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## The "efficiency defense" in the US American merger policy

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# The "Efficiency Defense" in the U.S. American Merger Policy

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## 1. INTRODUCTION

Faced with increasingly globalized markets, firms are forced to achieve efficiencies in order to respond to foreign producers or to keep pace with consumer demands for new products. Horizontal mergers are a commonly used way of generating those efficiencies. Though it is true that mergers often generate cost savings, mergers also raise competitive concerns through increased market power. This potential conflict between efficiencies and competition is known as the Williamson tradeoff (1968).<sup>1</sup> Following this standard approach to the ‘efficiency defense’ shows that efficiency gains can outweigh competitive losses from mergers. Yet, in spite of a wide consensus in economic and legal literature favoring some sort of balancing procompetitive effects against anticompetitive effects in merger analysis, the American merger policy has long been resistant to accept a full-fledged efficiency defense. Recently, however, efficiency considerations have begun to play a more significant role in merger analysis.

Horizontal mergers are reviewed under Section 7 of the Clayton Act, which declares illegal those mergers that may substantially lessen competition or that tend to create a monopoly. While Congress has passed relatively vague statutes into law, and instructed the Federal Trade Commission (FTC) and the Department of Justice (DOJ) to enforce those statutes, Congress leaves the task of defining the law to the federal courts, and ultimately to the US Supreme Court. Furthermore, the degree of discretion in interpreting the Clayton Act has to be seen in the context of its legislative history. Congress passed primarily the Clayton Act to prevent mergers that might lead to the creation of corporations with sufficient market power to extract wealth unfairly from consumers.<sup>2</sup> Thus, Congress embodies a strong preference for consumers over firms with market power. As the enforcement agencies and the courts have to take those congressional goals into account, efficiency benefits of mergers can only be considered in merger analysis when cost savings are directly passed through to consumers.

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1 See Williamson, Oliver E., *Economics as an Antitrust Defense: The Welfare Tradeoffs*, in: *American Economic Review* 18, 1968, 18-42.

2 However, Congress did not pass the antitrust law to secure a ‘fair’ overall distribution of wealth. Congress merely wanted to prevent one transfer of wealth that it considered inequitable, and to promote the distribution of wealth that competitive markets would bring. See Lande, Robert H., “Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged”, in: *Hastings Law Journal*, Vol. 34, 1982, 65-151 and also Bok, Derek C., “Section 7 of the Clayton Act and the Merging of Law and Economics”, in *Harvard Law Review*, 1960, 226-355.

In addition, American merger policy has varied widely over the last decades. In the 1960s the US had by far the most stringent antitrust merger policy in the world, striking down mergers among small firms in unconcentrated markets (e.g. *Brown Shoe Co. v. U.S.*). During that 1960s Warren Court era, the Supreme Court addressed several times the efficiency issue, but always by viewing efficiency gains negatively. By the mid-1980s, the US had moved to an extremely lenient merger policy. Under the Reagan Administration, the enforcement agencies chose a less restrictive antitrust enforcement rather than an evaluation of a tradeoff between efficiencies and market power. In 1984, however, the agencies took up the efficiency argument in their new merger Guidelines. In the 1990s, the antitrust agencies and the courts have accorded efficiencies far more competitive significance than previously was the case. This approach is supported by the revisions of the Merger Guidelines in 1997 and by the willingness of the courts to speak on that issue.

The goal of this paper is to analyze the decision-making process at the two antitrust enforcement agencies and in the courts with regard to the efficiency argument in merger analysis. The paper is organized as follows. Section 2 explains the development and the current state of the federal government's evaluation of efficiency claims. In section 3, the significance of the efficiency defense in case law is illustrated by reviewing important merger decisions in the past. Section 4 examines how the courts have addressed efficiency claims. The requirements that the courts impose on merging parties in order to accept efficiencies are analyzed and illustrated by recent merger decisions.

## **2. MERGER GUIDELINES AND EFFICIENCIES**

The Antitrust Division of the DOJ has issued Horizontal Merger Guidelines on several occasions and has most recently revised the 1992 Guidelines jointly with the FTC.<sup>3</sup> The Guidelines are designed to give merging parties and the general public guidance on how both agencies analyze the competitive effects of a merger and how they decide whether or not to challenge a proposed transaction under the antitrust laws. The Guidelines do not supersede the case law and are not binding on the courts. However, many courts find the analytical framework of the Guidelines helpful in resolving Section 7 issues in particular, since most of the expert economist testimony they receive is phrased in Guide-

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3 See U.S. Department of Justice, Antitrust Division and FTC, Horizontal Merger Guidelines (1997), reprinted in 4 Trade Reg. Rep. (CCH) § 13,105. Before the joint 1992 Guidelines, the FTC issued its Statement Concerning Horizontal Mergers in 1982, reprinted in 4 Trade Reg. Rep. (CCH) § 13,200.

lines terms. Moreover, defendants have also adopted the language of the Guidelines in their defense.

Tracing the language in different editions of the Guidelines shows the development of the agencies' public recognition of the efficiency defense. Starting with the release of the first Merger Guidelines in 1968, the DOJ took a fairly hostile position, opposing efficiency considerations in merger enforcement, stating that "unless there are exceptional circumstances, the Department will not accept as a justification for an acquisition normally subject to challenge under its horizontal merger standards the claim that the merger will produce economies (i.e. improvements in efficiency)".<sup>4</sup> Similarly, the 1982 Guidelines only recognized efficiencies as a mitigating factor in 'extraordinary cases'.<sup>5</sup>

The 1984 Guidelines reflect a significant modification in the treatment of efficiencies from the former Guidelines.<sup>6</sup> The DOJ announced under the 1984 Guidelines that they would give appropriate weight to "significant net efficiencies" if the cost savings were proven by "clear and convincing evidence" and if the savings could not be achieved by the merging parties "through other means". Moreover, the 1984 Guidelines established a sliding scale approach regarding efficiencies and dropped the term "except in extraordinary cases". With this, the DOJ made clear that efficiencies would only be one of many factors in deciding whether to challenge a merger, rather than an absolute defense.<sup>7</sup>

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4 U.S. Department of Justice, Antitrust Division, Merger Guidelines (1968), § 10, reprinted in 4 Trade Reg. Rep. (CCH) § 13,101. According to the Guidelines, the principal reasons for rejecting the efficiency defense were, on the one hand, the likelihood that the same efficiencies could be accomplished through internal growth and, on the other hand, the "severe difficulties" in establishing the existence and magnitude of the claimed efficiencies.

5 See U.S. Department of Justice, Antitrust Division, Merger Guidelines (1982), § V.A., reprinted in 4 Trade Reg. Rep. (CCH) § 13,102. The 1982 Guidelines also cited difficulties in proof and measurement as the basis for limiting efficiency considerations. See also the 1982 Federal Trade Commission Statement Concerning Horizontal Mergers, which incorporated much of the 1982 Guidelines.

6 See U.S. Department of Justice, Antitrust Division, Horizontal Merger Guidelines (1984), § 3.5, reprinted in 4 Trade Reg. Rep. (CCH) § 13,103.

7 See U.S. Department of Justice, Statement Accompanying DOJ Merger Guidelines (June 14, 1984), reprinted in 2 Trade Reg. Rep. (CCH) § 4490, at 6879-5. Both the 1968 and the 1982 Guidelines had either explicitly or implicitly treated efficiencies as an absolute defense. See Areeda, Philipp; Turner, Donald F., *Antitrust Law, An Analysis of Antitrust Principles and Their Application*, Vol. IV, 1980, § 939, 941ff., Muris, Timothy J., *The Efficiency Defense Under Section 7 of the Clayton Act*, in: *Case Western Reserve Law Review*, Vol. 30, 1980, 381-432, and Berg, Andrew G., *Cost Efficiencies in the Section 7 Calculus: A Review of the Doctrine*, in: *Case Western Law Review*, Vol. 37, 1986, 218-272.

The 1992 Guidelines represent no big changes in the efficiencies section.<sup>8</sup> The government eliminated, relative to the 1984 Guidelines, the “clear and convincing” evidence requirement but emphasized strongly that the burden of proof for efficiencies would lie in the hands of the merging parties. This modification was interpreted as a trend toward a more sympathetic treatment of efficiencies claims because the relevant efficiencies were referred to as “expected” rather than “established by clear and convincing evidence”.<sup>9</sup> The analytical framework set out by the 1992 Guidelines on whether or not to challenge a proposed merger is still in use today.

The Guidelines begin with an appropriate definition of a relevant market (product and geographic) and then set forth numerical thresholds as to levels of concentration and increases in such concentration that raise potential competitive concerns. For a proposed transaction that exceeds these levels, the Guidelines set forth in detail a series of factors that help to determine the competitive effect of a proposed transaction. Besides Hirschman-Herfindahl-Index (HHI) (Section 1), the analysis of potential adverse competitive effects from (Section 2)<sup>10</sup> and the timeliness, likelihood, and sufficiency of entry (Section 3), the Guidelines consider efficiencies (Section 4). This so-called efficiency section was the main subject of the revisions of the Guidelines in 1997.<sup>11</sup>

The newly revised section of the 1992 Merger Guidelines sets out, for the first time in such detail, the policies applied by both agencies to analyze efficiency claims in mergers.<sup>12</sup> The new Guidelines do not represent any radical change in the treatment of efficiencies. Rather, they are designed to bring the analysis of efficiencies in mergers up-to-date with the analysis of efficiencies in other areas of antitrust and the contemporary competitive environment.<sup>13</sup> The main purposes of the revisions are (1) to show the public, the agencies, and the merging firms how the government evaluates efficiencies in a

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8 See U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (1992), § 4, reprinted in 4 Trade Reg. Rep. (CCH) § 13,104.

9 See Stockum, Steve, The Efficiencies Defense for Horizontal Mergers: What is the Government’s Standard?, in: Antitrust Law Journal, Vol. 61, 1993, 829-855 at 833.

10 The section points out that mergers are likely to produce anticompetitive effects if (1) the proposed transaction creates a dominant firm that has the ability unilaterally to raise prices above competitive levels (“unilateral effects”) and if (2) the proposed merger creates an industry structure in which there is an increased likelihood that the remaining competitors will diminish competition by engaging in coordinated interaction (“coordinated effects”). See 1992 Merger Guidelines.

11 See FTC/DOJ Announce Revised Guidelines on Efficiencies in Mergers, April 8, 1997 and also Justice Department and Federal Trade Commission Announce Revisions to Merger Guidelines, April 8, 1997.

12 See 1997 Merger Guidelines, (1992 with April 8, 1997, Revisions to Sec. 4 on Efficiencies).

13 The efficiency revisions to the Merger Guidelines grew out of the FTC hearings report on “Competition Policy in the New High Tech, Global Environment” (1995), Chapter 2.



merger context, (2) to assist merging parties in explaining and demonstrating their efficiencies claims, and (3) to provide the courts with useful guideposts in merger litigation.<sup>14</sup> By clarifying the merger policy standards with regard to efficiencies, the government hopes to improve the quality of decision making and to ensure consistency of analysis, both within and across the antitrust agencies.

The new Section 4 begins with a general recognition of merger-related efficiencies, stating that

“mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction”.<sup>15</sup>

The Guidelines adopt a broad definition of potential procompetitive effects of mergers. According to the wording, it might appear that the government will accept all types of merger-related efficiencies as long as they result in lower prices, improved quality, enhanced services, or new products. Further remarks make clear, however, that the agencies deem efficiencies affecting marginal costs more likely to be cognizable than other efficiencies. Thus, greater weight is given to short-term efficiencies than to any claimed long-term cost savings, although, the Guidelines state that delayed efficiency gains will be taken into account.<sup>16</sup>

The revisions adopt the term *merger-specific* for all those efficiencies that the agencies will consider in merger analysis.<sup>17</sup> According to the Guidelines, merger-specific efficiencies are efficiencies

"likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects".<sup>18</sup>

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14 See Valentine, Debra A., Health Care Mergers: Will We Get Efficiencies Claims Right?, Prepared Remarks Before the Conference on Antitrust and Health Care, St. Louis University School of Law (November 14, 1997).

15 1997 Merger Guidelines, § 4, para 1.

16 Herefore see 1997 Merger Guidelines, remarks to footnote 3.

17 This definition comes from the Intellectual Property Guidelines. U.S. Department of Justice and Federal Trade Commission, Antitrust Guidelines for Licensing of Intellectual Property (1995), reprinted in 4 Trade Reg. Rep. (CCH) § 13,132.

18 1997 Merger Guidelines 1997, § 4, para 3.

Thus, the agencies need not consider procompetitive efficiencies that likely would occur absent the proposed transaction, e.g., through plain cost cuttings, joint venture, licensing or divestiture. As it is difficult to define the specificity of efficiencies and as there is, in fact, always theoretically internal growth as a least restrictive alternative to a proposed merger, the Guidelines point out that the focus is on practical alternatives that the merging firms face in their business situation. In addition, it is remarked that in cases where the timing aspect of achieving efficiencies plays a significant role, only this time advantage is deemed to be merger-specific. In order to minimize the leeway in assessment for other possible combinations, the agencies say that they will undertake careful investigations in the affected industry before determining which claimed efficiencies are merger-specific.<sup>19</sup>

Merger-specific efficiencies must be verified in order to be relevant for merger analysis. The revised Guidelines define precisely what merging parties will have to do to demonstrate claimed efficiencies. As in the 1992 Guidelines, the burden of proof lies with the merging firms. However, since efficiencies evidence is often more difficult to confirm through third parties than other facts relevant to merger analysis, and since merging companies tend to overstate cost savings, the agencies impose strict requirements for asserted efficiencies. Merging firms must be able to explain

- how, when, and at what cost the efficiencies (diseconomies of the transaction) will be achieved,
- why the cost savings are merger-specific,
- the likelihood and magnitude of claimed efficiencies likely to result from the merger, and
- how the efficiencies will affect the merged firm's ability or incentive to compete.<sup>20</sup>

When merger-specific efficiencies have been verified and do not result from market power related reductions of output and services or are speculative, the efficiencies are termed '*cognizable*'.<sup>21</sup> When weighing such efficiencies, the agencies will offset their benefits by the costs associated with the merger and with obtaining the savings. Hence, only net efficiencies are balanced against adverse competitive effects.

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19 Therefore, the agencies analyze the current competition in the industry, look at cost structures of merging firms and rivals and the behavior of competitors, ask for possibilities for less restrictive agreements, and take the time aspect of achieving efficiencies into account or try at least to do so.

20 See 1997 Merger Guidelines, § 4, para 4.

21 See 1997 Merger Guidelines, § 4, para 5.

The agencies will not challenge a proposed merger if the cognizable efficiencies are of such a type and magnitude that they would offset the merger's potential to harm consumers in the relevant market.<sup>22</sup> In conducting the overall competitive analysis, the agencies evaluate whether the benefits from efficiencies are sufficient to prevent price increases to consumers in the relevant market.<sup>23</sup> Therefore, they compare potential pro-competitive effects with anticompetitive concerns brought about by increased concentration (increase in HHI and postmerger HHI), potential adverse competitive effects, and entry barriers. There is a sliding scale aspect to this analysis, i.e., particularly large anti-competitive effects must be outweighed by extraordinarily great cognizable efficiencies in order to prevent a merger from being anticompetitive. The sliding scale analysis is, however, limited to the fact that efficiencies are almost never allowed to justify a merger to monopoly or near monopoly.<sup>24</sup>

In addition to the competitive analysis applied by the agencies, two remarkable aspects are new to the 1997 Guidelines. In footnote 2, with regard to the relevant market, the agencies explicitly acknowledge that they will also consider efficiencies that occur not strictly in the relevant market but that are 'inextricably' linked with that market.<sup>25</sup> Hence, it is possible that cost savings in a small, inextricably linked market can offset anticompetitive harm in other markets. Experience shows that such efficiencies rarely are a significant factor in merger analysis but could play a role in by-product production or in seasonal use of excess production capacities.<sup>26</sup>

With regard to the applied consumer welfare standard, the Guidelines state in footnote 3 that the government may as well look at "the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market."<sup>27</sup> The wording leaves the weight placed on delayed benefits from efficiencies unclear. This uncertainty is intended because it is difficult to predict precisely the achievement of efficiencies over the long term. Depending upon the case, the agencies consider efficiencies occurring from fixed

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22 See 1997 Merger Guidelines, § 4, para 6.

23 From this, one can draw the conclusion that the agencies still adopt the consumer welfare standard in their merger analysis. See also Werden, Gregory J., *An Economic Perspective on the Analysis of Merger Efficiencies*, in: *Antitrust*, Summer 1997, 12-16, at 14. Under a consumer welfare standard, efficiencies are given weight, contrary to the Williamson approach, in so far as they result in benefits to the welfare of consumers and not to profits of businesses. The Williamson tradeoff refers to a total welfare standard (consumer and producer surplus).

24 See 1997 Merger Guidelines, § 4, para 7.

25 See 1997 Merger Guidelines, § 4, para 6, footnote 2.

26 This argument goes back to *U.S. v. Archer-Daniels-Midland*.

27 1997 Merger Guidelines, § 4, para 6, footnote 3.

cost savings over a time period of 6 months through 2 years as likely to affect consumer prices.<sup>28</sup>

Finally, the revised section offers the most specific guidance yet as to the types of efficiencies most likely to be successful.<sup>29</sup> Efficiencies associated with rearranging production among facilities formerly owned separately, which enable the merging firms to cut the marginal cost of production, are most likely to be ‘cognizable’. Other efficiencies, such as savings in research and development are given less weight in merger analysis because they are inherently difficult to verify and may be the result of anticompetitive output reductions. Also, efficiencies relating to procurement, management, or capital cost are unlikely to be merger-specific or substantial.

### **3. SIGNIFICANCE OF THE EFFICIENCY DEFENSE UNDER SECTION 7 OF THE CLAYTON ACT**

The treatment of the efficiency defense has varied widely over the last few decades. During the Warren Court period, until the mid-1970s, the Supreme Court of the United States was involved extensively in the development of the Sec. 7 Clayton Act. There have been three major substantive merger decisions concerning the consideration of efficiencies in merger litigation, which are often cited for the proposition that efficiencies are not a proper factor in merger analysis. Since the Supreme Court has not addressed such claims again since that time, the case law still stands today.<sup>30</sup> Nevertheless, lower courts have begun to examine efficiencies in merger cases, and in some cases, efficiencies have been acknowledged as a potential defense. However, there has not been a single case where a full-fledged efficiency defense has been approved in court.

#### **3.1 Supreme Court Cases**

In the first of these cases, *Brown Shoe Co. v. U.S.*, the Supreme Court sustained the government’s challenge to the merger between two manufacturers and retailers of shoes. The Court acknowledged cost savings in the creation of a large national shoe chain with integrated manufacturing operations, by conceding that some of the postmerger results

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28 This time horizon refers to the entry barrier analysis in the Guidelines (rule of thumb).

29 See 1997 Merger Guidelines 1997, § 4, para 8.

30 *Brown Shoe Co. v. U.S.*, 370 U.S. 294 (1962), *FTC v. Proctor & Gamble* 386 U.S. 568, 580 (1967), *Philadelphia National Bank*, 374 U.S. 321 (1963).

would be beneficial to consumers,<sup>31</sup> although, the Brown Shoe company had denied significant cost savings in shoe retailing in the district court.<sup>32</sup> Relying on the congressional intent of arresting anticompetitive mergers in their incipiency, the Court, finally, states:

”But we cannot fail to recognize Congress’ desire to promote competition through the protection of viable, small, locally owned businesses...Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization. We must give effect to that decision”.<sup>33</sup>

The Brown Shoe opinion appears inconsistent and ambiguous. The Court announced, on the one hand, that the merger was harmful because it led or might lead to higher prices and, on the other hand, because it led to lower prices. In the end, the court condemned the merger for the reason that it would hinder the ability of small firms to compete in the shoe market. Thus, competitors were protected at the expense of consumers. The Court assessed, moreover, the achieving of cost savings as anticompetitive. As a result, the Court left the consideration of efficiencies unclear.

In *U.S. v. Philadelphia National Bank*, the Court declined to consider merger-related socially beneficial effects in holding that a merger between the second and third largest banks in the Philadelphia area violated Section 7. Defendants in that case did not argue that a larger bank would be more economically efficient or that the merger would generate certain cost savings. Rather, they argued that Philadelphia needed a bank to develop new business and stimulate the local economy. However, in finding for the government, the Court noted:

”We are clear, however, that a merger the effect of which ‘may be substantially to lessen competition’ is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial. A value choice of such magnitude is beyond the ordinary limits of judicial competence, and in any event has been made for us already, by Congress when it enacted the amended § 7”.<sup>34</sup>

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31 *Brown Shoe Co. v. U.S.*, 370 U.S. 294, 344 (1962).

32 *Brown Shoe Co. v. U.S.*, 179 F. Supp. 721, 738 (1959). Brown provided very little information in court, particularly regarding the economic sense of the merger. Thus the reason for acquiring the Kinney Company remains ambiguous.

33 *Brown Shoe Co. v. U.S.*, 370 U.S. 294, 344 (1962).

34 *U.S. v. Philadelphia National Bank*, 374 U.S. 321, 371 (1963).

The Court rejected, therefore, the argument that efficiencies based on an overriding public interest could justify an otherwise illegal transaction. In this context, the economies referred not to lowering costs, but (instead) to benefits resulting from economic advantages for the area.

The last time the Supreme Court addressed efficiencies was in *FTC v. Procter & Gamble*. The Court found the acquisition of Clorox Chemical Company, the nation's largest manufacturer of liquid household bleach, by P&G, the largest producer of soaps, detergents, and other related products, illegal. P&G had asserted that the merger would yield large savings in promotion, sales, and distribution. While acknowledging possible efficiencies in advertising, the Court considered the claimed cost savings not as real economies.<sup>35</sup> Although this argumentation could be interpreted as a consideration of efficiencies as a relevant factor in merger litigation, the Court in finding similar to the *Brown Shoe* case, noted that

“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 struck the balance in favor of protecting competition”.<sup>36</sup>

In several later cases, the courts, the antitrust agencies, and also defendants have taken the P&G court's decision in rejecting an efficiency defense in merger context. However, this 'narrow' interpretation was not generally supported. Judge Harlan, in his concurring opinion on the P&C decision, pronounced himself in favor of a more economic based merger analysis that might include efficiencies as a relevant factor if they represent real economies.<sup>37</sup> In interpreting the 'court language' less strictly, some legal commentators, who generally favor recognition of efficiencies in Section 7 cases, explained that the Court only referred to “possible” efficiencies and to economies that “may” result from mergers that lessen competition.<sup>38</sup> They explained further that a rejection of a efficiency defense based on 'possibilities' does not exclude such a defense based on more convincing proof.

Reading the three Supreme Court's decisions without regard to their contexts could lead one to conclude that an efficiency defense is precluded under Section 7 Clayton Act. Although the findings of efficiencies were discussed in court, in none of the cases was an

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35 *FTC v. Procter & Gamble*, 386 U.S. 568, 574, 602 (1967).

36 *FTC v. Procter & Gamble*, 386 U.S. 568, 580 (1967).

37 *FTC v. Procter & Gamble*, 386 U.S. 568, 604 (1967).

38 See Areeda; Turner, § 941b, *Muris* 1980, p. 412f, and Berg 1986, p. 239ff. (all note 6).

efficiency defense directly raised in court: The government did not place the issue of general efficiency justification before the Court, nor did the defendants assert an efficiency defense. The cases reflect the philosophy of another antitrust era. The decisions are based in large part on the understanding of the legislative history (Congress) and formalistic rules rather than on economic theory. Thus, it cannot be definitively said whether an efficiency defense is rejected or permitted in merger evaluation.

### 3.2 Lower Court Cases

Although the Supreme Court has not yet had the opportunity to reconsider its Warren Court era merger decisions on efficiencies, lower courts have become more receptive to the efficiency defense in recent years. Some lower courts have considered cost savings in the context of an absolute defense to an otherwise illegal transaction;<sup>39</sup> others have examined efficiencies in determining the merger's likely procompetitive or adverse effects.<sup>40</sup>

The FTC recognized efficiencies as a proper subject for consideration in merger analysis in its American Medical International (AMI) decision.<sup>41</sup> In regard to its facts and holdings, the AMI case is quite unremarkable; instead, what is striking is that the FTC embraced efficiencies as a full-fledged defense in merger litigation, albeit only beyond the prosecutorial discretion stage. Seeing that this case was argued before the release of the 1984 Merger Guidelines by the DOJ, it could be read as a response by the FTC to its position on efficiencies.<sup>42</sup>

U.S. v. Archer-Daniels-Midland (ADM) was the first litigated merger case where the defendants tried to implement an efficiency defense.<sup>43</sup> The case was quite remarkable because ADM's acquisition of Clinton Corn Processing took place seven years before the case was brought to trial, and therefore, it was possible to analyze the efficiencies claims and its impacts on competition after the fact. Although the defendants could prove that ADM had achieved significant efficiencies, the government tried in a pretrial motion in limine to limit severely the scope of a potential efficiency defense in court, e.g., by re-

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39 For examples see *RSR Corp. v. FTC*, 602 F.2d 1317, 1325 (1979).

40 For examples *FTC v. University Health, Inc.*, U.S. Court of Appeals for the 11<sup>th</sup> Circuit, 938 F. 2d 1206, 1222 (1991).

41 104 F.T.C. 1, 177 (1984), modified on other grounds, 104 F.T.C. 617 (1984). The case involved a hospital acquisition in California in which AMI asserted that significant cost savings would occur through the transaction.

42 See Berg 1986, note 6, p. 258-266.

43 See U.S. v. Archer-Daniels-Midland, *Opposition of Defendants to Plaintiff's Motion in Limine Relating to Efficiencies*, 1987 and Scherer, F.M., John F. Kennedy School of Government Case Study, "Archer-Daniels-Midland and Clinton Corn Processing", Cambridge 1992.

quiring that cost savings have to be passed on to consumers, refusing to consider managerial efficiencies and cost savings of by-products etc. The court denied the motion, and thus, two courtroom days were spent on the efficiency argument. Finally, the court allowed the merger but for reasons other than efficiencies.<sup>44</sup> The case demonstrates the reluctance of the government to entertain an efficiency defense in court, although its new 1984 Merger Guidelines provided, mainly for internal agency consideration, such consideration.

In *FTC v. University Health*, the court of Appeals acknowledged that efficiencies claims may rebut a government's prima facie case.<sup>45</sup> That means that efficiencies have been accepted as a "plus" factor that may tilt the balance in otherwise close cases. The appellees had argued that the proposed acquisition of nonprofit St. Joseph Hospital by nonprofit University Health would generate significant efficiencies and, therefore, would not impair competition. On appeal by the FTC, the Court stated that "in certain circumstances, a defendant may rebut the government's prima facie case with evidence showing that the intended merger would create significant efficiencies in the relevant market."<sup>46</sup> In this regard, the defendants must show that the intended merger would result in economies and that these economies ultimately would benefit competition and consumers.<sup>47</sup> Although the defendants' efficiencies claims were speculative, the case shows a willingness to consider efficiencies in merger litigation. All following mergers where efficiencies played a role referred to the *University Health* opinion.

Among the most recent cases, the court decision in *FTC v. Staples* takes up a very clear position on the subject of efficiencies.<sup>48</sup> The significance of the case has to be seen against the backdrop of the newly released revisions to the Merger Guidelines. While the Court approached efficiencies in a diffident way, by first pointing out to the old Supreme Court cases, it finally examined efficiencies with the approach undertaken in the revised Merger Guidelines. Thus, the Court adopted the government's methodology for reviewing claimed efficiencies. Although the Court refused to accept the alleged cost savings, the efficiency argument was incorporated into merger analysis as a relevant procompetitive factor. This is proven by the extensive courtroom discussions and the explanations in the written opinion. Therefore, the Court's analysis in *Staples* presents a model applica-

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44 See *U.S. v. Archer-Daniels-Midland*, 781 F. Supp. 1400 (1991).

45 See *FTC v. University Health, Inc.* 938 F.2d 1206, 1222 (1991).

46 See *FTC v. University Health, Inc.* 938 F.2d 1206, 1222 (1991).

47 See *FTC v. University Health, Inc.* 938 F.2d 1206, 1223 (1991).

48 See *FTC v. Staples*, 970 F.Supp. 1066, 1089 (1997).



tion of efficiencies and sets forth a new analytical approach for merger enforcement in the future.

#### **4. ANALYSIS OF EFFICIENCIES IN MERGER CASE LAW**

An examination of efficiencies in American merger case law is limited to an analysis of efficiencies claims in litigated merger cases. The figures of reported transactions under the Hart-Scott-Rodino Act reveal that most proposed mergers go through without any litigation.<sup>49</sup> As the agencies need not disclose their reasons for permitting transactions to go forward, the following analysis of efficiencies is based on the few litigated cases that have been become public. In addition, the previous expositions have shown that only lower courts have considered efficiencies claims. Since the case law in one district court is not binding on another one as long as the law is not overruled by a court of appeals or the Supreme Court, the treatment of efficiencies depends on the outlook of a particular court. The following analysis should be seen in this context.

As the case law has so infrequently addressed efficiencies in detail, it is difficult to classify which efficiencies are more likely to be taken into account. The courts have, in an approach similar to the agencies' approach in the Merger Guidelines, developed 'standards' that determine weight and priority in the efficiency area. The merger decisions reveal that judges deem economies most likely to be procompetitive if the claimed efficiencies are merger-specific, subject to reliable proof, and passed on to consumers.

##### **4.1 Types of Efficiencies**

An analysis of the case law shows that the courts have considered a broad range of efficiencies, ranging from economies of scale in production and process, plant specialization, transportation costs to distributional, promotional, transactional, managerial, and innovation efficiencies. However, not all claimed efficiencies are equally merger-specific and susceptible to reliable proof, nor do all kind of cost savings equally enhance competition and consumer welfare in the relevant market.

A review of litigated cases shows that the courts focus predominantly on production and plant economies. In these cases they refer to the P&G decision, where Judge Harlan stated in his concurring opinion that only economies in "real terms" can be recognized by

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<sup>49</sup> Most mergers go forward with 'fix it first' remedies and consent orders.

the courts.<sup>50</sup> For instance, in *U.S. v. Country Lake Foods*, the Court found economies of scale achieved by an increase in the volume of production relevant.<sup>51</sup> Pecuniary efficiencies, such as cost savings from tax advantages, have been repeatedly rejected by the courts.<sup>52</sup> Claims of innovation efficiencies are generally accepted as an important factor in the firm's growth but are more difficult to evaluate. Courts have only considered those efficiencies when they have been credibly proven by the parties.

As most of these cases demonstrate, other efficiencies, such as distributional, promotional, administrative, overhead, or managerial ones, are often less likely to be substantial in merger evaluation and depend strongly on whether they are unique to the specific transaction at issue. For instance, in *U.S. v. Rockford Memorial*, the court did not accept savings coming from the consolidation of nine separate overhead areas because some of the savings would occur from a drop in production.<sup>53</sup> On the other hand, the court acknowledged in *U.S. v. Long Island* operating savings stemming from reductions in personnel in various departments, in the cost of clinical laboratory consulting services and medical supplies, laundry costs, in-house consulting services, computer, and information services.<sup>54</sup>

It is even more difficult, almost impossible, to prove managerial efficiencies. In *U.S. v. ADM*, the defendants referred to efficiencies resulting from superior management.<sup>55</sup> In that case, ADM's operations were found to be substantially more profitable than its rivals (shown in higher productivity and superior profitability). ADM pointed out that, for a large part, the success was based upon ADM's management philosophy and argued in their response to the government's motion in limine that ignoring efficiencies achieved through their unique management approach would be to ignore much of what had happened.<sup>56</sup> As the court approved the merger without addressing the efficiency argument, it remains ambiguous as to what extent the courts consider managerial efficiencies in merger analysis.

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50 See *FTC v. Proctor & Gamble*, 386 U.S. 568, 604 (1967).

51 In this case, the efficiency argument was for the first time accepted; however, it was not necessary to justify the proposed transaction because no anticompetitive harm had been raised. See *U.S. v. Country Lake Foods, Inc.*, 754 F. Supp. 669, 680 (1990).

52 For example see *U.S. v. Rockford Memorial Corp.*, 717 F.Supp. 1251, 1289 (1989).

53 See *U.S. v. Rockford Memorial Corp.*, 717 F.Supp. 1251, 1290 (1989). See for further explanations paragraph 4.2 below.

54 See *U.S. v. Long Island Jewish Medical Center*, 938 F. Supp. 121, 148-149 (1997). See for further explanations paragraph 4.2 below.

55 See Scherer, F.M., 1992, note 42.

56 See *U.S. v. Archer-Daniels-Midland, Opposition of Defendants to Plaintiff's Motion in Limine Relating to Efficiencies*, 1987.

Capital-raising savings as efficiencies are generally not considered in case law, absent a strong demonstration that the proposed transaction would address identifiable capital market imperfections. However, in *FTC v. Butterworth* and *U.S. v. Long Island*, the courts have recognized capital avoidance savings incorporating cost differences between the capital expenses for buildings, equipment, etc., that the merging parties would need to compete with each other, and the capital expenses for buildings, etc., without competition.<sup>57</sup> As the amount of capital avoidance is difficult to ascertain, the courts acknowledged that fact and accepted in both cases capital expenditure avoidance in an unknown amount.

## 4.2 Merger-Specific Efficiencies

A reading of the different courts' decisions demonstrates that the courts begin to evaluate efficiencies by asking for the uniqueness of the claimed efficiencies. In this way, the district court has stated, in *U.S. v. Rockford Memorial*, that relevant efficiencies "must be made possible only through the merger and in no other manner."<sup>58</sup> Thus, the court of appeals has explained, in *FTC v. University Health*, that it is proper "to require proof that the efficiencies to be gained by an acquisition cannot be secured by means that inflict less damage to competition, such as internal expansion or merger with smaller firms."<sup>59</sup> Both quoted cases reveal that the courts impose a strict 'uniqueness test' on the merging parties.

As the critical focus has been, since the *Philadelphia National Bank* decision, on the competitive effects of a proposed transaction in the future, the courts have to contrast the probable future with the merger to the probable future without the merger. In order to determine the least restrictive way of achieving the alleged efficiencies, the courts compare what may happen if the merger occurs to what is likely to happen if the merger does not take place. This means that courts consider only those efficiencies that cannot be realized without a proposed transaction and rebut all efficiency claims that can be accomplished through alternate means, such as other business arrangements or internal growth. Contrary to the older Supreme Court cases, where the Court favored generally internal expansion to external growth,<sup>60</sup> lower courts in recent merger cases have fo-

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57 See *FTC v. Butterworth Health Corp.*, 946 F. Supp. 1285, 1300 (1996) and *U.S. v. Long Island Jewish Medical Center*, 938 F. Supp. 121, 148 (1997).

58 See *U.S. v. Rockford Memorial Corp.*, 717 F.Supp. 1251, 1289 (1989).

59 *FTC v. University Health, Inc.*, 938 F. 2d 1206, 1222 (1991).

60 See *Brown Shoe Co. v. U.S.*, 370 U.S. 294 (1962), *U.S. v. Philadelphia National Bank*, 374 U.S. 321 (1963), *FTC v. Proctor & Gamble*, 386 U.S. 568.

cused more on the feasibility of less restrictive agreements and on cost aspects. This approach is illustrated below.

In *U.S. v. Long Island*, the court accepted that a merger between the two premier teaching hospitals on Long Island was the least restrictive alternative to achieve the claimed efficiencies.<sup>61</sup> The government's witness on this subject had before (in court) questioned whether a number of efficiencies cited by the defendants were merger-related and had argued that the two hospitals could obtain comparable efficiencies through selling services to each other and working together, even in the absence of a merger. The court, however, doubted that two vigorous competitors, each a leading hospital, located within two miles of each other, would agree to share clinical laboratory services, claims recovery services, and other utilities without a merger. Hence, the fact that the two hospitals were fierce competitors struck the balance in favor of the merger. On the other hand, with regard to other claimed efficiencies, such as reduction of insurance premiums, interest expense savings, or the ambulatory care building, which were also disputed by the government's expert, the court stated that equivalent savings could be obtained by each hospital's acting independently.

In the recent *FTC v. Staples* case, the court determined the merger specificity of the alleged efficiencies between the first and second largest office product superstores by comparing the projected (not the past) cost savings of Staples as a stand-alone company with the projected cost savings of the merged company.<sup>62</sup> The defendants' largest cost savings, 40% of the total estimate, were asserted as a result of extracting better prices from vendors in the future. A cost analysis revealed that the claimed buying efficiencies were limited to those savings that would be achieved by reaching larger scale immediately rather than over 3 or 4 years.<sup>63</sup> As both merging parties were expanding rapidly by opening new stores, the court noted that those efficiencies would have occurred in any event as a result of internal expansion and therefore deemed the projected cost savings as not merger-specific.

In *U.S. v. Rockford Memorial*, a merger between two hospitals, the defendants had declared a large amount of efficiencies in diverse areas.<sup>64</sup> The court rejected most of the cost savings, stating that those savings could be achieved independent of the proposed

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61 See *U.S. v. Long Island Jewish Medical Center*, 938 F. Supp. 121, 148 (1997).

62 See *FTC v. Staples Inc.*, 970 F.Supp. 1066, 1090 (1997).

63 See Valentine, 1997, note 13.

64 *U.S. v. Rockford Memorial Corp.* 717 F.Supp. 1251, 1288-1289 (1989).

merger either through alternative action or through a drop in production. However, with regard to efficiencies coming from the standardization of clinical practices through the merger, the court adopted a different position.<sup>65</sup> It noted, first, that the standardization did not require a merger because one of the merging parties (Rockford Memorial Hospital) had shown through a standard step-by-step program implemented by a consulting firm that costs and inefficiencies in a variety of clinical practices could be reduced unilaterally. The court pointed out that the other merging partner (Swedish American Corp.) could also hire a consulting company. The court acknowledged, though, the cost of consulting for such a standardization program as a cost advantage in favor of a merger.<sup>66</sup>

### 4.3 Proof of Efficiencies

One key to establishing an efficiency defense in merger evaluation is the proof of economies. Existing case law imposes the burden of producing evidence of competitively relevant efficiencies on the merging parties.<sup>67</sup> As it is difficult to predict efficiencies precisely before a merger is consummated, the burden of proof is rather a persuasion standard. This ‘standard’ has changed over the last decades. In *U.S. v. Rockford Memorial*, the courts still required a “clear and convincing evidence” for claimed efficiencies.<sup>68</sup> But as such a requirement would impose on merging parties the nearly impossible task of rebutting a possibility with a certainty, this burden was rejected in *U.S. v. Baker Hughes*.<sup>69</sup> Moreover, the judge clarified that efficiencies claims must only be “credible” (*FTC v. Staples*)<sup>70</sup> or “clearly demonstrated” (*U.S. v. Long Island*)<sup>71</sup> in order to be considered by the courts. Analyzing the merger decisions shows that the courts have deemed efficiencies to be ‘credibly’ proven in cases where efficiencies claims are nonspeculative and quantifiable. Both aspects are illustrated below.

To distinguish efficiencies which are merely speculative from those that are based on sound business judgment, the courts usually begin by asking the merging parties to explain how the efficiencies would be created and maintained through the proposed transaction.<sup>72</sup> If the parties cannot convincingly expound the way to achieve the claimed sav-

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65 *U.S. v. Rockford Memorial Corp.* 717 F.Supp. 1251, 1289-1290 (1989).

66 See *U.S. v. Rockford Memorial Corp.* 717 F.Supp. 1251, 1291 (1989).

67 See *U.S. v. Marine Bancorporation*, 418 U.S. 602, 631 (1974) or *U.S. v. Citizens*, 422 U.S. 86, 120 (1975).

68 See *Rockford Memorial Corp.*, 717 F. Supp. 1051, 1289 (1989).

69 See *U.S. v. Baker Hughes, Inc.*, 908 F. 2d 981, 992 (1990).

70 *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1089.

71 *U.S. v. Long Island Jewish Medical Center*, 938 F. Supp. 121, 147 (1997).

72 See *FTC v. University Health, Inc.* 938 F. 2d 1206, 1223 (1991).

ings, the courts consider the efficiencies as speculative. For instance, in *FTC v. University Health*, the defendants simply asserted that the intended acquisition would reduce “unnecessary duplication” between both hospitals and approximated, in dollars, the amount of cost savings, but they could not reasonably explain how those efficiencies would be generated.<sup>73</sup> In *U.S. v. Mercy Health Service*, however, the court decided differently. Here, the government stressed that the claimed efficiencies were speculative because the merging parties, two general acute-care hospitals in the area of Dubuque, had failed to demonstrate which actions would be taken in order to implement any of the changes resulting in efficiencies.<sup>74</sup> The court noted, though, that the board of the new Dubuque Regional Health System could make no decision until the merger is approved and that, therefore, the efficiencies claims was not speculative.

As the proof of efficiencies becomes more and more a matter of detailed and expensive cost studies that seek to quantify the efficiencies that can be attained through a merger, the court have the task of assessing the reliability of the presented cost analysis. Reviewing litigated merger cases where cost studies were undertaken to support the evidence of efficiencies claims, findings were only taken for credible when the analysis was complete and persuasive at the same time. For instance, in *U.S. v. Rockford Memorial*, the court placed hardly any weight on the presented cost study because it was obvious that the efficiency analysis was hastily commenced after the announcement of the merger.<sup>75</sup>

Similarly, in *FTC v. Staples*, the merging parties were unable to explain the methods used to calculate many of the projected cost savings.<sup>76</sup> The court emphasized, furthermore, that the defendants’ cost savings estimates were unreliable because the claims submitted to the court exceeded by almost 500% the figures presented to the boards of Staples and Office Depot when they approved the transaction less than a year earlier. The projected savings were also substantially greater than those represented in a defendants’ statement.<sup>77</sup> Moreover, judges rather doubt the credibility of a defendants’ cost study when the analysis does not reflect the net savings of a proposed transaction. In *U.S. v. Rockford Memorial*, the merging parties had conducted a so-called one-sided study, i.e., only the benefits of efficiency claims were taken into account.<sup>78</sup> Expenses,

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73 See *FTC v. University Health, Inc.* 938 F. 2d 1206, 1223 (1991).

74 See *U.S. v. Mercy Health Services*, 902 F. Supp. 968, 988 (1995).

75 See *U.S. v. Rockford Memorial Corp.*, 717 F. Supp. 1051, 1289 (1989).

76 See *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1090 (1997).

77 See *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1089 (1997).

78 See *U.S. v. Rockford Memorial Corp.*, 717 F. Supp. 1051, 1289 (1989).

such as coordinating costs, that will always accrue in combining previous different owned assets were not considered.

A review of the merger decisions shows that the problem of proof is often the principal reason why the courts have repeatedly rejected efficiencies claims.<sup>79</sup> It appears that courts have tended to rebut claimed efficiencies on evidentiary grounds in cases in which they found that a proposed transaction is likely to be anticompetitive<sup>80</sup> and to credit efficiency claims when mergers have little competitive harm. That indicates that the courts have some leeway in assessing efficiencies. The freedom in decision-making is clearly illustrated in the recently litigated merger *FTC v. Butterworth*.<sup>81</sup> There, the court announced, after considering the plaintiff's and the defendants' efficiency estimates, that both sides had their "strengths and weaknesses". Without further examinations of the substance of the studies, the court simply found the defendants' case more persuasive and concluded that the proposed transaction would exceed an amount of \$100 million in savings.<sup>82</sup>

#### **4.4 Pass on to Consumers**

On the whole, the analysis demonstrates that courts have considered efficiencies in litigated merger cases. Furthermore, the courts have acknowledged that for efficiencies to be given weight in merger analysis, the efficiencies must be quantified and balanced against the adverse competitive effects of a proposed transaction. However, the need to make this tradeoff has not often arisen in litigated settings. This may be grounded in large part in the uncertainty of assessing efficiencies. Another reason seems to be the reluctance of judges to make a tradeoff analysis. Therefore, the courts have concluded that efficiencies can save an otherwise anticompetitive merger only if a proposed transaction leads to cost reductions that are passed on to consumers and are sufficient to offset the expected price increase associated with the merger. On this matter, *FTC v. University Health* is the leading case. Here, the court stated:

"Because of these difficulties, we hold that a defendant who seeks to overcome a presumption that a proposed acquisition would substantially result in

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79 For example *U.S. v. Long Island Jewish Medical Center*, 938 F. Supp. 121, 148 (1997), *U.S. v. Mercy Health Services*, 902 F. Supp. 968, 989 (1995), *FTC v. Owens-Illinois, Inc.*, 681 F. Supp. 27 (1988).

80 For example *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1089 (1997), *FTC v. University Health, Inc.* 938 F. 2d 1206, 1222 (1991), *U.S. v. United Tote, Inc.*, 768 F. Supp. 1064, 1084-85 (1991), *U.S. v. Rockford Memorial Corp.*, 717 F. Supp. 1051, 1289-91 (1989),

81 See *FTC v. Butterworth Health Corp.*, 946 F. Supp. 1285, 1301 (1996).

82 See for further explanations paragraph 4.4.

significant economies and that these economies ultimately would benefit competition and, hence, consumers”.<sup>83</sup>

The quoted sentence refers to the economic concept of consumer surplus (consumer welfare standard). This approach is generally adopted by the courts. Though an increase in consumer welfare can be achieved through lower prices, new products, or improved quality, it appears that the case law tend to favor price tests as an indicator.<sup>84</sup> Therefore, the courts rely on efficiencies that result in lower prices, for instance, reductions in marginal costs. The courtroom discussion on the efficiency argument in *U.S. v. Archer-Daniels-Midland* confirms this tendency.<sup>85</sup> In that case, the defendants’ party had shown in a survey that ADM had cut Clinton’s unit corn processing and administrative costs by half while output had increased. However, the cost-cutting effects did not seem to affect prices directly. A reason for this was the strong bargaining power of some buyers that dominated the price setting. Hence, even in a textbook case like this one, it seems that courts give less weight to other indicators than they give to prices.

In regard to the timeframe in which the claimed efficiencies must be passed on to consumers, the case law remains ambiguous. However, the courts have indicated that efficiencies need not be accomplished immediately and that a time lag between the realization and attainment of efficiencies is acceptable as long as the price-cutting effects of cost savings are likely. In analyzing the passing-on requirement in merger cases, the courts distinguish between for-profit and nonprofit entities.<sup>86</sup> The difference in ownership can play a role regarding the pricing behavior of the merging parties.

In *FTC v. Staples*, the two superstores had submitted an efficiency analysis that asserted that two-thirds of the claimed savings would be passed on to consumers in the form of lower prices.<sup>87</sup> The court found, however, that the projected pass through rate was unrealistic, although it had no doubt that a portion of the claimed efficiencies would be passed on to consumers. The court held that the passing-on requirement failed on two grounds. First, the evidence revealed that the Staples historic pass through rate was only

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83 *FTC v. University Health, Inc.*, 938 F.2d 1206, 1223 (1991). Before this case, the court in *U.S. v. United Tote* had addressed the same argument rejecting efficiencies gains because “there are no guarantees that these savings would be passed on to the consuming public.” *U.S. v. United Tote* 768 F. Supp. 1064, 1085 (1991).

84 See *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1090 (1997).

85 See Scherer, F.M., Case Study 1992, note 42, and also *U.S. v. Archer-Daniels-Midland*, 781 F. Supp. 1400 (1991).

86 Nonprofit corporations are directed by a board comprised of community members or other individuals.

87 See *FTC v. Staples, Inc.*, 970 F. Supp. 1066, 1090 (1997).



15-17%, much lower than the 67% figure. Second, the court considered the market context in order to get a more realistic prediction of the future behavior and then balanced the reduced competition from the merger against the projected efficiencies.<sup>88</sup> Increased concentration in many markets, sometimes near monopoly, led the court to the conclusion that the pass-through rate would decline rather than increase after the merger was consummated. In addition, the defendants' assertions were undermined by the fact that the pass-through rate was based in large part on too rosy predictions of efficiencies.

In the two recent health care mergers (*FTC v. Butterworth* and *U.S. v. Long Island*), the court accepted that the claimed efficiencies would ultimately result in benefits to consumers. In both cases, the courts found that the projected savings would be passed on to health care consumers because of the hospital's nonprofit status and the hospitals' commitment to help their communities.<sup>89</sup> Thereby, the courts assume that nonprofit hospitals behave differently because they serve public interests and support the proposition that nonprofit hospitals set lower prices than comparable for-profit hospitals.<sup>90</sup> In *U.S. v. Long Island* the judge was convinced as a result of (1) a testimony of a representative of a large managed care organization that the merger would reduce prices, (2) the hospitals' stipulation to the state attorney general that they would not rise prices for two years, and (3) an agreement that half of the savings would provide high-quality health care to economically disadvantaged and elderly members of the community. In spite of these findings, it appears that the court considered a price rise as unlikely regardless of whether any efficiencies would be realized. Finally, no real balancing between efficiency gains against competitive losses took place.

## 5. CONCLUSION

Efficiencies have yet not played a prominent role in American merger enforcement policy, although the federal antitrust agencies and the courts have recognized efficiencies as a factor in merger analysis that may tilt the balance in an otherwise anticompetitive transaction. A review of the development of the Merger Guidelines and an analysis of the case law reveals that the evaluation of efficiencies claims has evolved dramatically over the last few decades and that the trend has been toward a more sympathetic treatment of ef-

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88 See Valentine, 1997, note 13, and Pitofsky, Robert 1997: "Staples and Boeing: What They Say About Merger Enforcement at the FTC", Prepared Remarks Before Antitrust 1998, Business Development Associates, Washington, D.C. (September 23, 1997).

89 See *U.S. v. Long Island Jewish Medical Center*, 938 F. Supp. 121, 149 (1997) and *FTC v. Butterworth Health Corp.*, 946 F. Supp. 1285, 1301 (1996).

90 See Lynk, William J., "Nonprofit Hospital Mergers and the Exercise of Market Power", in: *The Journal of Law and Economics*, Vol. 38, 1995, 437 – 461.

efficiencies claims. To date, however, no court has upheld an otherwise anticompetitive merger on the basis of efficiencies. The 'second order importance' of the efficiency argument in merger analysis is based on varied grounds.

One reason for the limited significance of the efficiency defense in antitrust enforcement is, certainly, the scarcity of cases in which both substantial efficiencies and substantial market power coincide. In spite of that fact, efficiencies can, nevertheless, play a significant role in non-litigated merger cases. But as those cases never become public and the agencies do not disclose their reasons for allowing a merger, it is difficult to give a proper judgment of efficiencies in merger practice. Moreover, the courts' merger decisions have not contributed to shedding more light on that topic. Since the Supreme Court has not, since the Warren court era, addressed questions of relative weight and priority in the efficiency area, and the treatment of efficiencies in lower courts depends heavily on the outlook of a particular court, many issues are ambiguous and unsettled.

Another reason for this infrequent application is the inherent nature of efficiencies. Since it is difficult to measure efficiencies, in particular *ex ante*, it is therefore troublesome to determine the magnitude of anticompetitive loss against which efficiency gains should be balanced. The problem of proof is the principal reason why the agencies and the courts have been quite skeptical of efficiencies claims. Instead of making the formal tradeoff, the analysis of the litigated merger cases indicates that judges tend to resolve that issue indirectly. In some cases, it appears that the courts compare the efficiencies losses of a less restrictive alternative to the proposed transaction with the anticompetitive harm resulting from the merger. In doing so, the courts get an idea of the relative weight of the efficiencies but avoid a direct balancing of benefits against costs.

Finally, the strategic value of the efficiency defense has to be taken into account in order to understand the relatively small importance of efficiencies in antitrust policy. Antitrust agencies, which seek to block an anticompetitive merger in litigation, tend to place less weight on the efficiency argument because they want success in the lawsuit. Defendants, on the other hand, have an incentive to overestimate their efficiencies claims in order to win the case. The courts have, then, the difficult task of weighing the credibility of both sides' argumentation. It seems that courts tend to reject efficiencies claims when they find a proposed merger to be anticompetitive and to recognize efficiencies when the adverse competitive effects appear to be small.