficiencies argument because there were no guarantees that savings would be passed on to consuming public); United States v. Rockford Memorial Corp., 717 F. Supp. at 1291 (alleged efficiencies must produce a significant benefit to consumers before they would be recognized).

186. Mark N. Berry, Efficiencies and Horizontal Mergers: In Search of a Defense, 33 San Diego L. Rev. 515, 544 (1996) ("Berry Article").

purchasers in the relevant market count.[187] Any merger that raises price, without regard to magnitude of any associated savings, reduces consumer welfare. Thus, under this approach, efficiencies are only cognizable if passed on to consumers in the form of price reductions.[188] One problem with the passing on requirement is the relationship between presumed anticompetitive conduct and likely efficiencies. Also, the degree of pass-through depends on a variety of factors, including industry structure, price elasticity and cost structure.[189] Stennek and Verboven believe the focus should be on "firm-specific pass-on," since cost efficiencies typically are only realized by "the merging firms."[190]

Apart from whether the goals of antitrust laws should prohibit wealth transfers from consumers to producers, there appears to be an economic basis for eliminating the passing-on requirement. Former FTC Chairman Pitofsky indicated that the passing-on requirement is a killer qualification since it requires a nearly perfect competitive market, in which case, he posits that the transaction would not be a concern in the first place.[191] Accordingly, Pitofsky concludes that the passing-on requirement "prevent[s] consideration of an efficiency defense in most cases where it would make a difference."[192] More recently, Leary indicated that he "personally do[es] not favor any separate requirement that pass-on of efficiency savings be shown."[193]

The Tribunal reached the same conclusion when it flatly rejected the consumer surplus standard in the Superior Redetermination Decision:

187. One of the failures of both the consumer surplus standard and the price standard is that they do not take into account the effect of efficiencies to mitigate any incentives for collusion. This is discussed further below.

188. Robert H. Lande, Chicago's False Foundation: Wealth (Not Just Efficiency) Should Guide Antitrust, 58 Antitr. L.J. 632 (1989). See, e.g., University Health, 938 F.2d at 1223; see also, United Tote, Inc., supra, 768 F. Supp. at 1084-85. Joseph Kattan, Efficiencies and Merger Analysis, 62 Antitr. L.J., 513, 520 (1994) ("Kattan Article"). Kattan says that the consumer surplus standard is supported by legislative history – most commentators have interpreted the 1997 Revisions as adopting the "consumer welfare" approach – see n. 37 of the 1997 Revisions; see also Robert H. Lande, Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged, 34 Hastings L.J. 65 (1982); but see Muris 1999 Article at 733 (believes the 1997 Revisions rejected the requirement that cost savings be "passed on" to consumers).

189. See Stennek & Verboven at 161-183.

190. Id. at 184. But, as argued by Roberts and Salop, competing firms in an industry respond to the savings of a specific firm. Such responses also should be factored into the analysis. See Gary L. Roberts and Steven C. Salop, Efficiencies in Dynamic Merger Analysis, 19 World Comp. 5, 15 (June 1996) ("Roberts & Salop 1996 Article").

191. Pitofsky Georgetown Article at 207-208.

192. Pitofsky Georgetown Article at 208; accord Joseph F. Brodley, Proof of Efficiencies in Mergers and Joint Ventures, 64 Antitr. L.J. 575, 584 (1996) ("Brodley 1996 Article").

193. Leary Fall Forum Remarks at 9.

> The Tribunal concludes that the Consumer Surplus Standard, which requires that the full amount of the transfer be added to the deadweight loss in establishing the effects of an anti-competitive merger, is so limiting that its adoption in all cases would be contrary to the conclusion of the Court, would rule out the inquiry that Professor Townley regards as necessary to assess the welfare effects of the merger, and generally makes the efficiency defence unavailable under the Act, and so cannot be correct in law because it vitiates the statutory provision in subsection 96(1).
>
> The fact that in this case proven efficiency gains of 7.5% of sales would not satisfy the Consumer Surplus Standard adequately demonstrates that the requirement therein is so high that it would be met, if ever, only in rare circumstances. Based on its review of the legislative history of the Act and the Parliamentary review of the 1986 amendments, the Tribunal concludes that the efficiency defence (and the exclusion of the limitations thereon in preceding bills) was not inserted into the Act for such limited use; rather, it was meant to be an essential part of the Canadian merger policy that emphasizes economic efficiency.[194]

Moreover, DOJ economist Greg Werden and Vanderbilt University professors Luke Froeb and Steven Tschantz show that "greater competition does not imply greater pass-through. In fact, the reverse is true for some senses in which the degree of competition may be increased."[195] The pass-through rate is dependent on the elasticity of the elasticity of demand, i.e. on the proportionate rate of change in the elasticity of demand as price is changed.[196] Werden, Froeb, and Tschantz conclude, though, that although "pass-through rates may be quite high with mergers to monopoly or near monopoly . . . synergies are unlikely to be large enough to reverse the price-increasing effects of such mergers."[197]

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194. Superior Redetermination Decision at ¶¶ 214 and 215.

195. Gregory J. Werden, Luke M. Froeb, Steven Tschantz, The Effects of Merger Synergies on Consumers of Differentiated Products (Nov. 15, 2001) ("Werden, Froeb & Tschantz").

196. Werden, Froeb and Tschantz provide a useful appendix establishing pass-throughs for a single product monopolist. Id.

197. Werden, Froeb and Tschantz reach this conclusion because they find that "[p]ass-through rates are closely linked to the price-increasing effects of mergers; demand properties that lead to large price increases from mergers absent synergies also lead to high price-through rates. This implies the existence of simple and practical consistency checks on price increase and pass-through predictions." Id.

Yde and Vita[198] similarly note the greater likelihood for pass-through by firms with market power, but reach a different conclusion regarding the utility of a pass-through requirement when they state that "contrary to what appears to be the intuition supporting a passing-on requirement, the extent to which a merger-specific efficiency is passed on increases – rather than decreases – with the market power of the merged firm. . . . As a distinct element of efficiencies analysis, passing on should pass into obscurity."[199]

2. *Total Surplus Standard*

The total surplus standard, like the consumer surplus standard, is applicable to a merger that may result in both higher prices and lower costs. As mentioned above, total surplus is the sum of consumer and producer surplus, where consumer surplus is the difference between consumers' willingness to pay for a product and the amount they are required to pay on market prices and producer surplus is the difference between a firm's revenues and its economic costs (i.e. its economic profits). If the result of a merger is to raise the price of the relevant product without improving quality, consumer surplus decreases ceteris paribus; if the merger is profitable, producer surplus increases. Some of the increase in producer surplus arises from the decrease in consumer surplus. This is called the "transfer" of wealth or welfare, as an increase in price causes wealth to be distributed from the consumer to the producer. Under the total surplus standard, welfare transfers from consumers to shareholders are not taken into account. Rather, the anticompetitive effect of the merger is measured solely by the deadweight loss to society.[200] Therefore, under

198. See Yde & Vita. Professors Hausman and Leonard demonstrate in their article that for both differentiated products and dominant firms, there will be a significant (i.e. greater than 50%) share of the cost savings that will be passed on to consumers, regardless of the specific shape of the demand curve, so long as that curve is convex. Hausman and Leonard, Efficiencies from the Consumer Viewpoint, 7 Geo. Mason L. Rev. 707 (1999) ("Hausman & Leonard").

199. Yde & Vita at 736, 747 ("[I]n a highly competitive market the merged firm will retain most or all of the cost savings as an efficiency rent; prices will be relatively unaffected by the merger-specific cost reduction and virtually no passing-on occurs. Conversely, the merged firm must possess some post-merger power (i.e. demand for its output is inelastic) for a given merger-specific efficiency to affect the merged firm's prices. [i.e. if the firm is too small, it is unlikely to be able to impact the price charged in the market] Generally, for a given firm-specific cost reduction, the reduction in price will be greater the less elastic the firm-specific demand"). Yet, the less elastic the firm-specific demand, the greater will be the potential price increase, particularly in a payment to monopoly. The potential for a price increase is a factor that will be taken into account as part of the potential anticompetitive effects; see also IVA Areeda at ¶ 970a.

200. Michael Trebilcock and Ralph Winter, The State of Efficiencies in Canadian Merger Policy 19:4 Canadian Comp. Rec. 106 (Winter 1999-2000) ("Trebilcock & Winter"), cited in Superior Redetermination Decision at ¶ 427.

this standard, efficiencies need only exceed the deadweight loss to permit an otherwise anticompetitive merger to proceed.

Perhaps the arguments for the total surplus standard are best summarized by McFetridge:

> The Commissioner has apparently embraced the consumer surplus standard, first, in the mistaken belief that the total surplus standard is too easy to meet and, second, in the belated recognition that the balancing weights standard that he and his expert originally proposed is unworkable. As argued above, it is highly unlikely that mergers either to monopoly or to dominance could pass a properly-applied total surplus test. The consumer surplus standard will allow mergers that hurt consumers as consumers and forbid mergers that benefit the economy as a whole. It does not distinguish between the transfer of wealth and the destruction of wealth. The consumer surplus standard is acknowledged to have no basis in welfare economics. Proposing to interpret a statute that is often touted as being one of the most economically literate in the world in this way is ironic but it is hard to appreciate the irony.[201]

Unlike a consumer surplus approach, a total welfare standard assigns an equal weight both to the loss in consumer surplus and the corresponding gain to shareholders. In other words, the transfer of wealth on surplus is viewed as "neutral." The rationale for a total surplus standard is grounded in the belief that the wealth transfer effects of mergers are neutral due to the difficulty of assigning weights to certain effects a priori based on who is more deserving of a dollar.[202] In contrast, under a consumer-oriented approach (such as the standard price), the focus is on ensuring that consumers obtain a direct share of the wealth transfer rather than being indifferent to whether consumers or shareholders obtain the benefits. It is, of course, theoretically possible to assign differential weights to consumers and producers, as employed by the balancing weights approach discussed below.

The Canadian Commissioner argued in *Superior Propane* that the total surplus standard was too easy a test to meet, and, therefore, should be

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201. McFetridge Article at 54-55.

202. Margaret Sanderson, Competition Tribunal's Redetermination Decision in Superior Propane: Continued Lessons of the Value of the Total Surplus Standard, 21:1 Canadian Comp. Rec. 1-5 (Spring/Summer 2002) ("Sanderson Superior Article"). The difficulty in making these interpersonal utility comparisons occurs in both a theoretical sense and a practical sense. From a theoretical point of view, there is often no basis for valuing one consumer's welfare over another's welfare. From a practical point of view, it is often difficult to trace the beneficiaries of increased profits, which are largely pension funds.

abandoned. Margaret Sanderson believes that, when properly applied, the total surplus standard does not need to be abandoned, provided that pre-merger market power is taken into account:

> Enforcement officials and litigators may resist accepting the fact of pre-existing market power under the misconception that this reduces the magnitude of the substantial lessening of competition that may result from the merger. Again, the case of Superior Propane is instructive on this point. Notwithstanding the Tribunal's mention of the likely existence of pre-existing market power in this industry, it still found that the merger was likely to substantially lessen competition, with prices rising, on the Commissioner's evidence, by 7% to 11% depending upon the product and after taking into account the pass-through of cost savings. Mergers in markets with pre-existing market power can still give rise to a substantial lessening of competition. Further, the greater the amount of pre-existing market power, the greater the efficiencies must be in order to offset the resulting welfare loss. As a consequence, the more closely a merger approaches a merger to monopoly, the less likely it is that any efficiency accompanying the merger will offset the resulting welfare loss. The total surplus standard does not need to be abandoned to achieve this result. It only needs to be properly applied as articulated in the Merger Enforcement Guidelines.[203]

Gwillym Allen of the Canadian Bureau observes that the total surplus standard has been criticized because of several questionable implicit assumptions it makes, including on the neutrality of the transfer. He suggests that the use of the total surplus standard is appropriate if the transfer is indeed "neutral." He recognizes, however, for this to be a reasonable approximation of reality, the evidence would have to show that the commodity in question was widely purchased and comprised a relatively small proportion of the consumers' total expenditure. Moreover, according to Allen, if these conditions are not met, then the transfer cannot reasonably be expected to be neutral and the change in total surplus standard may not accurately reflect the overall welfare effects of the merger.[204] For example, Allen's view would suggest that, if the merging parties are privately held so that the shareholders are distinct from the

203. Sanderson Superior Article at 5.

204. Gwillym Allen, Assistant Deputy Commissioner of Competition Economics and International Affairs, Competition Bureau of Canada, The Treatment of Efficiencies in Merger Analysis, presented at Meet the Competition Bureau, Toronto (May 3, 1999) ("Allen Speech").

consumers, then the total surplus approach would be inappropriate since there would be a clear redistribution of wealth if prices were to rise despite large efficiencies. Under those circumstances, it is difficult to determine whether the pre- or post-merger state of the world is preferable because that comparison requires an interpersonal comparison of utility.

The relevant standard applied can also have a significant impact on the conclusions reached regarding the likely efficiency benefits arising from transactions. From the outset, Williamson, adopting a Kaldor-Hicks notion of allocative efficiency (sometimes referred to by economists "partial equilibrium welfare"), argued that a very small percentage increase in efficiency usually outweighs a larger percentage increase in price. Williamson used a total surplus standard that balances any cost savings that arise from a transaction directly against the deadweight loss that results from any post-transaction price increase. Sanderson suggests that the simplicity of the Williamson model requires a more detailed analysis of additional factors:

> Essentially, one must turn to a fuller modeling of the cost conditions and competitive interactions of firms pre- and post-merger. While this is more complicated, antitrust authorities are fully capable of conducting this type of economic analysis. One can use various assumptions relating to demand elasticities, cost conditions and competitive responses of rivals in order to arrive at possible price and output levels post-merger. While this is far from an exact science, it will give some order of magnitude to the expected losses from an increase in price post-merger.
>
> More difficult predictions related to measuring losses from a reduction in service, quality, variety, innovation and other non-price dimensions of competition may also have to made. In these cases, a qualitative assessment is made since no quantifiable figure is practically attainable. Further, the model assumes the consumers are in one single class, with no discrimination among consumers. If, for antitrust policy purposes, all consumers are alike, then the presence of distribution effects should not impact the analysis of the merger.
>
> As long as the monopoly surplus is used efficiently, its magnitude should not be relevant. Any monopoly overcharge paid by purchasers to the shareholders of the merged firm is merely a transfer from one member of society to another and can be ignored in the balance because the cost savings increase social efficiency and consumer welfare in the long term. Judge

Bork succinctly portrays this approach as follows: "the whole task of antitrust can be summed up as the effort to improve allocative efficiency without impairing productive efficiency so greatly as to produce either no gain or loss to consumer welfare."[205]

3. *Balancing Weights Approach*

The redistribution of income resulting from a transaction that increases a firm's market power normally will have a negative effect on consumers (through loss of consumer surplus) and a corresponding positive effect on seller/shareholders (excess profit). The balancing weights approach attempts to find a balance between these redistributive effects by assigning relative weights to each of the losses to consumers and gains to seller/shareholders. The difficulty in this approach, of course, is determining the appropriate weights to assign to each of these societal groups.

Whether these two effects offset each other in any capacity is a socioeconomic decision that requires a value judgment, depending on the individual characteristics of those consumers and shareholders affected by the merger. In some cases, the redistribution of income may be seen as "neutral;" in other cases, it will be seen as socially positive or socially negative. (This approach which was proposed by Professor Townley in *Superior Propane*, was endorsed by the Canadian Federal Court of Appeal in the Superior Appeal Decision and subsequently adopted in principle by the Tribunal.[206])

Yao and Dahdouh (and others) suggest a more appropriate approach would value the magnitude of the efficiency and the probability that it will be achieved by the transaction.[207] This approach seems to be consistent with the approach taken today by the agencies when deciding whether to challenge a merger (in contrast with what the agencies will argue as the standard when in court challenging a merger). As Kolasky points out, the test, in practice, is less of a pure consumer welfare test. Rather, although the U.S. agencies may "give greater weight to those efficiencies that will be passed on to consumers through lower prices in near term, footnote 37 to

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205. Margaret Sanderson, Bureau of Competition Policy, Canada, Efficiency Analysis in Canadian Merger Cases, Remarks Prepared for the Federal Trade Commission Hearings on Global and Innovation-Based Competition, Washington, D.C. (Nov. 2, 1995) available at http://www.ftc.gov./opp/global/sandersn.htm ("Sanderson FTC Remarks").

206. Superior Appeal Decision at ¶¶ 139-141 and Superior Redetermination Decision at ¶ 338. Prior to *Superior Propane*, the total surplus standard had been the proper test since the early 1990s in Canada and had been adopted in the Canadian Merger Guidelines.

207. Yao & Dahdouh at 44; accord FTC v. Honickman, supra.

the [1997 Revisions] . . . makes it clear that [the U.S. agencies] . . . 'also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices' where we think those efficiencies will ultimately redound to society's benefit."[208] Kolasky reports that the Bell Atlantic/NYNEX merger exemplifies a case in which the DOJ declined to challenge a merger even though a strict price test might have led to a contrary result:

> In that case, the Division concluded that while the likely price effects of the efficiencies were small, the efficiencies themselves were so likely and so large and the possible anticompetitive effects so speculative that we should clear the merger nevertheless. Subsequent history has proven the Division right. A retrospective history by one of the merger's critics, AARP, found that the . . . merger did, in fact, deliver, very substantial cost-savings that surpassed even the parties' projections, as well as a 'marked improvement' in service quality.[209]

The remaining issue is how to achieve this valuation. Kolasky suggests undertaking a hybrid approach of the consumer welfare/total welfare model: efficiencies that benefit consumers immediately through decreased prices or increased output will receive the most weight, but others will be considered to the extent they ultimately will benefit consumers.[210] Werden has developed a simple method for determining when efficiencies are likely to prevent price increases in the two standard unilateral effects models.[211] Others also have conducted studies that showed that very modest efficiency gains can outweigh competitive losses for mergers – moderate reductions in marginal cost, in many cases below 5% – may be sufficient to offset price increase of merger.[212]

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208. Kolasky London Speech at 3.

209. Kolasky London Speech at 4, quoting, Scott C. Lundquist and Scott A. Coleman, Promises and Realities: An Examination of the Post-Merger Performance of the SBC/PACIFIC Telesis and Bell Atlantic/NYNEX Companies, AARP Public Policy Institute, 9 (1999).

210. William J. Kolasky, Conglomerate Merger and Range Effects: It's A Long Way From Chicago To Brussels, Prepared Remarks before the George Mason University Symposium (Nov. 9, 2001) ("Kolasky George Mason Speech").

211. See Gregory J. Werden, A Robust Test for Consumer Welfare Enhancing Mergers Among Sellers of Differentiated Products, 44 J. Indus. Econ. 409 (1996); Gregory J. Werden and Luke M. Froeb, A Robust Test for Consumer Welfare Enhancing Mergers Among Sellers of Homogeneous Products, 58 Econ. Letters 367 (1998); (Werden 1997 Article).

212. See Steve Stockum, The Efficiencies Defense for Horizontal Mergers: What is the Government's Standard?, 61 Antitr. L.J. 829 (1993). But, as Kattan indicates, Stockum's model assumes unrealistically that every firm will attain efficiencies associated with merger at the moment of consummation. Kattan Article at 522. We submit that those concerns can be addressed by discounting the value of the efficiencies for both the risk of non-obtainment and delay.

Roberts and Salop[213] quantify the hybrid approach and add a "trickle down" element at a market level. Their basic hypothesis is that efficiency improvements are introduced for private gain but then frequently stimulate competition that creates significant spillover benefits for consumers.[214] Indeed, transactions can speed the pace of technical progress and reduce prices by facilitating innovations that initiate technological diffusion and induce competitive innovation.[215] Accordingly, their research suggests that, under some circumstances, efficiencies attained through a merger may be imitated or emulated by the merging parties' rivals over a period of years. Arguably, consumers will be the beneficiaries of these efficiencies.

The premise of this research is that some advantages of efficient firms will trickle down as others imitate and emulate their more efficient rivals.[216] Emulation occurs when rivals' competitive responses to the initial success by the combined firm is to reduce costs with different specific cost-reducing techniques; if a rival cannot imitate, then it will find another way to achieve the goal. Roberts and Salop account for delay and incompleteness in their models by discounting the results.[217] As a purely theoretical matter, the approach advocated by Roberts and Salop has some appeal. From a practical standpoint, it is unclear how easy it will be "to predict, let alone calculate, the likely imitation and emulation responses of rivals."[218] Nevertheless, given the various ways in which efficiencies are diffused over time and inure to the benefit of society, it is inappropriate that its use should be conditioned upon the requirement that the efficiency gains be shown to pass on to consumers directly.[219] Rather, even some rough directional barometer of likely dynamic effects would be less likely

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213. Roberts & Salop 1996 Article.

214. In contrast, Ilzkovitz & Meiklejohn at 20 suggest that mergers reduce R&D spillovers to other firms in the industry, and, where the other firms are much smaller and dependent on such spillovers, there is a risk that this could cause one or more of them to be forced out of the market, thus weakening competition.

215. Roberts & Salop 1996 Article at 9-10.

216. Accord Wesley M. Cohen and Richard C. Levin, Empirical Studies of Innovation and Market Structure, 2 Handbook of Industrial Organization 1059, 1090-95 (Richard Schmalensee and Robert Willig, eds., 1989); E. von Hippel, Sources of Innovation (Oxford U. Press, NY and Oxford 1988).

217. Kattan raises the point that, if one can achieve the efficiencies unilaterally, then they do not count. Kattan Article at 528-29. If this is the case, it is, arguably, inconsistent with recognizing the diffusion of innovations to rivals. If the transaction is necessary to achieve the efficiencies, then the imitation is unlikely; if diffusion is likely, then the innovation must be predictable so the merger must not be necessary to induce innovation. Roberts and Salop deal with this by pointing out that complete diffusion does not occur instantaneously and may not ever be complete. Roberts & Salop 1996 Article at 8-9.

218. Berry Article at n. 104.

219. Accord Berry Article at 547.

to cause beneficial transactions from being stopped due to reluctance to count likely efficiencies from the transaction.

Allocative efficiency is achieved when market forces lead society's resources to be allocated to their highest valued use among all competing uses. Thus, for example, if, as a result of production efficiencies, the same output can be created using fewer units of an input, wealth might be transferred from the suppliers of that input to the output producer. Such a shift may have ripple effects in other markets, initially disrupting equilibria across markets. Wealth transfers occur all the time in the business environment. Given the merger-specificity requirement imposed by antitrust authorities, these transfers would represent cost savings that would not exist at all absent the merger, and, therefore, consumers would not have benefited from them.[220]

4. *Cross-Market Balancing*

More complex welfare issues arise when the transaction parties participate in multiple markets: should the transaction parties be permitted to "offset" the possible injuries to geographic or products competition in one market with the efficiency benefits in a completely different product or service market (i.e. on the grounds that it will improve the ability of the combined firm to compete in another jurisdiction)? The easiest case for permitting such offset is when the transaction affects multiple product/service markets but involves the same consumers, for example, a supermarket transaction that leads to price increases in milk but price decreases in butter. In such a situation, cross-market effects could be aggregated without trading off harm to one class of consumers against losses to another set of consumers. The same principle applies, for instance, when there is only a single customer affected (e.g., the U.S. Defense Department). What if, however, different kinds of consumers are affected? Should all consumers therefore be treated equally?

According to Pitofsky, "[i]n the United States, an offset defense for mergers . . . will not be considered."[221] Pitofsky points out that such a

220. Allen highlights the "potential compensation" principle, which must be assumed and accepted when adopting the total surplus standard: "It is important to recognize that within the trade-off that is being made there is a principle embedded that economists refer to as the 'Potential Compensation Principle.' That is to say, there is a presumption that those that benefit from the merger could compensate those that are harmed. It is also important to recognize that the trade-off or compensation test is made without any regard to the identities of those who are harmed or those that benefit from the merger. That is to say, that a welfare loss of one dollar accruing to a person from the merger is offset by a welfare gain of one dollar accruing to another person without any regard to the economic, social, or political groups to which these individuals may belong. In economic jargon, this reflects an implicit assumption that we can make an ethical 'inter-personal welfare comparisons' on a one-to-one basis." Allen Speech.

221. Pitofsky Georgetown Article at 245.

defense has certain consumers paying a "tax" in one market in order to permit the firm to compete more effectively in another market. To date, U.S. courts have been reluctant to permit such an offset between markets.[222]

Nevertheless, as a general proposition, we would submit that transactions should be analyzed in terms of their overall welfare effects in all markets — even if the consideration of those effects is limited to consumer surplus. Leary recognizes the potential for balancing efficiencies when he recently indicated that he "personally reject[s] the notion that it is always improper to balance efficiencies in one area against personal harm in another area, particularly when the former area appears to be much more significant than the latter. What we are talking about, after all, are degrees of risk — not certainties — and it would be perverse to place arbitrary restrictions on the factors considered."[223] Although the balancing of the benefits and harms across markets may seem impractical to undertake in every transaction, there may be some cases in which such Solomonistic measures are warranted. The most compelling situation would be whenever markets are of significantly different size. Similarly, the 1997 Revisions recognize that:

> [I]n some cases . . . the Agency in its prosecutorial discretion will consider efficiencies not strictly in the relevant market, but so inextricably linked with it that a partial divestiture or other remedy could not feasibly eliminate the anticompetitive effect in the relevant market without sacrificing the efficiencies in the other market(s). Inextricably linked efficiencies rarely are a significant factor in the Agency's determination not to challenge a merger. They are most likely to make a difference when they are great and the likely anticompetitive effect in the relevant market(s) is small.[224]

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222. RSR Corp. v. FTC, 602 F.2d 1317, 1325 (9th Cir. 1979), cert. denied, 445 U.S. 927 (1980); 4A Areeda ¶ 972a. Perhaps the clearest rejection of efficiency considerations that occur outside the relevant market or markets in which the merger is challenged occurred in Mississippi River Corp. v. FTC, 454 F.3d 1083, 1089 (8th Cir. 1972), where the court stated that "the anticompetitive effects of an acquisition in one market cannot be justified by procompetitive effects in another market."

223. Leary Fall Forum Remarks at 20.

224. 1997 Revisions. Similar statements were made by the DOJ in the late 1980s. See Statement of Deputy AAG Judy Whalley, 29th Annual Antitrust Seminar, Practicing Law Institute (Dec. 1, 1989); Memorandum in Support of Plaintiff's Motion in Limine Relating to Efficiencies, United States v. Archer-Daniels-Midland Co., Civ. No. 83-51-D (S.D. Iowa, May 4, 1987). See discussion of the implications of the "inextricably intertwined" test in Gregory J. Werden, The "Inextricably Intertwined" Test for Merger Efficiencies (unpublished manuscript available through author).

The FTC's review of one transaction in 1996 provides a prime example of how this type of balancing of effects can be undertaken.[225] Both parties owned natural gas gathering systems (which transport natural gas from the wellhead to the nearest processing plant or transmission pipeline) in part of Texas. Although they were the only gas gathering systems serving several counties in Texas, the parties established that only a handful of producers were close enough to both gas gathering systems to benefit from competition between the two gas gathering systems in that area. Yet, all producers served by the two systems would benefit from the very substantial economies forecasted to occur once the gas gathering systems and associated plants — which were at the time grossly underutilized — were combined. (In fact, the FTC appears to have cleared the transaction on this basis.)

Welfare issues are further exacerbated when considered in the context of international trade and competition.[226] Pitofsky concludes that "although considerations of 'international competitiveness' have been slighted in United States merger enforcement, an offset defense seems an unwise reaction to the problem."[227] This raises some interesting and compelling questions. Should efficiency gains only be limited to those attained within the jurisdiction in which merger review is being conducted? If so, can one jurisdiction permit a merger where the post-merger efficiency gains offset or exceed the anticompetitive effects while another jurisdiction prohibits the merger because the countervailing efficiencies are not sufficient to balance the anticompetitive effects caused in that jurisdiction?[228] Surely, mergers involving companies with international operations are designed to create and promote economic and efficient consolidation on a global basis. Plants may be shut down in one country with capacity assumed by existing plants in other countries. The automobile industry in North America provides just one example of such activities. This multi-jurisdictional conundrum not only calls for a unified

225. Dick & Kolasky at 32-33.

226. For an interesting theoretical economic discussion of the effect of multijurisdictional review see Keith Head and John Ries, International Merger and Welfare Under Decentralized Competition Policy, 30 Canadian J. of Econ. 1104 (Nov. 1997); Andrew T. Guzman, Is International Antitrust Possible? 73 N.Y.U. L. Rev 1501 (1998) (discusses why national policies deviate from optimal global policy).

227. Pitofsky Georgetown Article at 245.

228. Section 96(2) of the Canadian Competition Act provides that the Tribunal shall consider whether increased exports or import substitution will result from any efficiency gains. The Director has determined that the efficiency gains constitute cost savings from efficient operations and not the entire value of incremental export sales or displaced imports. The Canadian Merger Guidelines state that "... this provision is simply considered to draw attention to the fact that, in calculating the merged entity's total output for the purpose of arriving at the sum of unit and other savings brought about by the merger, the output that will likely displace imports, and any increased output that is sold abroad, must be taken into account." Ch. 5, cited in Campbell at 156.

treatment of efficiencies, it also suggests the requirement for an efficiency analysis beyond the confines of a single jurisdiction, perhaps global in scale if need be. This requirement is particularly germane in the context of global trade and commerce and international trade treaties.[229]

There has been some judicial comment (at least in Canada) that the anticompetitive effects of a merger should be limited to those occurring in the jurisdiction in which the antitrust review takes place. In obiter dicta in *Hillsdown*, Justice Reed considered whether the Canadian Competition Act required neutral treatment of the redistribution of wealth resulting from an anticompetitive merger of foreign-owned firms located in Canada, where the excess profits earned from revenues derived from sales to Canadian consumers would flow to the foreign shareholders of the merging companies. In his article (which was cited with approval by Justice Reed), Professor Ross contemplated an anticompetitive acquisition of a Canadian company by a U.S. company where large efficiency gains occurred only in the United States while Canadian consumers would, arguably, pay higher prices and there would be significant layoffs in Canada, yet the total deadweight loss was small. While he concluded that, under a "total world welfare" standard the merger would be allowed, under the consumer surplus model it would be prohibited.[230] Further, under a "total Canadian welfare model," the merger would be prohibited if the efficiency gains in the United States were excluded.[231] There, are, in our view, significant adverse ramifications to limiting efficiency considerations to a single jurisdiction, particularly given that a country such as Canada is increasingly part of a larger trans-border market environment.

In the Superior Redetermination Decision, the Tribunal observed that the purpose of the Canadian Competition Act was, inter alia, to promote the efficiency and adaptability of the Canadian economy. Accordingly, in the Tribunal's view, efficiency gains and deadweight loss in foreign markets resulting from an anticompetitive merger in Canada were to be excluded in the application of the Canadian efficiency defense.[232] Although it may be more difficult to contend with, on balance and to the extent that there are world markets in products and services, we believe competition authorities should take into account total world efficiencies — even if the benefits are achieved outside of the home territory. Less clear is

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229. However, this issue may not arise in cases where geographic markets are broadly defined and the merger does not lead to a substantial lessening of competition within the broad market.

230. S. F. Ross, Afterword — Did the Canadian Parliament Really Permit Mergers That Exploit Canadian Consumers So the World Can Be More Efficient?, 65 Antitr. L.J. 641, 643-644 (1997).

231. This may raise issues of "discrimination" with respect to Canada's international obligations under NAFTA and GATT.

232. Superior Redetermination Decision at ¶ 196.

the practicability of permitting multi-jurisdictional offset when entirely separate markets exist across territorial boundaries and purported benefits arise solely outside of the reviewing jurisdiction.

Finally, antitrust officials should not ignore the benefits that might arise from a seller's ability to focus on its remaining business.[233] As mentioned above, the issue as to which standard should be applied stems from a more philosophical debate regarding redistribution effects and whether the overall objective of the antitrust laws should be to maximize allocative efficiency or consumer surplus. The ability (and desirability) of the competition authorities (and, where applicable, the courts) to judge what in the long run are the interests of consumers is questionable and should be undertaken with extreme caution. The end result of Type II errors (i.e. errors in over-enforcement) is consumer harm -- only there is no way to measure the losses. Nevertheless, we submit they are real, and a careful and objective assessment of all the evidence should be undertaken before condemning a transaction.

B. *What Standard of Proof Should Be Imposed?*

Initially, Judge Bork and Judge Posner, "the two most influential exponents of the Chicago School"[234] of Law & Economics opposed the consideration of efficiencies in the analysis, believing the defense would be "an intractable subject for litigation."[235] The expected value of an efficiency is a function of both the magnitude and the likelihood of the efficiency, and, if a low expected value is sufficient to outweigh the competitive risks of a transaction, then an efficiency of lesser magnitude or lower probability, or both, may meet the merging parties' burden. As Leary indicates, "we should [not] be overly fixated on immediate changes in the dimensions of 'rectangles' and 'triangles'; efficiency effects are much more subtle and long lasting."[236] Insistence of strong evidence of net efficiencies no longer seems to be appropriate and the hurdle for parties invoking the efficiencies defense should be lowered.[237]

Part of the skepticism about efficiencies arises from the difficulties in gauging with precision future events. Conrath and Widnell capture the

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233. See Kose John and Eli Olek, Asset Sales and Increase in Focus, 37 J. of Fin. Econ. 105 (1995) (seller's performance in remaining assets for three years following sale improved due to increased focus).

234. Kattan Article at 520.

235. See Richard A. Posner, Antitrust Law: An Economic Perspective 112 (1976) ("Posner"); Bork. Interestingly, Judge Bork filed an amicus brief in the D.C. Circuit's review of *Heinz* in support of Heinz's acquisition of Beech-Nut on the basis that it would create a stronger competitor against a firm that was dominant before the merger, rather than asking the court to accept an efficiency defense. See Baker Article at 23, n. 21.

236. Leary Fall Forum Remarks at 10.

237. Kattan Article at 522.

suspicion with which "evidence" of efficiencies is evaluated, when they postulate:

> The information relevant to evaluating claims of efficiencies from specific mergers is entirely within the control of the merging firms. They have an incentive to overstate or fabricate information to obtain a benefit – market power. It is easy to make glib efficiency claims; it is harder to deliver on them. Perhaps as a result of this phenomenon, there is, in the authors' experience, rarely a merger that attracts the attention of an enforcement agency whose proponents do not claim that their particular merger creates unique efficiencies that will be passed on to consumers and cannot be achieved without the merger.
>
> The firms and individuals that make overstated, excessively optimistic, or fanciful efficiencies claims in merger litigation do not have to live with all the consequences of being wrong about efficiencies. Suppose that an anticompetitive merger is approved on the prediction that efficiency price decreases will outweigh anticompetitive price increases. If the efficiencies claims turn out to be overstated, and the anticompetitive price increases occur, the net effect is anticompetitive higher prices. . . . Firms have other disincentives that discourage the firm from overstating efficiency claims. . . . On balance, however, it is always appropriate to evaluate efficiency claims with an eye on whether there is a connection between truth and consequences.[238]

The credibility of efficiencies claims depends on verification of the claims and the strength of the evidence overall.[239] The most common

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238. Craig W. Conrath and Nicholas A. Widnell, Efficiency Claims in Merger Analysis: Hostility or Humility? 7 Geo. Mason L. Rev. 685, 696-97 (Spring 1999) ("Conrath & Widnell"); In Muris 1999 Article at n. 132, Muris notes that "[t]he Conrath & Widnell article . . . illustrates the continued hostility of career government attorneys . . . In reading this Article, it is difficult to reject the conclusion that the authors believe that the Guidelines are just fine – the 1968 Guidelines, that is, which rejected consideration of efficiencies in most cases."

239. See John E. Kwoka and Frederick R. Warren-Boulton, Efficiencies, Failing Firms, and Alternatives to Merger: A Policy Synthesis, 31 Antitr. Bull. 431, 435 (1986) ("Kwoka & Warren-Boulton"). But see Raymond S. Hartman, Predicting the Efficiency Effects of Mergers, 9 J. of Forensic Econ. 295 (1996) (concludes that most ex ante analyses of expected merger efficiencies are incorrect). By way of comparison, the Canadian Merger Guidelines establish various sources of information that may be used to provide objective verification of particular sources of efficiency gains, including plant and firm-level accounting statements, internal studies, strategic plans, capital appropriation requests, management consultant studies (where available) or other available data.

source of evidence is a company's internal plans and cost studies, as well as public statements.[240] To the extent that the motive for a transaction is achievement of efficiencies, some engineering and financial evaluations may be available.[241] Depending on how extensively transaction parties undertake due diligence efforts and the number of people within each company who are involved in the transaction pre-announcement, there only may be preliminary and rough estimates of such cost savings, pre-transaction. After transaction agreements are executed, there may be antitrust limitations imposed on the transaction parties by counsel that may limit the level of details that can be achieved in cost savings identification and planning.

Moreover, the lack of detailed documents does not mean that transaction parties have not legitimately considered and relied upon the potential efficiencies in their business decisions regarding the transaction. (Now FTC Bureau of Economics Director) David Scheffman explained:

> Economists are generally frustrated by the paucity of company documents laying out merger efficiencies. This experience has helped develop agency economists' skepticism about merger efficiencies. It is unclear, however, whether agency economists recognize that they would generally find a paucity of company documents dealing with any major strategic investment decision that would have effects far into the future. Companies do not generally write reports or analyses in anything like the form that an economist would create. The business of business is taking risks, not writing reports.[242]

Nevertheless, to the extent that there are internal plans and cost studies developed by transaction parties, they should be considered by the antitrust officials, regardless of whether compiled before or after a transaction's announcement.[243]

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240. Publicly traded companies, however, may be conservative regarding their estimates regarding potential efficiencies due to the potential for the marketplace to punish severely (through the equity trading value) a company that fails to meet its claims; rather, firms may be rewarded in the long-term if they lowball their claims and then are able to tout achievements exceeding target.

241. Kwoka & Warren-Boulton at 435.

242. David T. Scheffman, Making Sense of Mergers, 4 The Antitr. Bull. 715, 723 (Fall 1993) ("Scheffman Article").

243. The U.S. antitrust authorities have tended to be skeptical of documents and studies developed after a transaction is announced, even though, as stated above, there may be practical reasons why pre-announcement documents do not exist or are in a preliminary state. Roberts & Salop 1996 Article at 15.

In addition, industry studies of size-related cost efficiencies may be available from third-party consultants (e.g., Frost and Sullivan, Chemical Economics Handbook), or in economics and engineering literature. Testimony from industry, accounting and economic experts also can be useful.[244] For instance, in the United States the agencies have considered probative the views of health care efficiency experts in their review of hospital mergers. Cross-sectional information also may be of some use (for example, studies on firm size, functions, etc.), although differences among sectors may affect the probative value of these studies.[245] Similarly, information regarding past merger experience of merging firms or other firms in the industry can be useful indicators of the likely cost savings from the proposed merger.

Stennek and Verboven provide an overview of how existing econometric evidence on scale economies could be used to indicate if the order of magnitude of potential cost savings justifies commissioning a more detailed study, utilizing an engineering approach.[246] Moreover, Röller, Stennek and Verboven[247] suggest that it may be desirable to put different weight on the amounts of efficiency claims depending on the source that certifies the validity of the information. They argue that there may be an advantage to considering information that is certified by outsiders (such as management consultants) since they need it to protect a reputation of future reliability. The problem with this approach, of course,

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244. Sanderson notes that, in order to verify the parties' cost savings claims, the Canadian Bureau often will employ the services of industry, accounting, or economic experts. By way of example, she notes that "an engineer may be contracted to: one, verify that a production line can physically be run three times in a day rather than two times; two, determine if the cost savings forecasted from the increased intensity of production are accurate; and three, identify any added costs which are likely to result from increasing the number of production runs, such as additional maintenance costs, increased downtime, or higher labour costs from overtime pay. Original corporate documents are relied upon, in addition to any independent work undertaken by the outside expert." She further advises that, "[g]iven the need for detailed cost information, and the risks that the parties incur under the conspiracy provisions if the merger does not proceed, firms are advised not to exchange detailed cost information directly when providing the Bureau with efficiency information. Instead, detailed cost information may be provided by each firm to its individual counsel who provides the information to an independent third party for analysis, typically an economist or industry consultant." Sanderson FTC Remarks.

245. Kwoka & Warren-Boulton at 435-6.

246. John Stennek and Frank Verboven, Merger Control and Enterprise Competitiveness – Empirical Analysis and Policy Recommendations (Working Paper No. 556, 2001), The Research Institute of Industrial Economics (May 3, 2001) at 160.

247. Lars Hendrick Röller, Johan Stennek and Frank Verboven, Efficiency Gains from Mergers (Working Paper No. 543, 2000), The Research Institute of Industrial Economics Sweden ("Röller, Stennek and Verboven Article") at 119.

is that it adds another layer of complexity to an already imprecise and arguably imperfect analysis.[248]

Finally, some evidence on efficiencies may be available from the stock market, since (at least conceptually) stock prices represent profit streams, a merger that is expected to lower costs should result in a higher stock market valuation.[249] The use of such evidence is not without controversy, and, given the mixed reasons why stock market valuation could increase, such an increase should not, in and of itself, be sufficient to support an efficiencies claim.[250]

Although review of the existing evidence may not eliminate all doubt regarding: (1) whether the efficiencies will indeed be achieved; and (2) the magnitude of savings that will actually be realized, this is not a reason to conclude that the efficiencies should not be counted at all or should be given less weight than evidence relating to market power. The same difficulties and uncertainties can be cited when trying to predict any future eventualities, including the effects of concentration and market power.[251] Given the societal costs of blocking a transaction that may produce

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248. Röller, Stennek and Verboven further argue that less weight should be assigned to studies on efficiencies that have been prepared after a merger has been taken to a detailed investigation by the antitrust authority as this would reveal that they were not the ostensible basis for the merger decision. Post hoc merger review, however, should not be a game of "gotcha" depending on the merging parties' "interest" at the time of the execution of transaction documents. Rather, the relevant inquiry should be on whether a transaction has been anticompetitive or even procompetitive because of the achievement of efficiencies. Röller, Stennek and Verboven Article at 119.

249. Kwoka & Warren-Boulton at 436. See also discussion in Scherer 2001 Article at 11-16 regarding stock market predictions of merger success.

250. Neil Campbell notes several difficulties using stock market valuation as a proxy for post-merger efficiencies: "To get a good performance reading, free of the immediate price excitements of the takeover process, one wants to track the firms over a fairly long period. But the longer the period, the more opportunity is there for other disturbing factors to affect the reading. Also, the assumption that stock price performance mirrors social value is a 'heavy' assumption. For example, an increase in stock price after a merger is just as consistent with supernormal profits deriving from enhanced market power as it is with efficiency gains. Sorting out which is the more plausible explanation is not an easy task. One strategy that has been suggested is to see whether stock prices of all major firms in the industry rise after a merger, which may be suggestive of a diminution of competition in the industry. On the other hand, if only the stock prices of the firms involved in the merger rise, this may be suggestive of firm specific efficiency gains." A. Neil Campbell, Merger Law and Practice, The Regulation of Mergers under the Competition Act 185 (Scarborough: Carswell 1997) ("Campbell Article"). See also Gregory T. Werden & Michael A. Williams, The Role of Stock Market Studies in Formulating Antitrust Policy Toward Horizontal Mergers, 1128 Q.J. of Bus. and Econ. 3 (1989); Gregory J. Werden and Michael A. Williams, The Role of Stock Market Studies in Formulating Antitrust Policy Toward Horizontal Mergers: Reply, 28 Q.J. Bus. and Econ. 39 (1989).

251. Accord William J. Kolasky, United States and European Competition Policy: Are There More Differences than We Care to Admit? European Policy Center, Brussels, Belgium (April 10, 2002) at 4.

significant synergies, enforcement officials should not adopt any presumptions against efficiencies, but, rather, they should evaluate the merits of such claims just as they would weigh the likelihood of anticompetitive efforts. For instance, Clayton Section 7 deals with "probabilities," not "ephemeral possibilities," and that standard also should be applied in determining the validity of an efficiency claim. Similarly, the standard used to verify efficiency claims in Canada is a "balance of probabilities" (rather than a stricter "clear and convincing" evidence standard), i.e. whether such efficiencies are "likely" to be achieved. Sanderson suggests that, while it is true that forecasting synergies from a merger is an uncertain and difficult exercise, it has been the Canadian Bureau's experience that this is often no more speculative than forecasting the competitive response of rivals or poised entrants to possible price increases by the merged entity.[252] Further, a stricter evidentiary burden also might negate the availability of the efficiency exception. Campbell concurs with this argument when he observes that "future efficiency gains need not (and usually cannot) be established conclusively. The same standard is used in the anticompetitive threshold where it appears to mean probable. There is no reason to assign a different meaning in the context of efficiency gains."[253] The standard of proof applied in the EU also is not one of certainty, but, rather, as recently indicated by the European Court of First Instance in *Airtours*, one of at least "convincing, adequate evidence."[254] The burden of proof imposed on transaction parties claiming an efficiency defense should be the same, less than absolute standard.

C. *How Should Efficiencies Be Factored into the Analysis?*

Debate remains regarding how efficiencies should be included in M&A analysis. There appears to be, at least in the United States, an unwritten "absolute rule" that recognizes efficiencies, for enforcement purposes only, on a sliding scale when compared to post-merger market concentration levels.[255] Simply stated, this rule suggests that the lower the concentration levels, the more likely antitrust agencies will factor into the analysis the efficiencies' benefits of a transaction.[256] For transactions

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252. Sanderson notes that Deyak and Langenfeld believe this is equally true in the U.S. Sanderson FTC Remarks. See Timothy Deyak and James Langenfeld, Efficiencies in U.S. Merger Analysis, International Merger Law: Events and Commentary, No. 25 (Sept. 1992).

253. Campbell Article at 156.

254. Airtours/First Choice O.J. L 93/1 (1993) (Comm'n) at ¶¶ 63 and 120.

255. Kolasky George Mason Speech at 8. But see Kattan Article at 520.

256. See Pitofsky Georgetown Article; accord Roberts & Salop 1996 Article at 13-14 (need greater efficiency benefit the more concentrated the market, the greater the market shares, and the higher the entry barriers and potential anticompetitive effects).

raising higher concentration concerns, this approach "discounts" efficiency claims. Moreover, as indicated in the 1997 Revisions and in recent court decisions, at some point, concentration may reach a level at which efficiencies almost never count (for example, monopoly or near monopoly, or, as proposed by former FTC Chairman Pitofsky, where the combined company would hold more than 35% of the market). Indeed, efficiencies have never been the primary reason that the U.S. antitrust authorities lost a merger challenge.[257]

Similarly, the uses of structural market indicators appear to correspond to the current EU model, to the extent the EU has not explicitly recognized an efficiency defense, but, rather, takes the likelihood of efficiencies into account by using a relatively high threshold for its structural presumptions.[258] Yet, as recognized by Ilzkovitz and Meiklejohn, to the extent the threshold of tolerance for adverse competitive effects is lowered through the concept of joint or oligopolistic dominance, it may be "more natural to consider efficiency more explicitly."[259]

The Canadian efficiency defense provides no limits to the level of concentration that can be authorized thereunder. Without such limits, the acceptance of a valid efficiency defense theoretically may permit the creation of a monopoly or near monopoly that eliminates competition altogether, increases prices for consumers, and, in effect, obviates or frustrates the other purposes of antitrust legislation. Indeed, the practical effect of the Tribunal's decision in *Superior Propane* was to allow near monopolies in several Canadian markets with great efficiencies to be created, at least arguably in the short run (as opportunities for entry were still available as noted by the Tribunal), notwithstanding the Canadian Commissioner's argument that "no merger to monopoly could ever, by definition, bring about gains in efficiency that offset the effects of the merger on competition."[260]

However, as Trebilcock and Winter observe, the Canadian Commissioner's argument that efficiency effects cannot possibly offset a merger to monopoly contradicts Section 92(2) of the Canadian Competition Act, which states that the Tribunal shall not find that a merger substantially lessens competition solely on the basis of market share or concentration.[261] In other words, Section 92(2) of the Canadian Competition Act contains no exception in the case of any specific combined market share. Similarly, Section 96 of the Canadian

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257. See Baker Article; see also Berry Article at 526-28; Conrath & Widnell at 688-70.

258. See Ilzkovitz & Meiklejohn at 22.

259. Id.

260. Konrad von Finckenstein, Speaking Notes for an address to the Canadian Bar Association (Sept. 1999), available at http:/strategis.ic.gc.ca/SSG/ct01616e.html.

261. Trebilcock & Winter at 109.

Competition Act contains no exception for merger to monopoly or near monopoly. Indeed, under the Canadian legislation, the very concept of a statutorily-defined (and a fortiori a judicially created) monopoly was eliminated in the 1986 amendments to the Canadian Competition Act, and it would be regressive if that were now reestablished. Simply put, the focus of M&A analysis should be on a combination of qualitative and quantitative factors. The imposition of a strict "monopoly" exception would eliminate this. Moreover, where would such a "monopoly" exception kick in — at 85%, 88%, 93%, or is 100% required? The result would be rather arbitrary and suggest a precision that is not realistic, particularly where there may be questions as to proper product or geographic market definition.

On the other hand, at least one member of the Canadian judiciary seems to be of the view that efficiencies should not act to facilitate monopolies and near monopolies. Mr. Justice Létourneau in the Superior Appeal Decision stated:

> In my respectful view, however, section 96 was not meant to authorize the creation of monopolies since it would defeat the purpose of section 1.1. The section was not intended to authorize mergers resulting in monopolies whereby, contrary to section 1.1, competition is eliminated, small and medium-sized enterprises are not able to enter or survive in the market and consumers are deprived of competitive prices.[262]

In the Superior Redetermination Decision, the Tribunal took strong exception to the above statement of Mr. Justice Létourneau, stating that, "[i]f, as it appears, Létourneau, J.A. is suggesting that the efficiency defence should not be available when mergers lead to structural monopolies then, with respect, he must be wrong."[263] The Tribunal noted that, while the restriction denying the defense when a merger would result in "virtually complete control of a product in a market" had been articulated in predecessor draft bills, it was not included in Section 96 of the Competition Act.[264]

As in Canada, then, would it be better to have the concentration presumption or "discounting" based on concentration dropped in favor of a case-by-case adjudication of the market conditions and net efficiencies, i.e. whether the magnitude of the claimed efficiencies outweighs the potential for-anticompetitive effects? There is, after all, an efficiency in decisionmaking by establishing a rule that is readily administrable rather

262. Superior Redetermination Decision at ¶ 173.
263. Id. at 277.
264. Id.

than, in each case, undertaking a full blown review of the competitive effects (including efficiencies) likely to occur as a result of the merger.[265]

But, how valid, however, is the concentration presumption in the first place? The presumption that a transaction will likely result in a price increase based on the concentration levels uniformly set across all industries by merger guidelines is viewed by some scholars as weak, absent extraordinary circumstances of creation or enhancement of unilateral market power. In other words, the empirical basis of existing theories for attacking mergers on concentration and market share grounds simply lacks a firm foundation.[266] This is particularly believed to be true in markets where technological development is rapid. For instance, under Canadian competition law, market concentration or market share is only one of the factors considered in a merger review. In fact, Section 92 of the Competition Act provides that the Tribunal shall not find that a merger substantially lessens competition solely on the basis of market share or concentration.

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265. See C. Frederick Beckner and Steven C. Salop, Decision Theory and Antitrust Rules, 67 Antitr. L.J. 41 (1999); see also Alan A. Fisher, Price Effects of Horizontal Mergers, 77 Cal. L. Rev. 777, n.4 (1989) (favors discounting efficiency claims when compared to likely consequences of a transaction). Of course, the unilateral effects analysis is not expressly based on concentration factors, and efficiencies can be incorporated under a welfare standard.

266. In 2001, the Antitrust Section of the ABA created a Task Force on Fundamental Theory to consider the role of concentration in merger review. A report of the Task Force issued in July 2001 ("Concentration Task Force Report"), which, among other things, included the following papers: (1) Barry C. Harris and David D. Smith, The Merger Guidelines vs. Economics: A Survey of Economic Studies ("Harris & Smith Paper"); (2) Ky P. Ewing, Re-Examining the Concentration Thesis: What do California Dental and the "New Learning" Teach About The Merger Guidelines? ("Ewing Paper"); (3) Michael B. Porter, Competition and Antitrust: Towards a Productivity-Based Approach to Evaluating Mergers and Joint Ventures ("Porter Paper"); (4) Thomas B. Leary, A Modest Defense of Concentration Calculations ("Leary Task Force Paper"); and (5) Jonathan B. Baker and Steven C. Salop, Should Concentration Be Dropped From the Merger Guidelines? ("Baker & Salop Paper"). The Harris & Smith Paper reviews the theoretical and empirical economics literature and concludes "[o]verall, the economics literature does not provide the basis for a merger enforcement policy based principally on concentration levels." Concentration Task Force Report at 11. "The overall conclusions from the review are that the empirical studies: (1) suffer from fundamental problems that render their results unreliable; (2) provide ambiguous results that differ from study to study and from industry to industry; (3) generally identify a relatively small price impact associated with increasing concentration; and (4) do not identify a critical concentration level that would be applicable across markets." Concentration Task Force Report at 29. Similarly, Ilzkovitz & Meiklejohn at 24 indicates that "market shares and concentration reserve alone cannot be considered as proving a reliable guide to market power;" see also Donald J. Boudreaux, The Second Edition of Judge Posner's Antitrust Law: A Tempered Appreciation, The Antitrust Source 3 (March 2002), available at www.antitrustsource.com ("the evidence that markets are prone to monopolization is extraordinarily weak, whereas the evidence that antitrust is used to hamstring competitive rivals is powerful.").

In reviewing the Superior Propane/ICG merger, the Tribunal stated that, while it may lessen and prevent competition substantially and deprive consumers of competitive prices, it did not eliminate all competition and therefore did not prevent entry by small and medium-sized businesses nor prevent their survival in the market. The Tribunal concluded:

> It follows therefore, that in terms of the section 96 inquiry, the finding of monopoly according to any particular definition thereof is irrelevant. If the creation of a so-called monopoly is not per se sufficient to justify a conclusion of substantial lessening or prevention of competition under section 92 of the Act, then its creation cannot be a bar to the application of section 96. . . . However monopoly may be defined, a merger thereto is not more objectionable under the Act than other instances of substantial lessening or prevention of competition unless additional effects are shown.[267]

We submit that, in the U.S. context, instead of strict conformity with the concentration presumptions found in *Brown Shoe*,[268] *Philadelphia National Bank*,[269] and their progeny, a better analytical approach would be to adopt, as part of the merger review, the procedures applied by the U.S. courts in a Sherman Section 1 claim. If the market were very concentrated, a "quick look" approach could be adopted – as recognized by the Supreme Court in the Sherman Section 1 context in *California Dental Association*[270] and *NCAA v. Board of Regents*.[271] Under this approach, once the plaintiff or government authority established a prima facia case of illegality (based on market shares, entry barriers, prior conduct, etc.), the burden then would shift to the defendants to produce evidence supporting an efficiency claim. Rarely would it be the case in the merger context that the rule of reason could be applied and dismissed "in the twinkling of an eye."[272] Rather, so long as the defendants were able to show some evidence of legitimate efficiencies claims, a full-blown rule of reason analysis would be undertaken to determine the relevant market's competitive dynamics and the likely competitive effects if the efficiencies were to occur. At the rule of reason stage, no presumptions of illegality would be asserted on the basis of concentration; rather, a balancing of the likelihood of anticompetitive effects against the potential for efficiency

267. Superior Redetermination Decision at ¶¶ 280-281.
268. United States v. Brown Shoe, supra.
269. United States v. Philadelphia National Bank, supra.
270. California Dental Assoc v. FTC, 526 U.S. 756 (1999).
271. 468 U.S. 85 (1984).
272 NCAA, supra, 468 U.S. at 109-10.

gains would be employed.[273] The standard of proof should be based on the balance of probabilities for both sides of the balancing process.[274]

D. *Will Achievement of Efficiencies Destabilize Coordination?*

As recognized in the 1997 Revisions,[275] a transaction that produces efficiencies also can have a destabilizing effect upon coordination. Even those scholars who believe there generally may be some correlation between concentration and price recognize there are a myriad of factors (for example, shares of rival firms, entry conditions) that can impact market performance.[276] Indeed, in some industries, concentration can both raise margins and lower consumer prices.[277] As discussed above,[278] contrary to the belief of some commentators, it is in the more concentrated markets that it is more likely that the cost savings will be passed-through to consumers: even a monopolist has an incentive to lower its price if its variable costs decline,[279] with the shape of the demand curve being the

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273. Accord Muris 1999 Article at 738, "Because of the weakness of the anticompetitive presumption, current merger policy doesn't give appropriate credit to mergers that are shown to likely reduce costs."

274. Such an approach is consistent with the "sequential approach" advocated by Ilzkovitz & Meiklejohn at 23, which would identify those cases for which it is relevant to carry out an in-depth efficiency investigation, except that they automatically would condemn mergers that result in a high (e.g., above 60%) market share.

275. See also Kai-Uwe Kühn, An Economists' Guide Through the Joint Dominance Jungle, unpublished manuscript initially prepared for Competition Policy Workshop, Bologna, May 26, 2000 (copy available from author).

276. See, e.g., Baker & Salop Paper, "economic theory does not suggest ignoring market shares and concentration in merger analysis.... In particular, a wide range of theories of oligopoly conduct – both static and dynamic (supergame) models of firm interaction – is consistent with the view that fewer firms and more concentrated markets on average are associated with higher prices." Concentration Task Force Report at 342. Moreover, "contemporary economic learning on the relationship between market concentration and price suggests that concentration be treated as an important factor relevant to the competitive effects theory . . . but far from an irrebuttable determinant of post-merger pricing." Concentration Task Force Report at 344; Paul A. Pautler, Evidence on Mergers and Acquisitions (Sept. 25, 2001) (unpublished) ("Pautler Article"), at 41.

277. Pautler Article at 41; accord Hausman & Leonard.

278. See Section II. A.1.

279. Assuming a uniformly lower marginal cost curve and downward sloping demand, as variable cost declines, equating marginal revenue with marginal cost at a higher level of output results in a lower price. For example, a monopolist with a linear demand will pass through 50% of any reduction in marginal cost. A firm's pass-through rate is the ratio of slope of firm-specific (residual) demand to slope of the firm's marginal revenues. With a reduction in marginal cost, the firm will increase its output so that marginal revenue declines by the same amount. See Baker Article at 19; Jeremy I. Bulow and Paul P. Pfleidere, A Note on the Effect of Cost Changes on Prices, 91 Journal of Pol. Econ. 182 (1983).

important determinant of the pass-through rate.[280] Therefore, by cutting costs, the transaction could create a "maverick" firm with both the ability and incentive to expand output.[281]

What also should be recognized is the impact that such cost-cutting ability can have on coordination with other market participants. To the extent that efficiencies result in greater variation among the costs of firms in a market, the task of successful collusion becomes more difficult.[282] Harris suggests that, "for any given price level, a competitor with lower costs has a greater incentive to ignore group goals and to pursue its independent goals, since its lower costs increase the profits it earns from each additional sale."[283] The EU Commission appears to have recognized this effect in *Airtours*, where it briefly noted that the efficiency gains resulting from the merger would reduce the merged parties' incentive to collude with the other two merged tour operators (but ultimately found the cost savings too low to constitute a material change in cost structure, and, therefore, the merger parties' incentive to compete would not be enhanced).[284]

On the other hand, Salop recently argued that, in oligopoly markets, cost reductions could create forces that increase prices.[285] Salop posits two theories: (1) cost reductions can facilitate oligopoly coordination by reducing incentives to cheat; and (2) cost reductions can facilitate coordination by eliminating cost-asymmetries. By way of illustration of the second theory, Salop cites the DOJ's competitive impact statement in the Premdor/Masonite transaction, a transaction in which a rival firm had certain cost advantages that it used to lower prices. The differing cost structure allegedly served as an impediment to coordination. However,

> post-acquisition, the cost structures . . . would be more closely aligned [due to the merging firm's reduction of costs] . . .

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280. Even a merger to monopoly can lead to price decreases. For example, Trebilcock and Winter postulate a case of linear demand and per unit costs that are invariant to quantity (to take a simple and commonly invoked example, a firm will pass on to consumers 50 cents of each dollar of savings in per unit cost). If a firm experiences a drop in per unit cost of 10%, consumers can expect a price decrease of 5%, relative to the price at the original cost level. In the case of a merger to monopoly that would have involved a price increase of 5% if costs had not changed, a cost saving of greater than 10% is enough to lead to a price decline. Trebilcock & Winter at 109. Unfortunately, few models predict price increases of only 5% when moving from duopoly to monopoly. The 5% threshold in the 1992 Guidelines is for market definition; it is not a threshold for competitive effects/acceptable price increases.

281. See Jonathan B. Baker, Mavericks, Mergers and Exclusion: Proving Coordinated Competitive Effects under the Antitrust Laws, 77 NYU L. Rev. 135 (April 2002).

282. Harris & Smith Paper, Concentration Task Force Report at 49.

283. Id.

284. Airtours, supra at ¶ 146.

285. See Steven C. Salop, Can Cost Reductions Raise Prices in the Short-Run, ABA Antitrust Section, Fall Forum, Washington, D.C. (Nov. 16, 2001).

> decreasing the opportunity for the [rival] firm to increase its market share profitably through lower prices . . . thus increasing the [rival]firm's incentive to coordinate. . . In fact, Masonite recognized that the [rival] firm's incentive to gain market share by lowering price would diminish if it faced a strong, integrated competitor.[286]

In reality, the marketplace is more dynamic and complex than the one-time competition round described above. It is not simply a matter of whether the merged entity actually achieves the efficiencies and costs become asymmetric, thereby destabilizing coordination in the marketplace. Rather, the achievement of efficiencies occurs throughout an extended time period, and not necessarily along a smooth linear path. Moreover, it is both the unpredictability and the disruption of the status quo ante time path for the realization of efficiencies that is likely to add to the potential destabilization of coordination. Given the complexity and fact-specificity of these dynamics, it seems inappropriate to impose automatically a steep presumption of illegality once the transaction parties produce some evidence supporting an efficiency claim. Rather, a case-by-case review is warranted.

E. *What Efficiencies Should Count?*

This section discusses the types of efficiencies that should count in offsetting concerns about the competitive effects of a transaction. As discussed below, we do not oppose a standard that requires a nexus between the transaction and the claimed efficiencies. Moreover, we recognize that certain categories of efficiencies are easier to verify and more likely to be substantiated and realized. We would not favor the outright rejection, however, of other categories of less certain efficiencies merely because they are less easily verified or occur less frequently. As Leary recently stated, "the most significant efficiencies may be hard to quantify, or even identify, but they must be there somewhere if a law-abiding company maintains a leading market position over an extended period of time."[287] Rather, we would suggest that, as with any other question of fact, the competition authorities (and, if applicable, the courts) weigh the evidence presented to determine whether to accept the specific efficiencies claimed by the parties in the specific transaction.

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286. United States v. Premdor and Masonite, Civ. No. 1: 01CV01696, Competitive Impact Statement (D.D.C., Aug. 3, 2001) at 9, available at http://www.usdoj.gov/atr/cases/9000/9017.htm.

287. Leary Fall Forum Remarks at 10.

1. Merger-Specificity

Acquisitions have a "unique potential to transform firms and to contribute to corporate renewal."[288] Firms undertake acquisitions when their management believes it is the most profitable means of enhancing capacity, new knowledge or skills, or entering new product or geographic arenas.[289] The decision to undertake a major acquisition typically is part of a broader plan to achieve long-term company growth and reorganization objectives.[290] The 1997 Revisions focus on this unique potential by incorporating a requirement that the efficiencies claimed must be "merger specific."[291]

To impose a rigid merger specificity test to transactions has the potential of hampering a firm from obtaining, as expeditiously as possible, efficiencies that may be critical to the firm's ability to compete (both domestically and internationally), and that may promote competition in the industry. Acquisitions are a major means by which firms achieve efficiencies.[292] In a recent survey of large global transactions, KPMG determined that managers and boards of directors consider market share gains (which is not necessarily the same as "market power") as the single most important reason for undertaking acquisitions.[293] A subsequent follow-up analysis conducted by business school Professor Ghosh

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288. Philippe C. Haspelagh and David B. Jemison, Managing Acquisitions: Creating Value Through Corporate Renewal, The Free Press: 1991 at 3 ("Haspelagh & Jemison").

289. Pautler Article at 1-2.

290. Sheffman Article.

291. Professor Hausman criticizes the "merger-specific" requirement as a "poor economic policy that can and has harmed consumers." Hausman & Leonard at 727. Yet, as discussed by Professor Scherer, the merger-specificity requirement is important to deal with so as not to count intracompany charges that are avoided (e.g., layoffs) simply because it may be preferable to wait for a merger to justify such actions. Scherer 2001 Article at 20-21. The tax law apparently provides a perverse incentive in this regard by permitting such severance costs to be deducted if part of a transaction, but not otherwise. Id. Professor Scherer indicates that such was the case in the proposed merger between Lockeed/Martin and Northrop/Grumman, and in such a situation that "scrupulously critical application of the 'no defense for efficiencies that could be achieved any way' criterion is warranted." Id. at 21.

292. See Paul M. Healy, Krishna G. Patepu, and Richard S. Ruback, Does Corporate Performance Improve After Mergers? 31 J. of Fin. Econ. 135 (1992) (post-acquisition performance for 50 largest U.S. mergers between 1979 and mid-1984 showed significant productivity improvements among firms with highly overlapping businesses).

293. KPMG Transactions Services Survey (2001), as reported in Aloke Ghosh, Increasing Market Share as a Rationale for Corporate Acquisitions (May 2002) ("Ghosh Paper"); as indicated by Pautler Article at 5, "it is doubtful that the bulk of more recent merger activity could be attributed to an effort to secure market power." Indeed, as FTC Bureau of Economics David Scheffman pointed out, "It is ironic that current antitrust policy views efficiency-related claims made about mergers to generally be too speculative to merit consideration, but the real money at risk in a merger views short-run market power effects generally too unlikely or speculative to merit financial weight." Scheffman Article at 715 and 720.

establishes that (1) the average market share of acquiring firms increases from about 10% to nearly 12% between pre- and post-acquisition years;[294] and (2) higher market shares do improve acquiring firms' profitability because of efficiency from better asset- and operating cost-margins.[295] The proposition that firms might benefit from higher market shares is not a new concept in industrial organization.[296]

Acquiring firms also can benefit from higher market share due to economies of scale in production, distribution and marketing activities. In addition, combinations can lead to greater efficiency in future operating and investment decisions.[297] As discussed in further detail below, the merger-specificity requirement is most likely to be satisfied in the case of synergies. Simple scale economies may fail this test if it is strictly interpreted because one or both of the merger parties might be able to achieve greater scale on its own.[298] This is particularly true in industries undergoing significant growth. According to Farrell and Shapiro, it also applies in declining industries, where excess capacity would exit the market following a transaction. It is preferable, under a consumer welfare standard, if the excess capacity is used to compete (which may result in the capacity exiting the market at some point in the future) rather than removed from the industry by merger, even if total costs would be lowered by the merger.[299] In the case of a merger, however, the merged firm will have a larger output base on which to apply the cost savings, thereby potentially rendering profitable a passing on of a portion of the cost savings, where, in contrast, unilateral internal expansion might not have been considered, or actually be, profitable. In addition, Farrell and

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294. Ghosh Paper at 26.

295. Id. at 22.

296. Id. at 1, citing R. Schmalensee, Inter-Industry Studies of Structure and Performance, Handbook of Industrial Organization (1987); and Joseph A. Schumpeter, Capitalism, Socialism, and Democracy (1942) ("Schumpeter"). Indeed, economist Joseph Schumpeter argued that increased market concentration results in greater innovation because it makes behavior more predictable. In addition, transaction costs might decline as the potential for hold-up costs creates incentives for the larger firm to invest in intangible/relationship specific assets to mitigate such costs. Thus, positive competitive effects can arise from acquisitions that stimulate innovation, including when such innovation is a result of efficiency gains. Accord Broadcast Music Inc. v. CBS, 441 U.S. 1 (1979) (superior quality and services are to be counted as procompetitive gains from a transaction).

297. Ghosh Paper at 2. "Greater efficiency in operating decisions would lead to higher profitability, which could arise because of (1) lower operating costs from economies of scale and/or (2) greater turnover from improved marketing and better distribution of products or other related reasons. Post-acquisition profitability also could increase if larger market share led to investments in R&D and other intangibles like advertising."

298. Joseph Farrell and Carl Shapiro, Scale Economies and Synergies in Horizontal Merger Analysis, 68 Antitr. L.J. 685, 691 (2001) ("Farrell & Shapiro"); Accord IVA Areeda ¶¶ 973b, 973c.

299. Farrell & Shapiro at 698.

Shapiro argue that the more classically competitive the market, the less likely it is that non-synergistic type scale efficiencies can meet the merger-specific requirement since individual firms will find it relatively easy to attract enough customers (without a devastating price decline) to achieve efficient scale.[300] As a result, "some of the factors that strengthen consideration of no-synergies efficiencies claims also fuel the underlying competitive concerns."[301] Thus, as Farrell and Shapiro suggest, the merger-specificity requirement brings to "center stage" the very difficult balancing concerns and challenges faced by counsel raising efficiencies defenses in the M&A environment.[302]

Competition authorities (and, ultimately, where applicable, the courts) should not force companies to choose less desirable means of achieving efficiencies or foregoing efficiencies because of some theoretical possibility that the firms could achieve those efficiencies absent a merger. The courts have – at the urging of the enforcement agencies – been very literal in their treatment of "merger specificity," focusing on whether a firm could achieve the efficiencies absent the transaction and blocking transactions in which the court found efficiencies would occur.[303] The focus should be on whether there will be "incremental" cost savings from undertaking a transaction rather than attempting an internal expansion. For example, increased speed in obtaining the efficiency objectives is such an incremental gain and should count. Transaction parties also should not be limited to counting only those efficiencies that will be achieved as a result of the transaction over the short-term.[304] To the extent a longer time period is considered, the value of efficiencies can be discounted to account for risk and opportunity costs associated with the transactions.

Although, theoretically, almost anything can be done without a merger, via, for example, a service contract, the mere theoretical possibility that an efficiency could be achieved through means other than a proposed transaction should not be the benchmark.[305] By way of comparison, in a Sherman Section 1 case, the plaintiff carries the burden of showing that the procompetitive effects can readily be achieved by reasonably alternative means.[306] Moreover, in a Sherman Section 1 case, a court typically will not

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300. Id. at 696.

301. Id. at 703.

302. See generally id.

303. See, e.g., FTC v. Tenet Health Care Corp., supra; FTC v. Staples, Inc., supra; FTC v. Cardinal Health, supra; Heinz, supra.

304. Some EU commentators, for instance, believe only a two- to three-year time frame should be counted. To date, there is no EU decision on this point.

305. The 1997 Revisions recognize that "the [a]gencies will not insist upon a less restrictive alternative that is merely theoretical."

306. See, e.g., Chicago Prof'l Sports Ltd. P'ship v. NBA, 961 F.2d 667, 675-76 (7th Cir.), cert. denied, 506 U.S. 954 (1992), as cited in ABA Section of Antitrust Law, Antitrust Law Developments (5th ed. 2002) ("ALD V"), at 76.

reject the countervailing justification (e.g., efficiencies) proffered by defendants merely because the restraint was not the "least restrictive means" of achieving the procompetitive objective, provided that undertaking the arrangement to achieve this objective is deemed "reasonable."[307] In contrast, some argue that under Clayton Section 7, "efficiencies are not merger-specific if individual firms likely can and will achieve them without the necessity of merging (or comparable restrictions)."[308] This formulation of the test may be too restrictive if it requires showing that the specific firms at issue could not and would not have undertaken the efficiency-producing activity absent the merger. Accordingly, Chairman Muris (correctly, we submit) favors a test that focuses on whether the efficiencies are likely absent the merger, rather than on the question of whether the merger is reasonably necessary to achieve the efficiencies.[309] This test implicitly recognizes the need to focus on the specific firms involved in a transaction to determine the likelihood that the efficiencies would be achieved absent the merger. Not only should the competition authorities apply this standard in their M&A review, but also they should not advocate a higher standard of merger specificity in the courts.

2. *Debate Over What Constitutes Cognizable Efficiencies*

Not all types of efficiencies are treated equally under the law (or, for that matter, by economists). Werden has indicated that "all of the ways in which a horizontal merger can generate [cognizable] efficiencies are largely vertical in nature."[310] Moreover, currently, there is an unwarranted bias towards accepting only those variable production cost savings that can be achieved in a relatively short time frame. Although there is a greater risk of non-achievement the longer the time horizon considered, such risk can be accounted for by applying an appropriate discount to the value attributed to those efficiencies, rather than blindly ignoring the potential benefits from those efficiencies. Accordingly, this section will discuss each of the major categories of efficiencies and the current views regarding recognition of the category as a benefit, as well as some possible reasons for broadening the categories of cognizable efficiencies.

a. Productive Efficiency

Productive efficiency (sometimes referred to by some financial scholars as "resource sharing") is the least controversial category of

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307. ALD V at 76.
308. Farrell & Shapiro at 690.
309. Muris 1999 Article at 732.
310. See Werden 1997 Article.

efficiencies. Currently, achieving productive efficiency is, reportedly, a strategic rationale for approximately 70% of all mergers.[311] Productive efficiency is optimized when goods are produced at minimum possible cost. Transactions can increase productive efficiency by creating economies of scale[312] and scope,[313] as well as synergies. As firms seek to achieve optimal scale, inefficiently scaled firms will be driven from the market by exit or acquisition. Combining the operation of two firms may reduce duplication, allow fixed expenditures to be spread across a larger base of output, and permit firms to reorganize production lines across plant facilities. Economies of scale also can arise at the individual plant level as plants are expanded toward their optimal size. In addition, at higher rates of output, mechanization of specific production functions previously carried out manually can give rise to scale-related resource savings. Economies of scope can be generated at the plant level when the cost of producing more than one product at a given level of output is reduced by producing them together rather than separately.[314]

(1) Economies of Scale

Other efficiencies that can arise at the plant level include savings that flow from specialization, elimination of duplication, reduced downtime, smaller base of spare parts, smaller inventory requirements and avoidance of capital expenditures that would otherwise have been required. Multi-plant-level savings can arise from plant specialization, rationalization of various administrative and management functions (for example, sales, marketing, accounting, purchasing, finance, production) and the rationalization of R&D activities.[315] In addition, mergers can bring about plant and multi-plant efficiencies in relation to distribution, advertising and capital raising.[316] The FTC Global Report indicated that "[p]lant and production economies of scale are generally accepted as important to a firm's competitiveness and subject to reasonable assessment as to their likely magnitude and probability."[317] Similarly, Chairman Muris endorsed "plant size economies [as]. . . among the most worthy of recognition."[318]

311. Max M. Habeck, Fritz Kröger, and Michael R. Träm, After the Merger: Seven Strategies for Successful Post-Merger Integration (Pearson Education Limited, London 2000) ("Habeck, et al.") at 7.

312. Economies of scale occur when the combined unit volume allows a firm to operate at a lower unit cost.

313. Economies of scope arise when the joint use of an asset results in a lower overall cost than firms had when they operated independently.

314. Id.

315. Id.

316. Id.

317. FTC Global Report at 90.

318. Muris 1980 Article at 418-19.

Ilzkovitz and Meiklejohn further recognize that such savings are "less likely to result from anticompetitive reductions in output."[319]

Balto points out, however, that "a merger of two companies, each with an inefficiently small plant, simply may result in a single firm with two inefficiently small plants."[320] Some commentators also challenge that conventional plant-level scale economies are less likely to be improved by merger since little can be done to improve production at existing, separate facilities.[321] In addition, economies of scale may be exhausted at firm sizes that are lower than those presented in a merger. Some studies argue that they may be exhausted at firm-size levels in the 10 to 15% market share range,[322] or that, to the extent that merging firms outperform industry-median firms, the results are likely to be biased by pre-acquisition performance.[323] Yet, minimum efficient scale will vary significantly among industries.[324] Moreover, depending on the circumstances, such scale economies may be achievable unilaterally, without a transaction, or may not be large enough and sufficiently passed-through such that consumers will benefit.[325] Given the variability of scale economies across different industries, a case-by-case review is warranted to determine whether, in a particular transaction, such economies are likely to be attainable.[326]

Plant-level scale economies can occur only through consolidation of production at an individual facility, where, for example, firms may be operating well below capacity because of market overcapacity or where economies can be improved by allowing a plant to operate continuously or a second shift.[327] A merger in such situations may allow the firms to close a plant and operate the other plant at more efficient levels. The potential benefits from such plant rationalization, for instance, might arise in a distressed industry or an industry with maturing or declining demand.[328]

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319. Ilzkovitz & Meiklejohn at 16.

320. Balto Article at 74.

321. Kwoka & Warren-Boulton at 433.

322. See Fisher & Lande at 1607.

323. Aloke Ghosh, Does Operating Performance Really Improve Following Corporate Acquisitions? 7 J. of Corp. Fin. 1152 (2001); see also Pautler Article at 22 (discussing McGuckin and Nguyen research and subsequent Makismovic and Phillips study, which suggest that, although most plant transfers improve productivity, the results are less robust for whole-firm mergers than more discrete asset transfers).

324. Kattan Article at 530; Stennek and Verboven at 160.

325. Farrell & Shapiro at 687. See discussion infra regarding the "pass-through" requirement.

326. There also may be variability in scale economies for a single industry through time for rapidly-changing technologies.

327. See generally Balto Article at 74-75.

328. In a distressed industry, other possible intangible benefits can arise from the transfer of technology or assets at a time when their owner is relatively healthy and thereby obviate the risk that their value will be dissipated by exit of key personnel or inadequate maintenance during a bankruptcy process.

On the other hand, some have argued that less weight should be given to savings from the elimination of redundant corporate overhead. This form of cost reduction is "marginal for productivity growth because it is a one-time benefit and does not affect the inherent operating cost of producing and delivering a product or service."[329] Also, obtaining economies of scale in a combination of firms producing differentiated products may involve a reduction in product diversity. Although more difficult to quantify, perhaps, this potential loss to consumers could be factored into the analysis as well.[330]

As discussed above, there is some debate as to whether efficiencies should be counted if they can be achieved internally, such as by expanding production facilities to achieve economies of scale.[331] There are a number of practical reasons, however, why internal expansion can be significantly costlier. First, it might be slower to occur due to the need to construct facilities, introduce new technologies, etc. Second, adding new capacity in a stable or declining demand environment may place downward pressure on price, thereby making such expansion unprofitable. Third, adding new capacity may result in social waste to the extent that duplicate resources at the acquired firm subsequently may be scrapped.[332]

(2) Economies of Scope

Companies also can increase productive efficiency through economies of scope. Such savings result from the cost savings of producing or distributing two products together rather than separately. Potential sources of scope savings include common raw inputs, complementary technical knowledge, or the reduction in or elimination of distribution channels and sales forces.

(3) Synergies

The third category of productive efficiency is synergies, i.e. marginal cost savings or quality improvements from any source other than the realization of economies of scale, such as the close integration of specific,

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329. Porter Paper, Concentration Task Force Report, at 164-65.

330. Stennek & Verboven at 45; compare Thomas B. Leary, The Significance of Variety in Antitrust Analysis, 68 Antitr. L.J. 1007 (2001), and Thomas B. Leary, Freedom as the Core Value of Antitrust in the New Millennium, before ABA Antitrust Section 48th Spring Meeting, Chairs Showcase Program, Antitrust at the Millennium: Looking Back and Moving Forward, Washington, D.C. (Apr. 6, 2002).

331. See, e.g., Farrell & Shapiro.

332. William J. Kolasky, The Role of Efficiencies in Merger Review, 16 Antitrust 82-87 (Fall 2001).

hard-to-trade assets.[333] Examples include: (1) improved interoperability between complementary products (e.g., seamless interface between equipment); and (2) sharing of complementary skills. "Synergies require cooperation and coordination of the two firms' assets that allow production on a superior production function, as distinct from causing different choices (such as scale) on a fixed-production function. In other words, synergies allow output/cost configurations that would not be feasible otherwise."[334] Therefore, by definition, a synergy will not be achieved absent a transaction.[335]

Mergers also can give rise to legitimate production-related savings attributable to the transfer of superior production techniques and know-how from one of the merging parties to the other merging party. However, claims that a merger is likely to give rise to efficiencies by reason of "superior management" or that particular savings are specifically attributable to management performance generally are difficult to establish objectively. Similarly, it typically is hard to establish that the efficiencies would not likely be sought and attained through alternative means if the merger did not proceed.[336]

b. Distribution and Promotional Efficiencies

The 1997 Revisions are silent regarding the acceptability of distribution and promotion efficiencies. (The Canadian Merger Guidelines, however, expressly acknowledge the acceptance of plant and multi-plant efficiencies relating to distribution and advertising activities.[337]) The FTC Global Report, however, viewed these types of efficiencies as "less likely to be substantial and often likely to be difficult to assess."[338] On the other hand, Chairman Muris previously noted that "in the cost structure of consumer goods, promotion plays an important role, particularly since the larger market share may be needed to achieve minimum efficient scale."[339] Chairman Muris, in a recent article (published prior to his appointment as FTC Chairmen) suggested that the government should recognize this type of efficiency.[340] Distribution and

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333. Habeck, et al. suggests that "growth" synergies should be the primary reason and focal point of acquisitions.

334. Farrell & Shapiro at 693.

335. Id.

336. Canadian Merger Guidelines, Appendix II.

337. Id.

338. FTC Global Report at 33.

339. J. Howard Beales and Timothy J. Muris, State and Federal Regulation of National Advertising (AEI Press, Washington, D.C., 1993) at 7-10 (as noted by Chairman Muris, Professor Stigler recognized the importance of these economies in consumer goods markets); Muris 1999 Article at 734.

340. Muris 1999 Article at 734.

promotion efficiencies can be significant, particularly given the consolidation throughout sectors of the distribution system, such as supermarkets, drug stores and wholesalers.[341] Advertising in some industries even produces externalities (for example, when a computer shop advertises a particular brand of computer, the consumer then may go elsewhere to buy the computer). When a company has a larger market share, this externality is reduced, however, since it becomes less likely that the consumer will actually divert its sale to some third party. We submit there is no reason that distribution and promotional efficiencies should not be counted.

c. Dynamic or Innovative Efficiency

Efficiencies also can occur in the form of improved quality or services. These efficiencies do not necessarily lead to express short-term cost reductions,[342] and are, therefore, more difficult to quantify. As Scheffman correctly indicated, "a company is not its existing products and current new product development projects. A merger is a profound long-run change. The net benefits lie in the effects of merger on long-run competitive advantage."[343] While "productive efficiencies are gains achieved from producing goods at lower cost or of enhanced quality using existing technology . . . [i]nnovative efficiencies are cost savings or product enhancement gains from the innovation, development, or diffusion of new technology."[344] In high-tech industries, especially, "much of the focus of efficiency analysis will be on R&D efficiencies. R&D efficiencies offer great potential, but because they tend to focus on future products, there may be formidable problems of proof."[345] The FTC Global Report acknowledged that "innovation efficiencies may make a particularly powerful contribution to competitive dynamics, the national R&D effort, and consumer (and overall) welfare."[346]

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341. See, e.g., FTC v. Cardinal Health, supra (defendants claimed that, among other things, closing of overlapping distribution centers would save between $220 and $307 million over the first three years in the Cardinal merger). Indeed, as mentioned supra, in 2001, the FTC permitted the merger of Bergen and AmeriSource (the third and fourth largest drug wholesalers) because the combination would result in significant efficiencies. In *Superior Propane*, distribution efficiencies were a significant portion of the overall expected efficiencies.

342. The exclusive focus on price effects is misleading and excludes improvements that can improve consumer welfare even with price increases. See discussion in Ilzkovitz & Meiklejohn at 20 of A. Jacquemin, Theories of Industrial Organisation and Competitive Policy, What are the Links?

343. Scheffman Article at 723.

344. Brodley 1996 Article at 579.

345. Balto Article at 76; Areeda ¶ 975g, at 81.

346. FTC Global Report at 32.

Indeed, innovative efficiencies may ultimately "provide the greatest potential enhancement of social wealth."[347] As a general proposition, society benefits from conduct that encourages innovation to lower costs and develops new and improved products. Economist Joseph Schumpeter argued that the short-run costs associated with allocative and productive inefficiencies stemming from market power can be offset by benefits from encouraging dynamic efficiencies through "creative destruction."[348] Thus, as Kolasky indicated in March 2002, "productive and dynamic efficiencies are at least as important as static allocative efficiency in promoting economic growth."[349]

Yet, the 1997 Revisions provide that efficiency claims "relating to research and development are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions." Just because they are difficult to quantify and verify, however, does not mean that such efficiencies should be ignored. Roberts and Salop, for instance, have adopted an approach that would apply a dynamic framework for assessing efficiencies – including R&D spillovers – and appropriately discount the results for the likelihood of success, as well as possible delays in implementation. As recognized by Ilzkovitz and Meiklejohn, dynamic efforts should be taken into account even though they do not necessarily lead to price reductions.[350] Moreover, cost reductions arising from a reduction in the number of R&D firms should be counted unless the number of remaining R&D firms drops to a level that is, in and of itself, problematic.

d. Transactional Efficiency[351]

An acquisition can foster transactional efficiency by eliminating the "middle man" (and, therefore, "double marginalization"). U.S. (and presumably EU) antitrust law has not always been sensitive to the role of mergers in reducing these costs.[352] In contrast, Canada has recognized the benefit of increased production-related efficiency resulting from

347. Brodley 1996 Article at 581.

348. Schumpeter, supra.

349. William J. Kolasky, Comparative Merger Control Analysis: Six Guiding Principles for Antitrust Agencies – New and Old, International Bar Association, Conference on Competition Law and Policy in a Global Context, Cape Town, South Africa (Mar. 18, 2002) at 3.

350. Ilzkovitz & Meiklejohn at 24.

351. For a broader discussion, see Paul L. Joskow, Transaction Cost Economics, Antitrust Rules, and Remedies, 18 J. Law, Econ. & Org. 95 (2002); Douglas W. Allen, What Are Transaction Costs? 14 Res. in Law & Econ. (1991).

352. See, e.g., Muris 1999 Article at 734; see generally Harry N. Butler and Barry D. Baysinger, Vertical Restraints of Trade as Contractual Integration: A Synthesis of Relational Contracting Theory, Transaction Cost Economics, and Organizational Theory, 32 Emory L.J. 1009 (1983).

integrating activities within the merged entity that were previously performed by third parties. (Attainment of these gains generally involves a reduction in transaction costs associated with matters such as contracting for inputs, distribution and services.)[353]

In general, market participants design business practices, contracts and organizational firms to minimize transaction costs and reduce exposure to opportunistic behavior (e.g., holdups). As Coase indicated, "a firm will tend to expand until the costs of organizing an extra transaction within the firm becomes equal to the cost of carrying out the same transaction by means of an exchange on the open market or costs of organizing another firm."[354] Joint ventures and common ownership can help align firms' incentives and discourage shirking, free riding, and opportunistic behavior that can be very costly and difficult to police using arms'-length transactions.[355] Transactional efficiencies, therefore, should be recognized as benefits from a merger.

e. Procurement, Management, and Capital Cost Savings

The 1997 Revisions place purchasing, management and capital cost savings in the category of efficiencies that "are less likely to be merger-specific or substantial, or may not be cognizable for other reasons." Indeed, some commentators have argued that certain types of cost savings should be accorded greater weight than others, owing to issues of the difficulty of evidentiary proof.[356] For example, savings arising from consolidating management or administrative functions are thought to be of lower value than those that might arise from economies of scale. Sanderson observes that,

> [i]n the Bureau's experience, administrative and corporate overhead savings are just as likely to be measurable as plant-level production savings. However, certain production efficiencies are generally more easily verifiable than others and are certainly easier to verify than dynamic efficiencies. Yet this has not resulted in according a differing status to a class of efficiencies in the trade-off analysis; rather, a probability weighting (or range of weightings) is assigned to the various cost claims. In this way the less likely cost savings are accorded less weight without discarding a class or type of efficiency claim.[357]

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353. Canadian Merger Guidelines, Appendix II. Indeed, distribution efficiencies have played significant roles in assessing the overall effects of a merger.

354. William J. Kolasky, Network Effects: A Contrarian View, 7 Geo. Mason L. Rev. 577, 611 (Spring 1999).

355. See id. at n. 143.

356. See, e.g., Sanderson FTC Remarks.

357. Id.

The EU Commission also appears to be hostile to this category of savings. In *Aerospatiale-Alenia/de Havilland*, for instance, the management cost savings identified by the parties were rejected as not merger-specific: "These cost savings would not arise as a consequence of the concentration per se, but are cost savings which could be achieved by de Havilland's existing owner or by any other potential acquirer." [358] Nevertheless, we submit that such cost savings should not be summarily dismissed since in the real world they do occur and can be significant in magnitude.

(1) Procurement Savings

Outside expenditures can account for as much as 50 to 70% of a company's cost structure.[359] A Booz-Allen & Hamilton report indicated that procurement synergies often comprise 50% of the total value of all synergies realized in a merger.[360] Not surprisingly, therefore, in the business world, procurement savings often are a touted source of merger savings, with "[p]rocurement consistently generat[ing] the bulk of near-term savings in merger integration efforts."[361] For instance, increased volume typically results in lower unit costs. In addition, combining best practices in sourcing approaches and purchasing practices can result in significant cost savings.[362] "Procurement savings are particularly persuasive where the reduction in the number of buyers or the streamlining of the buying process will reduce the costs of the suppliers and these reduced costs will be passed on to consumers in the short term."[363] It should be noted, however, that the Canadian Competition Act does not permit efficiency claims that merely represent "a redistribution of income between two or more persons," including a redistribution of income to suppliers extracted as reductions through the increased bargaining leverage of the merged firm.[364]

It is ironic that antitrust officials are skeptical regarding obtaining procurement efficiencies given that, in a few recent U.S. cases, the premise for the competition concern was the market power that the combined firm would have in the purchase of a particular input (i.e. monopsony

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358. Aerospatiale-Alenia/de Havilland O.J.L 334/42 (1991) (Comm'n) at ¶ 65.

359. Managing Procurement Through a Merger: Capturing the Value of the Deal, Booz-Allen & Hamilton at 2; accord Habeck, et al. at 71 (up to 80%).

360. Id.

361. Id. at 1.

362. James P. Andrew and Michael Knapp, Maximizing Post-Merger Savings from Purchases, Boston Consulting Group (2001).

363. Balto Article at 77.

364. Section 96(3) of the Canadian Competition Act.

power).[365] Röller, Stennek and Verboven recognize that purchasing cost savings can be achieved in a merger and suggest that:

> [t]o assess the social effects from increased bargaining power toward suppliers, it is important to know the degree of power at the supplier side. If there is little power on the supplier side, the increased bargaining power of the merging firm may be socially harmful. If, however, the increased bargaining power forms a form of countervailing power to an already strong supply side, then the private benefits from the merging firm may coincide with the social benefits.[366]

As reflected in the paucity of government challenges on these grounds, monopsony power rarely exists (or is sustained) in markets. As Balto indicates, "protecting the ability to secure lower prices is an important goal of the antitrust laws. . . . 'Courts should be cautious — reluctant to condemn too speedily — an arrangement that on its face appears to bring low price benefits to consumers.'"[367] Accordingly, absent monopsony issues, the competition authorities should permit parties to assert procurement savings as benefits from the transaction.

(2) Managerial Savings

Although antitrust enforcement officials may discount managerial efficiencies as not being merger-specific and being a fixed cost less likely to be passed on to consumers in the short term,[368] the financial literature recognizes the importance of the "market for corporate control" (acquisitions) as a means of weeding out bad management and moving assets to their highest-valued uses.[369] Leary indicates that "efficiencies of [the kind realized by General Motors], whether they are called innovation or managerial economies, are probably the most significant variable in

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365. See United States v. Aetna, Inc., No.3-99CV1398-H (N.D. Tenn. 1999); United States v. Cargill Inc., No. 1:99CV01875 (D.D.C. 1999); Susan M. Davies and Marius Schwartz, Monopsony Concerns in Merger Review, Vol. II No. 1 ABA Section of Antitrust Law Clayton Act Newsletter 19 (Winter 2002).

366. Röller, Stennek and Verboven at 46.

367. Balto Article at 78, quoting in part, Kartell v. Blue Shield, 749 F.2d 922, 931 (1st Cir. 1984).

368. See Kattan Article at 530.

369. Baker Article at 3; see also Pautler Article at 3; Michael C. Jensen and Richard S. Ruback, The Market for Corporate Control — The Scientific Evidence, 11 J. of Fin. Econ. 5 (1983); Halma Frydman, Roman Frydman, and Suzanne Trimbath, Financial Buyers in Takeovers: Focus on Cost Efficiency, Milken Institute, publication forthcoming in special issue on Strategic Finance (paper establishes that financial buyers are most likely to initiate takeovers of inefficient firms and can play a beneficial role in changing management's focus on cost management).

determining whether companies succeed or fail – or in determining whether certain more specific merger efficiencies are achieved or not. Yet, we do not take them into account when deciding merger cases."[370] In large public corporations particularly, a failure of management to maximize the profits of the corporation leads to internal inefficiency, sometimes referred to as "x-inefficiency."[371] It is the recoupment of some of these inefficiencies that motivates some transactions, particularly hostile transactions. One business text even indicates that, while market power and increased purchasing power can play a major role in some acquisitions, combination benefits are not at the heart of value creation in truly strategic acquisitions. It is through resource sharing and the transfer of functional and general management skills that capability transfer takes place in acquisitions.[372] Functional skill and general management skills transfer occurs when one firm improves its capabilities by obtaining functional skills from another firm. Examples include advanced manufacturing process skills, knowledge of an additional distribution channel and cutting-edge research,[373] as well as corporate leadership and human resource management. These managerial skills are, perhaps, more transferable within same or complementary industries than between different product or service industries.[374] In the right circumstances, for example, when a merger facilitates the use of superior know-how, such efficiencies should be recognized. Yet, as Muris reports, the DOJ acknowledged ADM's managerial prowess in the proposed Clinton Corn Processing acquisition, but, nonetheless, found that the merging parties had not provided a cognizable and sufficient defense.[375] Professor Scherer, who was an expert for the transaction parties in that case, notes that, "[i]t is a fact of life that some managements are better at reducing costs than others. To ignore efficiencies that result from superior management is to close one's eyes to an important component of reality."[376] Professor Scherer points to evidence of ADM's costs, which were lower than any other corn wet miller, as well as its unique approach to plant operations, as part of the evidence supporting the likelihood that ADM would achieve efficiencies out of Clinton's operations.[377]

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370. Leary Fall Forum Remarks at 10.

371. For a discussion of improvements in x-efficiency see Harvey Leibenstein, Allocative Efficiency vs. "X-Efficiency," 1966 Am. Econ R. 392 (1996).

372. Haspelagh & Jemison at 29.

373. Id. at 30-31.

374. See Id. at 126. This is in part due to a failure to appreciate and understand the subtleties of industry and firm context. Further, managerial efficiencies are extremely difficult to verify, and almost every business executive thinks they can run the target company better than the target's current team.

375. Muris 1999 Article at 735.

376. Scherer 2001 Article at 21.

377. Id. at 20.

Similarly, in a November 2002 ABA speech, FTC Commissioner Leary recognized that "innovation or managerial efficiencies. . . are probably the most significant variable in determining whether companies succeed or fail. . . Yet we do not overtly take them into account when deciding merger cases. . . We tend to ignore the less tangible economies in the formal decision process because we simply do not know how to weigh them."[378] Indeed, there are no reported instances in which any of the competition authorities studied expressly recognized managerial efficiencies in the merger review and permitted the transaction to proceed on that basis. Leary suggests that "one solution is to evaluate the track record of the acquirer and the key employees of the target company to determine whether they are likely to manage the company efficiently."[379] Leary further suggests that, even if the staff cannot quantify the value of such managerial efficiencies, such arguments should provide the staff with a non-competitive explanation for the transaction.

(3) Capital Cost Savings

A related category of efficiency disfavored by the antitrust enforcement agencies relates to capital raising efficiencies, again, presumably, because of the relatively fixed nature of these costs. Research reveals evidence of substantial efficiencies in capital raising costs as one of the most persistent advantages of corporate size. Empirical work indicates that companies with over $1 billion in assets enjoy, on average, about a 6% lower borrowing cost than firms with $200 million in assets. Moreover, $200 million companies enjoy a borrowing cost advantage of approximately 12% over $5 million companies.[380] A more recent study finds empirically that firms can increase their financial leverage post-consummation because of an increase in debt capacity,[381] thereby facilitating quicker expansions. Yet, the U.S. enforcement agencies (and Areeda) are unwilling to count such savings.[382] In *ADM-Clinton* mentioned above, the DOJ reportedly wanted the transaction parties to review each of the individual capital investment projects and show how capital costs would be reduced. The transaction parties submitted that it should be sufficient to show (as they apparently did) that ADM made capital investments far in excess of those planned by Clinton's previous

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378. Jaret Seiberg, FTC Redefines Merger "Efficiency," The Daily Deal (Nov. 11, 2002) at 3.

379. Id.

380. See F.M. Scherer and David Ross, Industrial Market Structure and Economic Performance 126 (3d ed. 1990).

381. Aloke Ghosh and Prem C. Jain, Financial Leverage Changes Associated with Corporate Mergers, 6 J. of Corp. Fin. 377 (2000).

382. See Areeda ¶ 975h.

owners, and that those investments, in the aggregate, expanded output relative to earlier plans, leading to substantial efficiency gains.[383]

As with productive scale economies, these pecuniary savings also should be recognized because they can dramatically improve a firm's cost position, and therefore,[384] its competitiveness in the marketplace. To the extent that these cost savings are likely to be passed on to consumers only over the long-term, and a consumer welfare standard is deployed, the value of these savings can be discounted appropriately.

F. *Should Firms Ex Post Facto Be Held Accountable for Not Achieving Efficiencies?*

As indicated above, Professors Posner and Bork opposed including efficiencies in the analysis of transactions among rivals. The primary reason cited by them was the difficulty in proving (or disproving) efficiencies pre-merger with any accuracy in the abstract. It is true that, in many transactions, even legitimately anticipated efficiencies may never materialize.[385] Certain scholars (including former FTC Chairman Pitofsky) suggest that "firms should be subject to an after-the-fact (ex-post) audit to determine whether efficiencies have in fact been achieved and, if not, [the competition authorities should] administer appropriate relief to restore competitive conditions."[386] Conrath and Widnell, among others, suggest that "if companies justify an otherwise anticompetitive merger with promises that efficiencies will benefit consumers, then they ought not be surprised if there are demands that they deliver on their promises."[387]

In a settlement setting, it may, in some specific circumstances, be possible to have the parties commit to passing through to consumers a specific level of cost savings. In *Long Island Jewish Hospital*, for example, the court permitted the merger to proceed, at least partially due to a settlement

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383. Scherer 2001 Article at 21.

384. The EU Commission appears to have viewed GE's borrowing power and capital resources as reasons not to permit GE's merger with Honeywell since it would give the combined firm a "competitive advantage."

385. David J. Ravenscraft and F.M. Scherer, Mergers, Sell-offs, and Economic Efficiency (Washington, D.C.: Brookings Institute 1987).

386. Brodley 1996 Article at 577; Pitofsky Georgetown Article at 218; F.M. Scherer, R&D Cooperation and Competition, Brookings Paper on Economic Activity (Microeconomics) (1990); see also, Pitofsky Explores Subsequent Review as Approach to Antitrust Enforcement, 69 Antitrust & Trade Reg. Rep. (BNA) No. 1725 at 157 (Aug. 10, 1995) (suggests conditioned clearance of transaction subject to later efficiencies review as possible future policy); see also F.M. Scherer and D. Ross, Industrial Market Structure and Economic Performance (3d Ed. 1990, Boston, Houghton Mifflin Company) at 188; see also Scherer 2001 Article at 22 (it might be desirable to allow mergers to go forward provisionally for a certain period, e.g., three years).

387. Conrath & Widnell at 704.

between the merger parties and the New York Attorney General that required that the savings for two years be passed on to consumers. Similarly, in the drug wholesaling merger case, the court suggested, during the course of trial, that the case could be settled by allowing the merger and imposing efficiency pass-through commitments on the combined firm.[388]

Sanderson discussed the practical effect of post-merger analysis in Canada:

> While there have been some merger cases where the Director monitored the implementation of efficiencies post-closing, the Bureau has not undertaken a comprehensive analysis to determine what proportion of pre-merger efficiency claims are fully realized post-acquisition. Anecdotal evidence on this is mixed. There are cases where the parties exceeded their original cost savings estimates and other cases where the parties failed to realize the significant savings anticipated. In some cases, unanticipated exogenous shocks (e.g., recession, labour difficulties) made the realization of efficiencies difficult. No clear trends have appeared, and as a result, parties' cost claims are approached in a similar and consistent fashion, whatever the industry or market characteristics.[389]

Outside of this context, the ex post review of efficiencies is troublesome on a number of accounts.[390] Perhaps the most important reason is that transaction parties should not be held accountable for failing to achieve efficiencies because, even if a transaction is unable to achieve the synergies, that does not mean it was, in fact, anticompetitive. Many transactions are deemed "failures"[391] by the business world because they failed to increase shareholder value — which has nothing to do with

388. Sporkin Watch, FTC: Watch (July 13, 1996) at 1.

389. Sanderson FTC Remarks.

390. For instance, the task of undertaking such studies would not be easy or without controversy regarding the appropriate benchmarks. See generally Pautler Article (discusses merits and limitations of using stock market studies of merger events, large scale studies of mergers, structure-conduct performance studies, and experimental economic studies). As Dr. Pautler indicates, in n. 70, "accounting data, for example, may not reveal the true economic rate of return for a firm."

391. For a useful summary of the literature concerning merger effects see Paul A. Pautler, The Effects of Mergers and Post-Merger Integration: A Review of Business Consulting Literature (2002). It is important to recognize that, in the business world, "failures" are not limited to acquisitions, but also include internal projects. These internal failures are often less visible, however, and, therefore, typically do not draw the same level of notice. See Dennis Carey, Lessons from Master Acquirers: A CEO Roundtable on Making Mergers Succeed, at 5, reprinted in Harvard Business Review on Mergers and Acquisitions (Boston, MA, 2001). See Pautler Article n. 210 ("Based on work by Ravenscraft . . . et al., and Sirower, mergers fail 35% to 75% of the time," with success variously defined).

whether the transaction harmed consumers. The evaluation of the success of transactions is quite complex and equity market performance may not provide a complete picture. Conducting profitability studies to compare pre- and post-merger results poses significant methodological difficulties. For instance, in a "purchase accounting" transaction, the acquired company's assets are "written up" to reflect any premium paid by the acquirer. When a premium is paid over book value, "the perceived post-merger profitability of the company is reduced in two ways: asset on stockholders' equity values are increased. . . , reducing calculated returns on any measure of invested capital; and profits themselves are reduced due to the depreciation of written-up asset values."[392] Moreover, some of the transactions deemed failures ultimately may result in decreased market concentration (not because the merged firm successfully increases its prices and reduces its output, but because it has lost key personnel or others in the industry have caught up) and increased competition.[393]

The Winter 2001 McKinsey Quarterly indicates that mergers often fail because of a loss of revenues momentum – only compounded by the failure to meet projected cost savings.[394] Thus, the merged entity's "share" of the market might actually fall as a result of the transaction,[395] or the transaction could have resulted in efficiencies, but the increased profits and benefits achieved may have been competed away by rivals matching those efficiencies.[396] "[A]cquisitions may actually increase a company's vulnerability to competitive attack because the demands of integration can divert attention away from competitors. Acquisitions also create an opportunity for competitors to poach talent while organizational uncertainty is high."[397] Also, a company with a poor delivery performance

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392. Scherer 2001 Article at 14.

393. One business professor notes that "competitors will not sit still while an acquirer attempts to generate synergies at their expense... What's more, acquisitions increase vulnerability to competitive attacks, because acquirers often allow the challenge of integrating organizations to divert their attention away from the competition... Acquisitions also create an opportunity for competitors to poach talent [citing Deutche Bank/Banker's Trust example]." Mark L. Sirower, What Acquiring Minds Need to Know, Wall Street Journal (Feb. 22, 1999) ("Sirower Wall Street Journal Article").

394. Mathias M. Bekier, Anna J. Begardus, and Tim Oldham, Is the Belief that Mergers Drive Revenue Growth a Delusion? The McKinsey 2001 No. 4 6, 8 ("Bekier"). Indeed, Salant, Switzer and Reynolds show that some mergers induce losses for merging firms, even when the transaction creates large efficiency gains through scale economies that benefit society.

395. S. Salant, S. Switzer, and R. Reynolds, Losses from Horizontal Merger: The Effects of an Exogenous Change in Industry Structure on Cournot Nash Equilibrium, 98 Q. J. Econ. 185 (1983).

396. Dick & Kolasky at 4.

397. Alfred Rappaport and Mark L. Sirower, Stock or Cash? The Trade-Offs for Buyers and Sellers in Mergers and Acquisitions, Harv. Bus. Rev. 147, 149 (Nov.-Dec. 1999) ("Rappaport"); a 1999 KPMG study estimates that as many as 50% of managers leave following the first year of an acquisition, Unlocking Shareholder Value: The Keys

in one acquisition may face harm on a more long-term basis in the stock market, with investors being even more guarded about future transactions. This also can affect the motivation of employees and slow a company's momentum, which also can adversely affect successful integration. It also can trigger a spiral decline because companies whose share prices perform badly find it hard to attract and retain good people.[398] Indeed, poor acquisitions increase the likelihood that the acquirer will itself become an acquisition target.[399]

Moreover, it is important to remember that, in most transactions, the primary reason that efficiencies are being projected is not to "fool" the government into approving an otherwise anticompetitive transaction, but because the company believes it will achieve those benefits. No one enters a transaction intending to lose shareholder value.[400] In transactions other than "Mergers of Equals" there typically is an acquisition premium paid,[401] which is justified by the expectation of achieving synergies.[402] To the extent that the target's shareholders obtain upfront the lion's share of the value of the anticipated synergies and such synergies are not met or exceeded, the transaction will be deemed a "failure" by the acquiring company's shareholders. Failure to achieve these synergies can greatly affect stock prices — and, ultimately, the very jobs of management. Companies clearly pay a high cost for failing to deliver on projected cost savings post-merger. "Up to 40% of mergers fail to capture the identified cost synergies. The equity market penalizes the slippage hard: failing to meet an earnings target by only 5% can

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to Success, KPMG Mergers and Acquisitions Global Research Report (1999) at 12. According to Kearney, for example, the "Citibank and Travelers Group . . . merger to form Citigroup is already having problems with unexpected departures from the top management team." A.T. Kearney, Corporate Marriage: Blight or Bliss? A Monograph on Post-Merger Integration, at 10.

398. Rappaport at 158.

399. Pautler Article at 6; accord Suzanne Trimbath, Mergers and Efficiency: Changes Across Time, The Milken Institute Series and Financial Innovation and Economic Growth, Kluwer Academic Publishers, Norwell, Massachusetts, 2002 ("Trimbath") at 71 (relatively inefficient firms have a higher probability of being taken over).

400. Merger Integration: Delivering on the Promise, Booz-Allen & Hamilton at 1.

401. Making Acquisitions Work: Capturing Value After the Deal, Booz-Allen & Hamilton, at 4 (overestimating value, paying excessive premiums among reasons for deal failure); see also Robert G. Eccles, Kersten L. Lanes, and Thomas C. Wilson, Are You Paying Too Much for That Acquisition? at 46-47, reprinted in HBR (many failures, such as Quaker Oats's acquisition of Snapple, occur simply because the acquirer paid too much). Possible reasons for overly optimistic projections include: (1) disparate use of various cost categories such that it may appear that certain costs are more easily eliminated than they are; (2) costs may be incurred in different places depending on a company's structure so that a function cannot be eliminated as anticipated; and (3) it is easier to eliminate positions than the personnel who fill them. Id. at 55.

402. See generally Mark L. Sirower, The Synergy Trip: How Companies Lose the Acquisition Game (The Free Press 1997).

result in a 15% decline in share prices."[403] The antitrust authorities, however, should not be concerned with whether the transaction will cause the redistribution of wealth from one set of shareholders to another.

Part of the justification for viewing skeptically efficiency claims is the high percentage (i.e. about 50%) of transactions that reportedly fail.[404] Careful review of the business literature, however, reveals that the "success" rate for transactions among firms in the same or closely related businesses is higher.[405] The fact that a transaction to enter into a separate market (that may or may not ultimately converge) "fails" to achieve synergies or "fails" from a business standpoint[406] does not necessarily mean that consumers have been harmed. Acquisitions fail for any number of reasons. First "competitors will not stand idly by while an acquirer attempts to generate synergies at their expense," but will, instead, seek to replicate those benefits.[407] These risks are particularly attenuated in industries that are undergoing rapid change, such as deregulation.[408] It is important to consider the impact of procompetitive market changes on a transaction's financial returns when trying to determine the probativeness of an individual company's success rates post-acquisition. Second, acquisitions (in contrast to internal growth and development) require "full payment up front."[409] Investors want – and expect – timely performance gains to materialize; if they do not, the company's share price will suffer. Execution-related reasons include loss of key staff, poor due diligence, and delays in communication.[410] In most transactions, the problem arises

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403. Bekier at 8.

404. Habeck, et al. at 3 ("A global survey of 115 transactions conducted by A.T. Kearney in 1998/1999 revealed that 58% of mergers failed to reach the value goals set by top management.").

405. See Carey from HBR at 6; A.T. Kearney, Corporate Marriage: Blight or Bliss? A Monograph on Post-Merger Integration, at 4 ("A.T. Kearney"); accord Habeck, et al. at 22 (the highest success rates, as measured on the basis of total shareholder returns, were realized in concentric (mergers done for value enhancement such as a combination of two firms that purchase the same type of services) and lateral (acquisitions around a central competence) acquisitions).

406. See Joseph L. Bower, Not All M&As Are Alike – And That Matters, Harv. Bus. Rev. 93, 99-100 (March 2001) (cites as an example, "When AT&T acquired computer manufacturer NCR, it did so because AT&T (and many others) thought that computers and telecommunications were convergent industries. The combination never succeeded."), see also David Henry, Mergers, Why Most Big Deals Don't Pay Off, Bus. Week (Oct. 14, 2002) at 60.

407. Rappaport; Sirower Wall Street Journal Article.

408. Gregor Andrade, Mark Mitchell and Erik Stafford, New Evidence and Perspectives on Mergers, 15 J. of Econ. Perspectives 103 (Spring 2001) (deregulation was a dominant factor in M&A activity and accounted for nearly half of merger activity in the 1990s).

409. Id. at 149.

410. Booz-Allen Report on Merger Integration: Delivery on the Promise ("Booz-Allen Delivery") at 3.

during the actual integration process.[411] Three recurring "process-based" reasons cited by the financial scholars are: (1) determinism (i.e. the tendency to cling to the original justification even after the realities suggest a changed course is appropriate or preferred); (2) value destruction (i.e. the impact of an acquisition on management and employees); and (3) leadership vacuum (i.e. lack of an articulated common purpose or objectives).[412] These missteps affect a firm at least as much as the marketplace and do not result in the merged entity having any greater ability to harm competition.

Antitrust officials should not disallow transactions simply because some transactions (or even most transactions) are viewed as failures by the equity markets, particularly to the extent that a consumer welfare model or preference exists. It is not relevant or appropriate for competition authorities (unless adopting a total welfare approach) to second-guess business executives regarding the sagacity of undertaking acquisitions to achieve financial performance. Moreover, even under a total welfare standard, shareholder gains are but one aspect to be considered – consumer welfare also matters. Thus, the failure of a company to realize full value for a transaction in the equity market would be only one part of the equation.

In addition, antitrust officials consistently apply a prospective mode of analysis to assess market power, including likely effect on prices, barriers to entry and the other factors. There is not routinely an ex post facto review of whether these concerns materialize in fact. If the same standard of balance of probabilities is applied to efficiencies, the same principle of the ex post facto review should apply. There simply are too many market forces, including macro- and micro-economic changes, which can cause even the best predictions to fail or not be achieved in their entirety. For example, few would have predicted that the Federal Reserve Bank would lower rates so many times in such short order in late 2001-early 2002 for the particular reasons that emerged.

As mentioned above, there is a broad continuum of what constitutes a "failure"[413] from a management's perspective – from failure to meet overly optimistic revenue and profit margin targets to failure to achieve synergies that exceed an acquisition premium, to failure to the point that the acquired business is sold off or otherwise exits the marketplace. This last category rarely occurs, though it is true that certain acquisitions can be ill conceived.[414] Interestingly, a study of 1997 and 1998 transactions

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411. Id. at 2.

412. Haspelagh & Jemison at 122.

413. Alexandra Reed Lajoux and J. Fred Weston, Do Deals Deliver on Post Merger Performance? Mergers & Acquisitions 34 (Sept./Oct. 1998).

414. See, e.g., Quaker Oats/Snapple; Wells Fargo/First Interstate; and Novell/WordPerfect.

showed that, for those combinations that were simply intended to achieve scale effects, 55% met their objectives.[415] As mentioned above, other combinations may have achieved at least some of their efficiency objectives. In any event, even if none of the efficiencies were subsequently obtained, an acquirer should not be required to take some remedial action (for example, an unwind of the transaction or disposition of key assets) so long as the transaction, in retrospect, does not violate Clayton Section 7 or other similar antitrust legislation.

As FTC Commissioner Leary recently stated:

> The Hart-Scott-Rodino process has made it both possible and mandatory to review the vast majority of significant mergers in advance . . . Moreover, history has demonstrated that it can be difficult to obtain effective post-merger relief. For these reasons, the agencies may have tended to de-emphasize scrutiny of consummated transactions. Conditions are somewhat different now; and the Chairman . . . has already expressed an interest in some post-transaction reviews. (One advantage of post-hoc review, of course, is that it can focus more on history than on predictions.)[416]

G. *What if the Transaction Ends Up Being Anticompetitive?*

As mentioned above, no accounting can ever be made regarding those transactions blocked on competitive grounds that would have produced significant synergies, and, despite the government's allegations, would not have in fact been anticompetitive. The transaction parties never have the opportunity of proving that, in fact, the government was wrong. Although not the preferred course,[417] the U.S. enforcement authorities do have a second chance though to challenge a transaction that lessens competition post-consummation.

Clearly, the first preference of the enforcement agencies and the business community is not to reassess the legality of transactions as a routine matter; but, if faced with the choice of being blocked or receiving

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415. Id. See also Booz-Allen & Hamilton, Making Acquisitions Work: Capturing Value After the Deal (May/June 1998).

416. Statement of FTC Commissioner Thomas Leary in Synopsys Inc./Avant! Corporation, File No. 021-0049 (Aug. 9, 2002) at 2 available at http://www.ftc.gov/05/2002/07/avantlearystmnt.htm.

417. The Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended ("HSR Act"), 15 U.S.C. § 18a (2000), was enacted in 1976 to provide the U.S. federal antitrust authorities with the opportunity to investigate, and, where appropriate, to challenge preconsummation under Clayton Section 7 those transactions that would be likely to lessen competition substantially.

conditional approval with the knowledge that the competition authorities "would be watching," then post-merger review and challenge would be an acceptable outcome should the transaction end up not producing efficiencies and being anticompetitive.[418] There is no statute of limitations preventing the U.S. agencies from investigating or challenging a transaction. Rather, Clayton Section 7 is written in the subjunctive tense. Mergers are unlawful if and when they "may tend" to lessen competition or create a monopoly. While it is unlikely that a transaction will be challenged long after it was consummated, it is possible. The most famous example of this remote possibility becoming real is DuPont having to divest its interest in General Motors over 40 years after it acquired its interest.[419]

The remedies that the U.S. government can seek post-consummation include: rescission of the transaction; divestiture of the assets or stock of the entity that raise the antitrust problem; and such other equitable relief as the court may deem appropriate. Recently, in an action brought against the Hearst Corporation for HSR Act and Clayton Act violations arising from Hearst's acquisition in 1998 of First Databank, the FTC sought disgorgement in addition to divestiture and civil penalties. Ultimately, Hearst agreed, among other things, to "disgorge" $19 million in unlawful profits as part of its settlement with the FTC.[420]

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418. Contra Kleit & Sanderson at 49-50; Kenneth Elzinga, The Antitrust Law: Pyrrhic Victories? 12 J. of Law and Econ. 43 (1969); R.A Rogowsky, The Economic Effectiveness of Section 7 Relief, 12 Antitr. Bull. 187 (1968).

419. See, e.g., United States v. E.I. duPont de Nemours & Co., 306 U.S. 316 (1961). See also In re BF Goodrich, 110 F.T.C. 207 (Mar. 15, 1988) (Final Order requiring the divestiture of a vinyl chloride monomer plant.) Monier Lifetile LLC, 1998 WL 649054 (Sept. 22, 1998) (administrative complaint charged that the Monier Lifetile LLC joint venture formed by concrete roofing tile manufacturing division of Boral Ltd. and LaFarge SA could significantly diminish competition in areas of the Southwest and Florida; consent order required divestiture of certain production facilities); United States v. Miller Indus., Inc., 2001-1 Trade Cas. (CCH) ¶ 73,132 (D.D.C. 2000) (DOJ alleged that the acquisition by Miller Industries, Inc. ("Miller") of two companies that competed with Miller in the manufacture, design and sale of towing and recovery vehicles was anticompetitive; a consent decree required Miller to license technology used in towing and recovery vehicles to other smaller competitors in the industry). More recently, the FTC challenged three consummated transactions in October 2001 -- two of which have settled. FTC, News Release, FTC Challenges Chicago Bridge's Acquisition of Pitt-Des Moines' Industrial and Water Storage Tanks Assets, dated (Oct. 25, 2001), available at http://www.ftc.gov/opa/2001/10/chicagobridge.htm. Agreement Containing Consent Order, In the matter of Airgas, Inc., File No. 001-0040 (Oct. 26, 2001), available at <http://www.ftc.gov/os/2001/10/airgasagr.htm>.

420. FTC v. The Hearst Trust, Civ. No. 1:01CV00734 (D.D.C.) (final Order is available at http://www.ftc.gov/opa/2001/12/hearstfinalorder.pdf). In *Hearst*, the division among Commissioners as to the propriety of disgorgement to remedy anticompetitive conduct or HSR Act violations was made apparent. Two FTC Commissioners, Sheila Anthony and Mozelle Thompson, clarified that disgorgement is appropriate under "exceptional circumstances," and that Hearst's conduct in this case

Thus, to the extent that any post hoc review is warranted, it should be under the substantive standards of Clayton Section 7. Given the ability of the government to correct any "mistakes" in permitting transactions to go forward, there simply is no reason for the U.S. agencies to view efficiencies with hostility and to impose additional evidentiary burdens and standards on the transaction proponents than what the government bears in connection with establishing the potential for anticompetitive effects.

The current EU merger review scheme appears to be less flexible in its ability initially to permit transactions to proceed and to reverse its decision if later the transaction is determined to be anticompetitive. Perhaps this objective could be achieved through conditional approval of transactions. After all, absent fraud, the EU Commission typically cannot exercise jurisdiction over a transaction (and thereby take additional remedial action in connection with a transaction) once it issues its decision. Might the EU Commission circumvent this limitation by issuing a decision that conditions its approval or makes the approval contingent upon certain subsequent conditions being met? If so, such an approach might be preferable in those close cases where otherwise the EU Commission would decide to block the transaction due to its uncertainty regarding whether the efficiencies will offset competition concerns.

IV. CONCLUSION

As set forth in Section I of this article, the role of efficiencies in merger review is still evolving, with the current environment in at least the EU, and to some extent the United States, still more hostile than would appear to be optimal. In Canada a more amicable view towards efficiency exists, but there remains considerable controversy regarding how to achieve the right balance. Section II of this article focuses on five issues that impact the treatment of efficiencies and suggests certain improvements.

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was "sufficiently egregious" to justify disgorgement. FTC Commissioner Swindle agreed that disgorgement was appropriate in certain cases, but believed that the decision to seek it in this case was "incorrect." FTC Commissioner Leary also believed that disgorgement was inappropriate, although he would not go "so far as to say that disgorgement should never be sought in an antitrust case." Probably because of this continuing disagreement among FTC Commissioners about when disgorgement is appropriate in antitrust cases, the FTC recently issued a Notice in the Federal Register seeking comments from the antitrust bar and the public on the use of disgorgement as a remedy for violations of the HSR Act, the Clayton Act and the FTC Act. 66 Fed. Reg. 67,254 (Dec. 28, 2001) available at http://www.ftc.gov/os/2001/disgorgfrn.htm. Comments were due by March 1, 2002.

The first threshold issue relates to the standard that should be applied in determining whether, on balance, the efficiencies justify the merger. Currently, in the United States and the EU, the entire analysis is colored by the consumer surplus standard that seems to apply in those jurisdictions, under which post-merger prices must fall or a direct benefit must flow through to consumers. While a total surplus approach finds considerable support among a number of economic experts, a balancing weights approach may be a reasonable compromise solution that balances the interests of both consumers and suppliers, and would permit antitrust agencies (and, where applicable, the courts) to take a more global and protracted view towards efficiencies that would over the long-term benefit society as a whole.

Second, the evidentiary burden of proof imposed on the transaction parties seems to be greater with respect to efficiencies than that imposed on the government with respect to possible anticompetitive effects. There is no reason why this must be the case. Rather, a more holistic approach that imposes the same evidentiary burdens and likelihoods on efficiencies as on evidence relating to market power would be desirable.

Third, there should be no presumption of illegality asserted based solely on post-merger market concentration. Rather, a full-blown analysis of the effects of a substantial lessening of competition, taking into account the effects of post-merger efficiencies, is warranted. Further, although on its face the shifting of the burden to the transaction parties once the antitrust agency has established high market shares and a theory of unilateral or coordinated effects does not seem objectionable, in practice the burdens imposed are asymmetric and unwarranted. We would advocate an approach consistent to that undertaken by the courts in Sherman Section 1 cases, in which there is a balancing of probabilities imposed equally on both sides.

Fourth, the regulatory filter deployed by the agencies regarding which efficiencies should count is unduly fine and limiting. For example, merger specificity should not require proof that the efficiencies could not be achieved through means other than the proposed transaction. Rather, the more appropriate question is whether the efficiencies were likely to occur absent the transaction. Moreover, there appears to be an unwarranted bias towards accepting those variable cost savings that can be achieved in a relatively short time frame. Accordingly, while productive efficiencies are likely to be recognized in all three jurisdictions, other categories of efficiencies are likely to be viewed with more skepticism or rejected outright. Distribution and promotional efficiencies, dynamic efficiencies, and efficiencies from transactional, procurement, and capital cost savings may be given less weight or be rejected, notwithstanding the fact that transactions are designed and entered into on the expectation that such efficiencies will be attained, and, in many

transactions, they are actually realized. These represent real cost savings. There is a clear need for greater receptivity and understanding by the agencies of all efficiencies and their underlying rationale (as well as the expected benefits to consumers, whether short or long term), combined with review on a case-by-case basis of the likelihood of achieving such efficiencies.

Fifth, while there may be concern by the enforcement agencies of allowing close-call transactions on the basis of efficiencies that may, in actuality not be achieved, it would be inappropriate to single out this category of transactions to a higher standard of accountability post-consummation. If, as in any other transaction, the transaction subsequently is determined to be anticompetitive, the government, at least in the United States and Canada (for three years) can challenge the transaction. But, the failure to achieve the forecasted efficiencies does not, in of itself, mean the transaction becomes anticompetitive. The government should still need to prove its case regarding anticompetitive effects.

Finally, it would be a mistake for each jurisdiction to proceed in a vacuum in developing divergent efficiency policies. It is essential to the continued evolution of the global marketplace that efficiencies be promoted by competition authorities and that efficiency policies be consistent across jurisdictions. The adoption and evolution of a broader and more universally consistent efficiency defense increasingly will require antitrust authorities to develop an expertise in calculating efficiencies and their effects, including: (1) determining what efficiencies should be included in a trade-off against post-merger anticompetitive effects; (2) how such efficiencies should be quantified; and (3) once quantified, how they should be weighed against the perceived loss to consumer surplus. Evidence to support the foregoing analyses is sometimes readily ascertainable, but also may be varied and not necessarily attainable with ease. For example, to calculate the effects on interrelated markets the deadweight loss and transfer effects resulting from a price increase in each market affected by the merger would have to be determined. Such a measurement for commodities with end uses extending to a very large number of businesses would be complex. However, it can be done with the benefit of proper accounting and economic expertise. Deadweight loss should similarly be calculated for each industry or interrelated market.

The challenge is even greater in the context of transborder merger cases. With practice, and development of the appropriate expertise[421] though, these and other challenges arising from the consideration of

421. See Scherer 2001 Article at 22 ("To do the job right . . . [the agencies] will have to seek new kinds of expertise – e.g., the kind possessed by high-priced management consulting firms.").

efficiencies should become more manageable. The analytical work relating to efficiencies must continue if we are to see M&A reviews conducted in a balanced and sensible manner that does not (1) incorrectly impose political values in order to block potentially beneficial transactions out of an abundance of caution; nor (2) permit transactions to proceed that result in rampant and prolonged monopoly rent-seeking by the merged firm. Such judgments require an enlightened and unbiased careful examination of the entire record rather than reactions premised upon faulty or unsupported political or economic assumptions. It is only through a continued dialogue among competition authorities, economists, lawyers and business executives that a more appropriate role for efficiencies can emerge in our increasingly global M&A environment.