2-3-2011

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Boston University School of Law Working Paper No. 11-05
(February 3, 2011)
Forthcoming, *Review of Industrial Organization* (2011)

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Abstract: The new Horizontal Merger Guidelines, if treated by courts as a source of law, would reduce the discretion traditionally exercised by courts in defining relevant markets and market power in merger cases. This is an undesirable shift in the balance of power because courts have used the market power inquiry stage of merger analysis as a general checkpoint or weigh station for evaluating factors relevant to the welfare effects of a merger.

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For an antitrust insider, it is not easy to object to the new Horizontal Merger Guidelines.[1] They are intended to reflect actual practice at the enforcement agencies, and it appears that they do reflect that practice as it has evolved recently. To voice strong objections, one has to set out to be provocative and to deliberately go against modern trends.

At the risk of being viewed as an outsider, I will voice some objections to modern trends here. The new Horizontal Merger Guidelines reflect an effort by the enforcement agencies – the Federal Trade Commission and the Antitrust Division of the Justice Department – to move merger law in a direction that facilitates enforcement efforts. Courts have looked to the merger guidelines in recent years as a source of law in merger cases. The 1984 and 1992 guidelines have been mined by courts for useful analytical tools in merger cases; however, those guidelines did not significantly alter the balance of power between the agencies and the courts. The new guidelines, in contrast, attempt to alter the balance of power in favor of the agencies.[2]

The new guidelines, if treated by courts as a source of law, would reduce the discretion traditionally exercised by courts in defining relevant markets and market power in merger cases. This is an undesirable shift in the balance of power because courts have used the market power inquiry stage of merger analysis as a general checkpoint or weigh station for evaluating factors relevant to the welfare effects of a merger. For example, a court's beliefs with respect to the relative costs of false convictions and false acquittals will influence its judgment on the market definition issue. Overall, this is a desirable feature of the discretion exercised by courts in merger cases.

In a big-picture sense, there is nothing new in this struggle over the balance of power in merger cases. Antitrust law has been shaped over time by a process of give-and-take between the courts and the enforcement agencies.[3] The agencies typically pressure the courts to adopt standards that facilitate enforcement. The courts often oblige, for a time, until the law reaches a stage where it can no longer be justified on the basis of the rule of reason analysis that has been at the core of the antitrust case law.[4] When that point is reached, courts typically retreat to a framework that provides greater discretion to judges.[5] This process is likely to replay itself in the context of the new merger guidelines.

I. *Market Definition and Defining a Violation of Clayton Act Section 7*

As the new guidelines make clear, the enforcement agencies will put less emphasis on market definition, which is reflective of current practice. The guidelines offer the following statement:

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[1] U.S. Dept. of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (2010) [hereinafter Guidelines], available at http://www.ftc.gov/os/2010/08/100819hmg.pdf.
[2] I am not accusing the enforcement agencies of deliberately setting out to alter the balance of power. I assume they have tried to improve enforcement procedures.
[3] Keith N. Hylton, Antitrust Law: Economic Theory and Common Law Evolution xii-xiv (2003).
[4] Id.
[5] Id.

> The Agencies' analysis need not start with market definition. Some of the analytical tools used by the Agencies to assess competitive effects do not rely on market definition, although evaluation of competitive alternatives available to customers is always necessary at some point in the analysis.
>
> Evidence of competitive effects can inform market definition, just as market definition can be informative regarding competitive effects. For example, evidence that a reduction in the number of significant rivals offering a group of products causes prices for those products to rise significantly can itself establish that those products form a relevant market. Such evidence also may more directly predict the competitive effects of a merger, reducing the role of inferences from market definition and market shares.
>
> Where analysis suggests alternative and reasonably plausible candidate markets, and where the resulting market shares lead to very different inferences regarding competitive effects, it is particularly valuable to examine more direct forms of evidence concerning those effects.[6]

This has been the most controversial part of the new guidelines. Still, it is not easy to see the reason for controversy. The description of the agency's approach seems to be entirely reasonable, and especially so in light of recent practice.

The famous example of recent practice on the question of market definition is *FTC v. Staples*.[7] The FTC challenged the merger of Staples and Office Depot even though the two firms, combined, would constitute less than 5 percent of the market in office supplies.[8] The two firms combined would constitute a much larger share of the submarket consisting of office supply superstores. The FTC focused on the impact of the merger in the office supply superstore market, and persuaded the court that this was indeed a relevant market for merger analysis. The FTC's econometric evidence indicated that a merged entity combining Staples and Office Depot would be able to raise price by at least 5 percent without facing significant loss of consumers to other sellers of office supplies.[9]

The experience of the FTC in *Staples* and other recent cases suggests that market definition is not, as a practical matter, the most important question in a merger analysis. To the enforcement agencies, the important question is whether the merging firms will gain sufficient market power to harm consumers through an increase in price.[10] If that proposition can be demonstrated, then defining a relevant market for antitrust purposes would seem to be secondary, and a necessary implication of the pricing evidence.

I think this is a fair description of where the enforcement agencies stand on the role of market definition (or power) analysis, and what the new merger guidelines set out to

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[6] Guidelines, supra note 1, at 7.
[7] 970 F. Supp. 1066 (D.D.C. 1997).
[8] Id. at 1075.
[9] Id. at 1076, 1088.
[10] Equivalently, the firms could maintain the price and degrade the quality of their product.

describe in a transparent way. This position has much to be said for it, given the well known difficulties in defining a relevant market for antitrust purposes.[11]

II. *Changing Perspective*

It is at this point where one has to step outside of familiar antitrust analysis to raise objections to what the new guidelines propose to make formal. One has to think less about the need for rigorous enforcement tools for the agencies and more about the role of the courts in interpreting Clayton Act Section 7. The new guidelines reflect a change in statutory interpretation and enforcement philosophy that has occurred gradually,[12] but should not escape questioning. Moreover, the new guidelines are likely to run into some obstacles in the courts eventually, where judges may be unwilling to cede much of their law making function in the area of mergers to the enforcement agencies.[13]

A. Interpretation and Philosophy of Enforcement

The newly "codified" (in the form of the guidelines) approach of the FTC, brought down to simplest terms, implies that a sufficient basis to find a violation of Clayton Act Section 7 is that the merging firms will gain the market power to impose a significant increase in price for their consumers – provided that they are unable to prove the existence of countervailing efficiencies that will be passed on to consumers. It follows that under this interpretation of the Clayton Act a merger for the apparent purpose of gaining additional pricing power is an unambiguous violation of the law. Of course, the new guidelines are merely codifying enforcement norms that have operated in practice for many years now, but the codification entails an appeal to courts to treat these norms as law.

This new standard is different from what Clayton Act Section 7 says:

> No person engaged in commerce ... shall acquire ... the whole or any part of ... another person engaged also in commerce ... where in any line of commerce or in ... any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.[14]

The statute does not say that an acquisition is unlawful if it will lead to an increase in the price paid by consumers of the merging entity. And yet, a simple "price-increase standard" is not so fanciful that it should have entirely evaded the thought processes of legislators, even in 1914 when the statute was enacted. The fact that the statutory

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[11] On those difficulties, see, e.g., Franklin M. Fisher, Diagnosing Monopoly, 19 Quarterly Review of Economics and Business 7-33, 1979.
[12] On the evolution of the guidelines, see Carl Shapiro, "The 2010 Horizontal Merger Guidelines: From Hedgehog to Fox in Forty Years," 77 Antitrust Law Journal 701 (2010).
[13] For a sign of the difficulties that might confront the guidelines in court, see City of New York v. Group Health Incorporated, 2010 WL 2132246 (S.D.N.Y.), 2010-1 Trade Cases P 77,053. In the course of rejecting the plaintiff's claim, the court noted that it could find nothing in the prior case law to support a market definition based on upward pricing pressure.
[14] 15 U.S.C. § 18.

standard is comparatively vague suggests that at a substantial percentage of legislators intended to give courts flexibility in applying it.

It is well known that the Clayton Act was designed to change the standards courts applied to specific antitrust violations.[15] It was a reaction to the Supreme Court's *Standard Oil*[16] decision,[17] which adopted the rule of reason test under the Sherman Act. The Clayton Act was designed to restrict the discretion of courts with respect to the violations enumerated in it, by replacing the rule of reason test with an alternative that put greater emphasis on lessening of competition or movement toward monopoly. Still, the alternative test stated in the Clayton Act left a fair degree of discretion in the courts to interpret and apply it.[18]

The key early case interpreting Clayton Act Section 7 is the Supreme Court's *Brown Shoe* decision.[19] *Brown Shoe* is famous for setting out the "incipiency doctrine",[20] which created enormous problems in merger law until it was rejected in the Court's *General Dynamics*[21] opinion.[22] In addition to the incipiency doctrine, and more important, *Brown Shoe* sets out a truncated rule of reason analysis for horizontal mergers. The analysis is truncated in the sense that it does not explicitly incorporate an efficiency defense, except through some narrow defenses referred to as "mitigating factors".[23] Overall, *Brown Shoe* takes the view that horizontal mergers are undesirable to the extent that they remove competitive choices from consumers over a substantial period of time.

To be more specific, *Brown Shoe* sets out a three-part inquiry. The first is an examination of market conditions, such as the level of market concentration, and other evidence bearing on the structural and operational intensity of competition. The second is an examination of entry conditions and the trends on concentration. The third is a set of narrow defenses – mitigating factors – that effectively constrain the sorts of efficiency defenses that can be admitted into the evidence in a merger case.

Although there is room, to be sure, for interpretive disagreements, there is quite a distance between the theory of Section 7 as envisioned in *Brown Shoe*, and the modern enforcement policy stated in the new Horizontal Merger Guidelines. There is a

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[15] See, e.g., Hylton, supra note 3, at 39-40.
[16] Standard Oil Co. v. United States, 221 U.S. 1 (1911).
[17] Hylton, supra note 3, at 39.
[18] The early cases interpreting Clayton Act Section 7 do not suggest that the FTC's price-increase test was a commonly understood or accepted interpretation of the statute's language. The FTC's interpretation is supported in the case law by just a small number of recent decisions. Of course, one might argue that this just reflects the natural evolution of law.
[19] Brown Shoe v. United States, 370 U.S. 294 (1962).
[20] A definition of the incipiency doctrine is provided in Hylton, supra note 3, at 319-20 ("… the incipiency doctrine, which holds that a horizontal merger may violate Section 7 even though the share of the market absorbed is relatively small, because the merger is an indicator of a movement toward concentration"). See also, Shapiro, supra note 12, at 703 (discussing "shocking" approach under one set of arguments advanced in early merger cases).
[21] United States v. General Dynamics Corp., 415 U.S. 486 (1974).
[22] Hylton, supra note 3, 325-28.
[23] Brown Shoe, 370 U.S. at 346.

substantial difference between the traditional approach to the statute, which aims to prevent mergers that effectively eliminate or seriously degrade alternatives to consumers, and an approach that, in addition to the traditional view, prevents consumers from having to pay a higher price resulting from the additional market power created by a merger.

The courts, for the most part, are reading a case law that is based on the older interpretation, while the enforcement agencies are coming to court with the modern interpretation. This is consistent with the broader history of antitrust law; enforcement agencies have typically pressured courts to adopt interpretations of the antitrust statutes that facilitate enforcement.

One might argue that the new interpretation should prevail because it is clearer, in addition to giving the agency greater enforcement authority. Isn't it obvious that any merger that could result in a price increase to consumers as a consequence of additional market power is what the statute should aim to prevent? This is an open question.

One reason why this position is contestable is that it anticipates virtually no role for market forces in controlling the pricing power of merging entities. I mean this in two senses. First, prices will sometimes rise as part of the competitive process. This is implied by the entry and exit process.[24] If economic profits are negative in the short run, firms will exit, which will cause prices to rise toward the long run competitive equilibrium level. The exits that occur as part of the adjustment toward the long run level effectively give surviving firms additional pricing power.[25]

Sometimes exit occurs by firms just shutting down. Other times, probably more often in reality, weaker (or maladjusted) firms are acquired by healthier (better positioned) firms. The mergers that occur as part of the exit process will necessarily lead to higher prices. These higher prices will hurt consumers in the short run, but they are part of the process of long run competitive adjustment. Exogenous changes could occur, leading to negative economic profits – or entry could overshoot, leading to the same result. In the short run, consumers will enjoy a price level that is too low relative to the long run level.

The exit process is described in basic economics classes as one in which some firms just leave the market. However, when one firm acquires another in the exit process, assets are redeployed in an efficient manner. In the redeployment process observed in the case of a merger that operates as a form of exit, the higher quality assets of the exiting firm are retained by the acquiring entity, while the lower quality assets of the both the acquiring

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[24] Incorporating endogenous entry and exit in the merger process alters some of the standard results of the static analysis. See Gautam Gowrisankaran, A Dynamic Model of Endogenous Horizontal Mergers, 30 RAND Journal of Economics 56-83 (1999); Morton I. Kamien and Isreal Zang, The Limits of Monopolization through Acquisition, 105 Quarterly Journal of Economics 465-500 (1990). The analysis underlying the new guidelines is based on static models of the merger process, such as in Joseph Farrell and Carl Shapiro, 2001, Scale economies and synergies in horizontal merger analysis, Antitrust Law Journal, vol. 68 (3), 685-710.

[25] Consider a simple Cournot model with N firms, each with marginal (and average) cost c, and demand curve $p = a - bQ$ (where Q is the total quantity of the firms). The Cournot equilibrium price is given by $p = (a + Nc)/(N+1)$. As firms exit, each remaining firm effectively gains additional pricing power.

and acquired entities are shed. The merger facilitates an efficient reassignment of assets that would otherwise have to take place through a comparatively cumbersome process involving market transactions. This is an implication of Coases's theory of the firm.[26] To the extent the merger process reduces transaction costs, it reduces the long run costs of the industry.

The second sense in which market forces regulate pricing is through entry, which regulates price increases. If too many mergers occur, so that prices rise above the long run competitive level, entry occurs until prices are driven back to the long run level. Entry can also occur through the merger process, where the acquiring firm chooses to enter a new line of business by acquiring a firm already in the market.

When considering the new interpretation of Clayton Act Section 7 by the FTC, one has to ask whether it leaves sufficient room for the competitive adjustment process to function. If it does not, then the FTC's enforcement approach can harm consumers in the long run. The FTC's modern interpretation of Section 7 empowers the agency to bring enforcement actions which benefit some consumers in the short run only to result in greater long term harm.

To illustrate the potential for harm from the FTC's interpretation, suppose there is a short-run equilibrium with firms making negative economic profits. One firm attempts to acquire another, in a merger that will lead to greater pricing power. The FTC blocks the merger. The weak (maladjusted) firm, unable to be acquired by the stronger firm, eventually exits the industry. In the long run, its assets will be redeployed to some other activity. However, the most efficient process of consolidation has been blocked by the FTC. The likely result is that some resources will depreciate to a larger degree than would be observed in an efficient redeployment process. This, in turn, implies that the industry long run costs will be greater and the long run equilibrium price higher. In addition, the transaction costs from the more cumbersome redeployment process also feed into greater long run costs. In the end, society has expended resources in an enforcement process that effectively transfers wealth from generations of consumers in the steady state (long run) to a specific temporal cohort of consumers in the short run.

Of course, one response to this concern is to say that the enforcement agencies will refrain from opposing mergers that do not threaten serious harm to consumers in the long run. Indeed, if the agencies make accurate enforcement decisions, the potential harm just described will never be observed. However, this position assumes that the enforcement agencies operate without error, a premise that I take to be false.

This story has nothing to do with the "failing company defense".[27] Firms may be earning negative economic profits even when they are thriving if measured on the basis of accounting profits. All that is necessary for the existence of negative economic profits is

[26] The Nature of the Firm. R. H. Coase. Economica, New Series, Vol. 4, No. 16. (Nov., 1937), pp. 386-405
[27] For a discussion of the failing company defense, see, e.g., Areeda, Kaplow, Edlin, Antitrust Analysis: Problems, Texts, and Cases 708 (Sixth Edition 2004)

that the resources used in one activity are more valuable in another activity. A business could be profitable in accounting terms, while unprofitable in economic terms.[28]

I have assumed in this account that the FTC is accurate in distinguishing mergers for pricing power from mergers for efficiency.[29] If I assume instead that the FTC sometimes errs in making this distinction, the social costs of its enforcement conduct would be higher. Taking error into account would require us to compare false conviction and false acquittal costs from the FTC's merger enforcement decisions.[30]

The alternative to the FTC's modern interpretation of Section 7 is the less rigorous standard of *Brown Shoe*. Under that standard, a merger to gain pricing power might be approved under Section 7. The reason is that a reviewing court might find that competition is intense and that entry is relatively easy. There were facts that would have supported such findings even in *Staples*. Competition had led stores to exit from the office supply superstore market in greater frequency than to enter in the years immediately before the merger challenge.[31] The evidence of exit is a sign that office supply superstores were making negative economic profits at the time of the merger, and that the merger may have been part of this exit process. Under the *Brown Shoe* standard a court could have concluded that the Staples-Office Depot merger was unlikely to violate Section 7.[32]

The benefit of the *Brown Shoe* standard, relative to the FTC's standard, is that it gives courts the flexibility to permit mergers for the purpose of gaining pricing power in settings where the evidence suggests that the ordinary processes and pressures of competition are resilient – as in the case where the merger facilitates exit. Where competitive pressures are resilient, not every merger that results in greater pricing power will substantially reduce competition or tend toward monopoly.

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[28] The example considered in the text is consistent with the familiar story of the industry that suffers a negative demand shock, or a declining industry. But it is also consistent with an industry that experiences a shock on the supply side which causes some factor of production (e.g., land) to become more valuable in an alternative use. On the declining industry interpretation, see D. Filson and B. Songsamphant , Horizontal Mergers and Exit in Declining Industries, Applied Economics Letters 12(2): 129-132 (2005). For the equivalent supply side adjustment, suppose a firm produces with constant returns to scale in the long run. A positive supply shock causes it to shift to a short run average cost curve which has a greater minimum efficient scale. The adjustment process will involve firms exiting and the price rising toward the long run level, with industry output greater in the long run.

[29] On the other hand, this discussion assumes that the agencies are not perfectly accurate in distinguishing mergers which threaten substantial long term harm to consumers from those that do not. Obviously, if the agencies operate with perfect accuracy, none of the criticisms suggested here merit consideration.

[30] One way of assessing the error-cost record of merger enforcement is to use evidence on price effects of mergers. However, even this evidence could be flawed to the extent price increases may be efficient. On using evidence to evaluate the accuracy of agency decisions, see Orley C. Ashenfelter and Daniel S. Hosken, The Effect of Mergers on Consumer. Prices: Evidence from Five Selected Case Studies, NBER Working Paper, 2008.

[31] Staples, 970 F. Supp. 1066, at 1086-1089.

[32] Of course, the court in *Staples*, operating within the *Brown Shoe* framework, found that the merger was likely to violate the statute. However, the *Staples* court, rather strangely, took the evidence of exit from the office supply superstore market as evidence that the entry and exit process did not serve to regulate pricing power.

Although I have focused on the example of a merger for exit, there are other instances where mergers that result in additional pricing power may not be harmful to overall welfare, or to consumer welfare in the long run. Consider, for example, a merger in response to monopsony power on the buyer's side.[33] If the merger enables the combined entity to push price above the monopsonistic level, social welfare will be enhanced. Alternatively, suppose the merger results in a price increase to some subset of consumers and price reductions for other consumers, with the net result being a gain in social welfare.[34] Yet another class of scenarios to consider involves a firm that innovates in its product or service and uses the pricing-power merger as a method of appropriating the gains from innovation.[35] In these scenarios the merger serves as an alternative to some form of intellectual property protection, which may not be available, or may be available only at great cost.

In implementing the discretionary test of *Brown Shoe*, courts have traditionally required a definition of the relevant market. In order to determine whether competition appears to be structurally or operationally intense, or whether entry is easy, courts first have to define a relevant market. The definition of a relevant market has involved a fact-intensive inquiry that trades off many concerns, in addition to the strict concern of finding a market which could be monopolized by the defendant (through an acquisition or through some anticompetitive conduct). When courts determine a relevant market, they are taking into account the consequences of that decision for the competitive process itself. If defining a market too narrowly will lead to the replacement of the market process of industrial rationalization with an administrative process, or discourage innovation incentives, courts are likely to take those costs into account. They are aware of the possibility that they could err in the decision, and will therefore tend toward a market definition that minimizes the costs of errors.[36]

The FTC's standard would relegate the market definition component of a merger dispute to a lesser status. In so doing, it would constrain the ability of courts to make the tradeoffs that currently go into a market definition finding.[37] If courts consistently make

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[33] Federal Trade Commission v. Tenet Health Care Corp., 186 F.3d 1045 (8th Cir. 1999).

[34] A merger may have a mixed effect, leading to an increase in the price of one item in one market (or submarket), and price reductions in the same or in other items in other markets. See Joshua D. Wright, Comment on the Proposed Update on the Horizontal Merger Guidelines: Accounting for Out-of-Market Efficiencies (August 10, 2010). George Mason Law & Economics Research Paper No. 10-38. Available at SSRN: http://ssrn.com/abstract=1656538.

[35] Hylton, Keith N. and Lin, Haizhen, Optimal Antitrust Enforcement, Dynamic Competition, and Changing Economic Conditions, 77 Antitrust Law Journal 247, 266-269 (2011).

[36] Id, at 264-265.

[37] One response to this argument is that courts should simply find some other legal peg on which to do their general balancing, and leave market definition to the more rigorous definitions provided by the agencies. To some extent, this is unavoidable result of having merger cases decided in court. Courts will choose the optimal "legal peg", from their own perspective, for deciding cases, and the market definition peg has some attractive attributes. It provides a blanket immunity for the defendant, and allows a dispute to be resolved at an early phase of the litigation. A court could deal with its issues about the error cost tradeoffs at some other stage of the litigation, such as the damages phase, but that would clearly lead to a greater cost being imposed on the defendant. In other words, the market definition test serves a function akin to that of the

the wrong decision in the implicit balancing of error costs that influences the market definition finding, the FTC's approach could be desirable. But I am aware of no evidence to suggest that courts generally make poor decisions under the *Brown Shoe* standard.

B. Drawbacks

The obvious drawback of *Brown Shoe* is that it does not provide a rigorous or scientific approach to enforcement. There are no econometric tests that would permit the agency to provide a definite answer to a court under the *Brown Shoe* standard, while the price-increase standard has provided a rigorous tool for the agency. It may seem unfair to criticize the agency after having developed such a tool for enforcement. In addition, an objective test minimizes the likelihood that political influence will drive the agency's decision rather than economic analysis.

The problem with this defense of the price-increase standard is that it provides a test that answers a question that is different from the one that courts should be concerned with under Section 7. If rigor alone is a sufficient defense, then the agency could just as well adopt other rigorous tests that have less relevance to the economic concerns motivating the enactment of Section 7.

One could also argue that the price-increase standard should be sufficient for its purposes, which is to present sufficient evidence to justify a preliminary injunction. If a court wishes to apply the *Brown Shoe* standard, it could still do so in order to resolve the dispute if it goes all the way to a court judgment. In other words, merger law could operate with two standards, one applied at the preliminary injunction stage and another applied at the court judgment stage.

There are several problems with this argument. One is that the enforcement agencies have benefited from the courts' tendency to use the guidelines as a source of law. If the guidelines are going to serve as a source of law, then they should provide standards that should be applicable to the merits of the merger decision regardless of the forum in which they are addressed. Courts should not adopt one set of substantive standards for preliminary injunction decisions and another set of substantive standards for the actual application of the statute, which is an error that the D.C. Circuit has committed in its *Whole Foods* decision.[38]

Another problem with the two-standards argument is that a preliminary injunction is essentially a permanent injunction in merger disputes. In the majority of cases in which the preliminary injunction is issued, the parties walk away from the proposed merger. Too many things are likely to change between the date of the preliminary injunction and the ultimate resolution of the litigation.

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duty test in tort law, Keith N. Hylton, Duty in Tort Law: An Economic Approach, 75 Fordham L. Rev. 1501, 1525 (2006) (comparing the duty and proximate cause tests in tort doctrine).

[38] FTC v. Whole Foods Market, Inc., 548 F.3d 1028 (DC Cir. 2008).

If the law is going to serve as a set of guidelines for courts and for firms to follow, then it should be constructed with an eye toward its impact on merger decisions. Mergers that enhance social welfare in the long run should be permitted. This suggests that it would be unwise to defend a particular merger test on the ground that it is especially appropriate for the preliminary injunction phase, even if it not appropriate as a standard to assess the overall merits of the merger.

Chevron[39] provides another set of potential objections to a court's decision to adhere to the *Brown Shoe* standard in merger analysis. *Chevron* instructs courts to defer to an agency's interpretation of the statute it enforces, as long as that interpretation is reasonable and consistent with the settled meaning of the statute. However, *Chevron* has unclear implications in this setting, as in so many cases. The Supreme Court has issued several opinions, from *Brown Shoe* to *General Dynamics*, setting out its views of the meaning of Clayton Act Section 7. The *Chevron* doctrine does not clearly instruct courts to defer to the agency in light of this history. There is a conflicting doctrine, stare decisis, which constrains courts from deviating far from the interpretation set out in the Supreme Court's early merger cases.

III. *Innovation in the Guidelines*

Closely related to the matter of industrial rationalization – more precisely, the allocation of assets to their most productive uses – is that of innovation, which the new horizontal merger guidelines treat in a one-sided way. Again, there are sufficient qualifications to find support for just about any view on the implications of merger enforcement for innovation in the guidelines, but the general thrust is that mergers may be harmful to rival (i.e., non-merging) firms that wish to innovate.

Certainly mergers can be harmful to consumer welfare if they reduce incentives to innovate. The line of thought that appears to be missing from the guidelines is recognition that the incentive to innovate is a function of the efficiency of future industrial rationalization. If a firm innovates by creating a new product market, it will certainly realize that the new market may change over time in a way that requires the exit process to function smoothly. The efficiency of industrial rationalization will, in turn, be a function of the ease with which mergers for such purposes will be allowed. If firms expect that such mergers will not be allowed, their expected long run costs will be higher. The incentive to innovate will be lower, in turn, and less innovation will occur. As in the industrial rationalization context examined in the previous part, merger enforcement may transfer wealth from consumer generations in the steady state to a particular cohort of consumers or firms in the short run.

Obviously, there is an optimal level of enforcement in light of innovation concerns. Too little enforcement will permit mergers that reduce innovation incentives to occur; too much will chill innovation incentives. But this proposition fails to incorporate the risks and costs of error. The discouragement of innovation by rivals that has not occurred is a particularly difficult thing to prove or to disprove. Moreover, if the agency seeks to

[39] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

block mergers on the ground that they may stifle future innovation by rivals, it will not lack for complainants, some of whom may be seeking to avoid more vigorous competition. There is an obvious risk of error in connection with claims of rival firm innovation forgone as a result of the fear induced by the merging entity.

In settings where the innovation effects are largely speculative, the high risk of error suggests that the market should be left to its own devices. In the ordinary setting where innovation is not at stake, merger enforcement can increase long run industry costs, harming consumers. In the setting where innovation is at stake, this risk is still present, in addition to the risk that innovation will be chilled.

The error cost arguments here are entirely analogous to the case of predatory pricing, and need not be set out in great detail. Complainants – the market participants who oppose a merger – often have incentives that are unaligned with the social interest, and the theories of consumer harm are often speculative. The market imposes a constraint on the cost of false acquittals: the entry process.[40] However, the costs of false convictions are both substantial and not clearly constrained by the market. That an enforcement agency rather than a private plaintiff stands behind the complaint is insufficient to view the merger cases in a completely different light.

IV. *Conclusion*

Overall, the new enforcement guidelines represent an additional step in the ratcheting process that expands the enforcement agencies' scope of authority and minimizes that of the courts. Their success, from the agencies' perspective, will depend on how well they are received by courts. Some courts may choose to push back, relying on established legal doctrines. From society's perspective, the ideal path would require some resistance by courts. The *Brown Shoe* standard suffers from vagueness and appears to constrain courts too weakly, but it is probably a better standard for courts to use in reviewing merger enforcement decisions than is the FTC's new guidelines.

[40] Frank H. Easterbrook, The Limits of Antitrust, 63 Texas L. Rev. 1 (1984).