Efficiencies and Horizontal Mergers: In Search of a Defense

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A controversial issue facing U.S. antitrust law is whether horizontal mergers involving market power should be permitted on the basis of efficiency claims. Historically, the notion of an efficiencies defense has met with judicial hostility, but attitudes are changing. This Article critically analyzes the developments and argues the case for the emergence of an absolute judicial formulation of the defense and wider enforcement discretion.

I. INTRODUCTION

One of the most complex and uncertain questions facing U.S. antitrust law today is how to account for efficiency claims in the case of horizontal mergers involving market power. Notwithstanding the rhetoric of merger, and the inevitable claims about efficiency motivation, studies have concluded that a significant number of mergers do not achieve their efficiency expectations.[1] However, it is recognized that

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1. *See, e.g.*, DAVID J. RAVENSCRAFT & F.M. SCHERER, MERGERS, SELL-OFFS, AND ECONOMIC EFFICIENCY (1987). While this study concentrated upon the conglomerate merger wave of the 1960s and surrounding years, it also included data of horizontal acquisitions. *Id.* at 56-122.

some horizontal mergers may involve significant economies of scale in production[2] and other efficiencies.[3] Accordingly, it is appropriate that the potential for an efficiencies defense should be on the agenda, but the trends just described also suggest that it is an issue which should be approached with caution.

The defense has an uncertain past. When Congress enacted the antitrust laws impacting on mergers, it had no appreciation of the potential for horizontal mergers to involve both market power and efficiencies. Rather, Congress was preoccupied with the unfair transfer of consumers' wealth and a range of "populist" goals.[4] Against this background it is not surprising that there has been judicial hostility to the concept of an efficiencies defense. But the level of hostility, in particular the hostility of the Supreme Court in the 1960s, has begun to subside.[5]

The defense has benefited from greater knowledge. Professor Oliver E. Williamson first advanced the notion of an efficiencies defense in 1968 as an exception to the restrictive rule which had emerged in the Supreme Court's opinions.[6] However, progress on the adoption of the defense since 1968 has been slow. This is not surprising. The scholarship on the defense since Williamson's seminal work has demonstrated its complexity and uncertainty. The defense has been raised only in a small number of cases and in circumstances where the courts have not been required to decide the matter. Nonetheless, there

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2. This proposition is not without qualification. In the short run there is the rationalization problem of plants which are already built and this obviously impacts on the ability to achieve plant-specific economies of scale. Plant closure may in some cases be possible, with the most efficient units being retained or expanded. If there is no immediate plant closure or expansion, the merger may still yield scale economies in the longer term. Companies with older plants are more likely to invest in large-scale replacement and companies with increased market share are also better suited to invest in sizeable new plants. For further discussion of these qualifications see F. M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 163-64 (3d ed. 1990).

3. For example, product-specific economies of scale, advantages in marketing, the infusion of superior management, and advantages in capital-raising. For an economic critique of these claims see *id.* at 164-67.

4. *See infra* part II.B.

5. *See infra* part II.C.

6. Oliver E. Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 AM. ECON. REV. 18 (1968) [hereinafter Williamson, *Economies/Welfare Tradeoffs*]. Williamson developed his arguments for the defense in four further articles. *See* Oliver E. Williamson, *Economies as an Antitrust Defense: Correction and Reply*, 58 AM. ECON. REV. 1372 (1968); Oliver E. Williamson, *Allocative Efficiency and the Limits of Antitrust*, 59 AM. ECON. REV. PAPERS & PROC. 105 (1969); Oliver E. Williamson, *Economies as an Antitrust Defense Revisited*, 125 U. PA. L. REV. 699 (1977) [hereinafter Williamson, *Defense Revisited*].

has been an appreciable shift in judicial attitudes and many of these cases have at least commented favorably on efficiency considerations.

Notwithstanding recent claims that the international competitiveness of American firms will be threatened if some form of efficiencies defense is not adopted,[7] the progress of the defense will inevitably be conditioned by the normal decision-making process. It may not be difficult for the courts to continue to comment favorably on efficiencies in future cases. But, judicial acceptance of the defense will involve a bold move, a move which few judges may be confident enough to make. The defense has questionable theoretical foundations and there are significant problems involved in the formulation of a workable test.[8]

This Article will outline the central issues which require consideration if the efficiencies defense is to emerge. The scheme of this Article will be to consider:

(1) Whether the legislative history and judicial treatment of the efficiencies defense precludes its emergence;

(2) how certain theoretical foundations (such as the goals of antitrust, the comparative forms of efficiency, and economic models) may impact on the emergence and formulation of the defense;

(3) whether the defense should be based upon a net efficiencies or absolute test;

7. *See* Robert Pitofsky, *Proposals for Revised United States Merger Enforcement in a Global Economy*, 81 GEO. L.J. 195, 198, 213-15 (1992). While many U.S. corporations may view an expanded domestic production base as being critical to their international competitiveness, such justification for the efficiencies defense may be overstated. For example, it may be argued that concerns about international competitiveness can be accommodated by defining markets to be international in appropriate cases. Admittedly, the definition of international markets raises complex issues, but if such an approach is adopted it has the potential to impact dramatically on market power assessments. *See, e.g.*, William M. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 963 (1981); *see also* George Hay et al., *Geographic Market Definition in an International Context*, 64 CHI.-KENT L. REV. 711, 729-34 (1988); *cf.* Robert G. Harris & Thomas M. Jorde, *Antitrust Market Definition: An Integrated Approach*, 72 CAL. L. REV. 1, 57-59, 62-64 (1984) (emphasizing the uncertainties surrounding the ability of firms to divert the potential supply of exported goods back to the relevant market, and of foreign firms to increase supplies into the market). Alternately, from an economics perspective, it can be argued that the adoption of domestic terms of reference may be appropriate because active domestic rivalry is strongly associated with international success. *See* MICHAEL E. PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS 644 (1990).

8. *See infra* parts III and IV.

(4) whether the defense should be rejected because of measurement ambiguities;

(5) whether the defense should set a distributional standard requiring that the cost savings be passed on to consumers; and

(6) whether the defense should be available if the claimed efficiencies can be achieved by other means, such as internal expansion or joint ventures.

A final section will consider how enforcement discretion may accommodate the notion of an efficiencies defense, even if it does not receive judicial recognition.

II. CURRENT TREATMENT OF EFFICIENCIES

A. *Horizontal Mergers Generally*

It is appropriate to commence with a brief outline of the current analysis of horizontal mergers in the United States, because it is within this framework that the efficiencies defense must be considered. The prevailing legislation which governs mergers is section 7 of the Clayton Act,[9] which prohibits mergers where the result may be to lessen competition substantially or to tend to create a monopoly.[10] The current approach to the application of section 7 reveals a preoccupation with governmental guidelines[11] rather than case law developments. This is due in large part to the fact that while the Supreme Court has initiated certain analytical trends, it has not had the opportunity to refine these since the mid-1970s.[12] Rather, the trend over recent years has been to negotiate settlements with the enforcement agencies during the Hart-Scott-Rodino process.[13]

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9. 15 U.S.C. § 18 (1973).

10. Other legislative provisions which have the potential to apply to horizontal mergers are the Sherman Act, 15 U.S.C. § 1 (1973) (which prohibits every contract, combination or conspiracy in restraint of trade or commerce), and the Federal Trade Commission Act, 15 U.S.C. § 45 (1973) (which prohibits unfair methods of competition). These provisions have potentially broader coverage than § 7 of the Clayton Act. The question of the efficiencies defense is likely to involve the same considerations under each of these legislative provisions as is the case under § 7.

11. Horizontal Merger Guidelines, 57 Fed. Reg. 41,552 (1992) [hereinafter Merger Guidelines].

12. For a recent discussion of the case law developments relating to the analysis of horizontal mergers, see STEPHEN F. ROSS, PRINCIPLES OF ANTITRUST LAW 318-54 (1992). *See also* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE 441-500 (1994).

13. For a discussion of Hart-Scott-Rodino procedures see 1 STEPHEN M. AXINN ET AL., ACQUISITIONS UNDER THE HART-SCOTT-RODINO ANTITRUST IMPROVEMENTS ACT (rev. ed. 1995).

Two significant trends have emerged from the Supreme Court opinions. First, there is the rule of presumptive illegality which is based upon concentration and market shares. This development of the Warren Court in the 1960s was given its clearest expression in *United States* v. *Philadelphia National Bank*.[14] Second, in *United States* v. *General Dynamics Corp.*,[15] the only substantive horizontal merger case decided by the Supreme Court since the Warren Court judgments, the majority accepted this approach, but added a further step to the process. The rule of presumptive illegality was made subject to "the absence of other considerations."[16]

The *Merger Guidelines* have developed an approach which is generally consistent with these trends,[17] but there is an increased sophistication to the analysis. On the basis of the *Merger Guidelines*, horizontal mergers are likely to be viewed as presumptively unlawful where the merged firm will achieve a fifteen to sixteen percent market share. This threshold may be lowered in cases where concentration in the relevant market is high. Conversely, where concentration is low, a combined market share in excess of sixteen percent may not be challenged. Additionally, if one of the merging firms has less than a two percent

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14. 374 U.S. 321, 363-64 (1963). The connection between a few number of firms and the exercise of market power has been a matter of debate in the economics literature. The various studies have demonstrated that it is difficult to develop rules of universal application which establish a connection between concentration and market power. Early studies suggested that concentrated markets are more likely to exhibit features of market power, such as increases in price and reduction of output. However, more recent studies have argued that industry structures are dictated to a large extent by the degree to which scale economies prevail or by the comparative efficiencies of firms. For a discussion of the early oligopoly theories see Leonard W. Weiss, *The Concentration-Profits Relationship and Antitrust*, *in* INDUSTRIAL CONCENTRATION: THE NEW LEARNING 184, 188-93 (Harvey J. Goldschmid et al. eds., 1974). For a critical review of these theories and wider discussion on the theories of oligopoly pricing see Harold Demsetz, *Two Systems of Belief About Monopoly*, *in* INDUSTRIAL CONCENTRATION: THE NEW LEARNING, *supra*, at 164-84. *See also* SCHERER & ROSS, *supra* note 2, at 199-233.

15. 415 U. S. 486 (1974).

16. *Id.* at 497-98.

17. It has been suggested that the *Merger Guidelines* have one area of major divergence from case law trends insofar as concentration is not a factor. Trends toward industry concentration are of potential concern because a series of mergers, or indeed an isolated merger, can transform a market to a situation where oligopoly takes control. *See* ROSS, *supra* note 12, at 334.

market share, then combinations up to thirty percent may be permitted.[18]

This presumption is rebuttable.[19] For example, the presumption may be rebutted when dominant firm behavior and coordinated interaction is unlikely to result[20] and where new entry to the market is easy.[21] Market factors pertaining to both efficiencies[22] and failure[23] can also be taken into account under the *Merger Guidelines*. While the failing company defense has received judicial recognition,[24] the position relating to efficiencies is unsettled.

B. Legislative Treatment of Efficiencies

The language of section 7 of the Clayton Act is silent on the question of efficiencies. Whether a judge-made efficiencies defense is available under section 7 will depend on whether Congress precluded its application or considered efficiencies to be an adverse consequence of mergers. This question necessitates an inquiry primarily into the legislative history of the 1950 Celler-Kefauver amendments to section 7.[25]

Several attempts have been made to retrace the chronology of events leading up to these amendments, with particular reference to the efficiencies defense. It appears to be common ground that the predominant concern in enacting these provisions related to the fear of concentration and the transfer of wealth from consumers to monopolists.[26] It also appears to be common ground that these amendments had various

18. Market share under the *Merger Guidelines* is measured according to the Herfindahl-Herschmann Index (HHI). The HHI is calculated by summing the squares of the market shares of each firm in the market. If a post-merger HHI is above 1800, the market will be regarded as highly concentrated. If the merger produces an increase in the HHI of more than fifty points in such a market, it will be presumed to create or enhance market power or facilitate its exercise. Merger Guidelines, *supra* note 11, § 1.51(c); *see also* Pitofsky, *supra* note 7, at 200-01.

19. Merger Guidelines, *supra* note 11, § 1.51(c).

20. *Id.* § 2.

21. *Id.* § 3.

22. *Id.* § 4.

23. *Id.* § 5.

24. For recent discussions of the evolution and elements of the failing company defense see Timothy B. Walthall, *The Failing Company Defense and Corporate Collapse: Probing for a Rational Approach to Business Failure*, 5 GEO. MASON U. L. REV. 51 (1982); *see also* Richard D. Friedman, *Untangling the Failing Company Doctrine*, 64 TEX. L. REV. 1375 (1986).

25. 15 U.S.C. § 18 (1973).

26. *See, e.g.*, Timothy J. Muris, *The Efficiency Defense Under Section 7 of the Clayton Act*, 30 CASE W. RES. L. REV. 381, 395-97 (1980); Alan A. Fisher & Robert H. Lande, *Efficiency Considerations in Merger Enforcement*, 71 CAL. L. REV. 1580, 1588-93 (1983).

secondary goals, such as providing opportunities for small businesses and encouraging corporate expansion through internal growth rather than through merger activity.[27]

Efficiency was not a significant theme in the Congressional consideration of section 7. There was limited reference to efficiency considerations in the Congressional debates. Such matters as the potential for the merger of small firms and the acquisition of failing companies received ambiguous, but nonetheless favorable, comment to the extent that they would enhance efficiency.[28]

Significantly, Congress did not directly address the situation of a merger which involved both concentration concerns as well as significant efficiencies. Therefore, it is hardly surprising that there have been different interpretations of the legislative history relating to efficiencies. Some have suggested that the concern about concentration is of such magnitude as to prohibit mergers, regardless of their efficiency characteristics.[29] But, it has also been strongly argued that a close reading of the legislative history supports the conclusion that the new law was not intended to preclude an efficiencies defense.[30] The predominant view is that neither the language nor the legislative history of section 7 precludes the application of an efficiencies defense.[31] However, the preoccupation of Congress with concerns other than efficiency will materially impact the manner in which any efficiencies defense may be formulated, as will be discussed later.[32]

C. *Judicial Treatment of Efficiencies*

Three Supreme Court opinions dating back to the 1960s have been viewed by some to preclude an efficiencies defense. Arguably these decisions render the achievement of efficiencies an adverse factor in

27. *See* Fisher & Lande, *supra* note 26, at 1588-93.
28. *See* Muris, *supra* note 26, at 399-400.
29. *See, e.g.*, Derek C. Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 318 (1960).
30. *See* MURIS, *supra* note 26, at 396.
31. *See, e.g.*, 4 PHILLIP AREEDA & DONALD F. TURNER, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION 151-54 (1980); Muris, *supra* note 26, at 402; C. Paul Rogers, *The Limited Case for an Efficiency Defense in Horizontal Mergers*, 58 TUL. L. REV. 503, 507-10 (1983); Pitofsky, *supra* note 7, at 211-13.
32. *See infra* part III.

assessing the legality of mergers. In more recent times, however, lower courts have both rejected and supported the notion of an efficiencies defense.

The first of the Supreme Court's opinions was *Brown Shoe Co.* v. *United States*.[33] This case involved a challenge by the government of a merger between Brown Shoe Company and G. R. Kinney Company. Both of these companies were manufacturers and retailers of shoes. The essential concern raised in this case was one of vertical integration and the foreclosure of competition,[34] but the Court also purported to analyze the horizontal aspects of the merger.[35]

Significantly, Brown Shoe Company did not raise efficiencies considerations as a justification to this merger. Indeed, in an effort to overcome the concerns of the District Court that the merged firm would enjoy advantages that would enable it to lower prices,[36] Brown Shoe Company argued that vertical integration produced no economic advantages.[37] This background may, to some extent, explain the confused analysis of the Supreme Court on efficiencies issues. Chief Justice Warren stated:

> A third significant aspect of this merger is that it creates a large national chain which is integrated with a manufacturing operation. The retail outlets of integrated companies, by eliminating wholesalers and by increasing the volume of purchases from the manufacturing division of the enterprise, can market their own brands at prices below those of competing independent retailers. Of course, some of the results of large integrated or chain operations are beneficial to consumers. Their expansion is not rendered unlawful by the mere fact that small independent stores may be adversely affected. It is competition, not competitors, which the Act protects. 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.[38]

This passage does not, as has been suggested, represent a definitive rejection of the efficiencies defense. Indeed, not only does it fail to directly address the issue of the defense, but it is also, for the most part, internally inconsistent. First, it suggests that efficiencies generated by vertically integrated enterprises should be prohibited where such enterprises can sell at prices below those of independent retailers. But

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33. 370 U.S. 294 (1962).
34. *Id.* at 323-34.
35. *Id.* at 334-46.
36. United States v. Brown Shoe Co., 179 F. Supp. 721, 738 (E.D. Mo. 1959), *aff'd*, 370 U.S. 294 (1962).
37. *See* Muris, *supra* note 26, at 404.
38. Brown Shoe Co. v. United States, 370 U.S. at 344 (1962).

it then suggests that such a result would be beneficial to consumers. Secondly, it is contradictory to state that the focus of the legislation is on "competition, not competitors," and that Congress opted "in favor of decentralization."

Thus, it is doubtful that *Brown Shoe* rejects the possibility of an efficiencies defense. Indeed, there are arguments to the contrary. At the conclusion of its section on vertical mergers the Court implied that the merger may be saved if it produced "any countervailing competitive, economic, or social advantages,"[39] and, in concluding remarks in its consideration of horizontal merger issues, the Court again implied that "no mitigating factors" had been presented in support of the merger.[40] These statements at least leave open the inference that efficiency considerations should be taken into account.

The subsequent judgment of the Supreme Court in *United States* v. *Philadelphia National Bank*[41] has the potential to pose a more significant threat to the evolution of an efficiencies defense. This case concerned a challenge by the government to the proposed merger of Philadelphia National Bank and Girard Trust Corn Exchange Bank, the second and third largest commercial banks headquartered in the Philadelphia metropolitan area. Having concluded that the consolidated bank would control an undue percentage share of the relevant market and that the consolidation would result in a significant increase in concentration, such that competition would be inherently likely to be substantially lessened, the Court turned to consider "three affirmative justifications" advanced by the appellees.[42] One of these adjudications has been viewed as a rejection of the efficiencies defense. Specifically, Justice Brennan stated:

> This brings us to appellees' final contention, that Philadelphia needs a bank larger than it now has in order to bring business to the area and stimulate its economic development. 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,

39. *Id.* at 334.
40. *Id.* at 346. One possible interpretation of this latter statement, however, is that such mitigating factors may be limited to business failure, inadequate resources, or the need for small companies to combine to enter into more meaningful competition.
41. 374 U.S. 321 (1963).
42. *Id.* at 370.

> by Congress when it enacted the amended [section] 7. Congress determined to preserve our traditionally competitive economy. It therefore proscribed anticompetitive mergers, the benign and the malignant alike, fully aware, we must assume, that some price might have to be paid.[43]

Closer analysis of the subject matter of this passage, however, reveals that it should not be viewed as a condemnation of the efficiencies defense. Philadelphia National Bank was arguing that if it was bigger it would attract more customers into the region. This is different than an argument that there would be efficiencies which would benefit competition. Further, Justice Brennan had earlier noted that the appellees' arguments about the achievement of economies of scale had not been mentioned by the District Court and were considered abandoned in these proceedings.[44] Thus, in *Philadelphia National Bank* the Court was not being asked to balance efficiencies against market power. Rather, it was being asked to consider whether benefits to a community, what the Court referred to as "social or economic debits and credits," might justify an otherwise illegal merger.

The final case in the Supreme Court trilogy is *FTC* v. *Procter & Gamble*.[45] In this case, the Federal Trade Commission challenged the acquisition of Clorox Chemical Company, the nation's largest manufacturer of liquid household bleach, by Procter & Gamble Company, the largest producer of soaps, detergents, and related products. The Court characterized this acquisition as a "product-extension merger."[46] The arguments raised by the Commission in this case were essentially concerns about the competitive advantages that the merged entity would be able to achieve. The Court accepted that advertising and sales promotion for the products of both merging firms was vital,[47] and noted with concern "that the merger would facilitate advertising economies."[48] It concluded that the merger had anticompetitive effects for two reasons. First, it substantially reduced the competitive structure of the industry by raising entry barriers and by dissuading smaller firms without comparable marketing power from engaging in aggressive rivalry. Second, it eliminated the acquiring firm as a potential competitor.[49]

Of particular relevance to the efficiencies defense, Justice Douglas stated, "Possible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may

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43. *Id.* at 371 (citation omitted).
44. *Id.* at 334 n.10.
45. 386 U.S. 568 (1967).
46. *Id.* at 570.
47. *Id.* at 573.
48. *Id.* at 574.
49. *Id.* at 578.

also result in economies but it struck the balance in favor of protecting competition."[50]

The *Brown Shoe* opinion was cited as authority for this proposition. On a first reading, this passage appears to negate the possibility of an efficiencies defense. However, more detailed consideration raises questions about the weight that can be attached to this statement. The Court's reliance on *Brown Shoe* and the legislative history of the amendments to section 7 do not, as discussed earlier, provide a clear basis for the proposition advanced in *Procter & Gamble*. Further, the issue of a general efficiencies defense was not in fact placed before the Court. The scope of the purported prohibition of the efficiencies defense is also ambiguous and analytically incomplete. For example, does the fact that "possible economies" are excluded from consideration, mean that more clearly identifiable economies must also be excluded? Additionally, the prohibition in *Procter & Gamble* focuses only upon mergers involving a lessening of competition and fails to contemplate the situation where the economies may enhance competition.[51]

Clearly these three Supreme Court opinions reflect a bias against the evolution of the efficiencies defense. However, for the reasons stated above, it would be wrong to conclude that the Supreme Court has expressly rejected the defense. Several other Supreme Court opinions have, in fact, suggested that efficiencies should be taken into consideration in the general analysis of antitrust, and in relation to section 7 cases in particular. In *Northern Pacific Railway* v. *United States*[52] the Court identified economic efficiency as one of the principal goals of antitrust,[53] and in *United States* v. *Gypsum Co.*[54] economic efficiency was characterized as being procompetitive.[55] The Court, in *Aspen*

50. *Id.* at 580.

51. In considering the weight to be attached to the majority opinion in *Procter & Gamble*, it is also interesting to note Justice Harlan's concurring opinion. At the outset, he suggested that the state of economic knowledge at that time may have been insufficient "to enable a sure-footed administrative or judicial determination to be made *a priori* of substantial anticompetitive effect[s] in mergers of this kind." *Id.* at 599. Justice Harlan further accepted that "economies could be used to defend a merger." *Id.* at 603. Justice Harlan did not apply his analytical framework in the present case because Procter & Gamble failed to present any true efficiencies. *Id.* at 604.

52. 356 U.S. 1 (1958).

53. *Id.* at 4.

54. 438 U.S. 422 (1978).

55. *Id.* at 441 n.16.

Skiing Co. v. *Aspen Highlands Skiing Corp.*,[56] also accepted that monopoly conduct challenged as being exclusionary, anticompetitive, or predatory may be justified on the basis of an efficiency explanation.[57] Finally, the exclusion of an efficiencies defense would also be contrary to the Court's stated desire in its last significant word on section 7 to consider economic evidence in assessing the legality of mergers.[58]

The continuing judicial uncertainty surrounding the efficiencies defense is reflected in the more recent decisions of lower courts. While these cases have not sanctioned any mergers and are divided in their views on the defense, the relevance of efficiencies and the possibility of an efficiencies defense has nonetheless received surprisingly favorable treatment given the Supreme Court's apparent bias against the defense.

The circumstances in which efficiencies have received affirmative comment fall into several categories. First, there is the situation where the government may seek a temporary restraining order or preliminary injunction against a proposed merger. Section 13(b) of the Federal Trade Commission Act conditions the issuance of any such order or injunction to circumstances where "weighing the equities and considering the Commission's likelihood of ultimate success, such action would be in the public interest."[59] In weighing equities, the courts, on a number of occasions, have taken into account various claims of procompetitive efficiencies.[60] In so doing, Justice (then Judge) Ginsburg expressly recognized in *Weyerhaeuser* that "it is permissible for the court to weigh among 'the equities' the potential benefits, public and private, that may be lost by a merger-blocking preliminary injunction, whether or not those benefits could be asserted defensively in a proceeding for permanent relief."[61] A second, and analytically analogous, situation in which efficiencies have received favorable consideration is where the government may enter into consent decrees under which divestiture is agreed upon to restore competitive conditions. One factor which the courts are required to consider under section 2 of the Tunney Act[62]

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56. 472 U.S. 585 (1985).

57. *Id.* at 605-11. *See also* Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 482-83 (1992).

58. *See* United States v. General Dynamics Corp., 415 U.S. 486, 498-504 (1974); United States v. Marine Bancorporation, 418 U.S. 602, 623-42 (1974).

59. 15 U.S.C. § 53(b) (1973).

60. *See* FTC v. Weyerhaeuser Co., 665 F.2d 1072, 1088 (D.C. Cir. 1981); FTC v. Owens-Illinois, Inc., 681 F. Supp. 27, 52-53 (D.D.C. 1988), *vacated as moot*, 850 F.2d (D.C. Cir. 1988); FTC v. Occidental Petroleum Corp., 1986-1 Trade Cas. (CCH) ¶ 67,071, 62,518 (D.D.C. Apr. 29, 1986); FTC v. Great Lakes Chemical Corp., 528 F. Supp. 84, 94 (N.D. Ill. 1981).

61. *Weyerhaeuser*, 665 F.2d at 1083.

62. 15 U.S.C. § 16(e)-(f) (1994).

before entering into any consent judgment is whether such judgment is in the "public interest." It has been accepted that efficiency considerations, such as cost savings, which will enable the merged company to compete more effectively, may be a public interest factor.[63] While none of these cases relating to restraining orders, preliminary injunctions, and consent decrees is directly supportive of the efficiencies defense, they at least reflect favorably upon efficiency considerations as equity and public interest factors.

The final category of recent cases which have commented favorably on efficiencies are those which have been directly concerned with the legality of mergers. These cases have addressed the question of efficiencies, but have not been required to decide upon the legality of the efficiencies defense because the mergers in question have either been found to be legal,[64] or have not involved any convincing claim of efficiencies.[65] The views expressed in these cases relating to efficiency considerations are largely of a general nature. They suggest that efficiencies should be regarded as factors to be considered in assessing postmerger competition. There has been only one case which has expressly advanced the possibility of a defense, namely the judgment of the Eleventh Circuit in *University Health* where Chief Judge Tjoflat stated, "We conclude 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

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63. *See* United States v. LTV Corp., 1984-2 Trade Cas. (CCH) ¶ 66,133, 66,343 (D.D.C. Aug. 2, 1984).

64. *See* United States v. Country Lake Foods, Inc., 754 F. Supp. 669, 680 (D. Minn. 1990) (efficiencies were relevant as a further factor to demonstrate that the merger would enhance competition); United States v. Carilion Health Sys., 707 F. Supp. 840, 849 (W.D. Va. 1989), *aff'd mem.*, 892 F.2d 1042 (4th Cir. 1989) (the merger of two hospitals would result in more efficient operations which would be able to compete more effectively in terms of both price and quality of service).

65. *See* FTC v. University Health, Inc. 938 F.2d 1206, 1222 (11th Cir. 1991) (appellees failed to introduce sufficient evidence of efficiencies to rebut the government's prima facie case); United States v. United Tote, Inc., 768 F. Supp. 1064, 1084-85 (D. Del. 1991) (efficiency claims were insufficient to offset the anticompetitive effects of the merger, with the Court being guided in this finding, in part, by "the reality that even if the merger resulted in efficiency gains, there are no guarantees that these savings would be passed on to the consuming public"); American Medical Int'l, Inc., 104 F.T.C. 1, 219-20 (1984) (noted that efficiencies should be taken into account in antitrust analysis in general and, in particular, under section 7, but concluded on the facts that there was no establishment, with any certainty, that substantial efficiencies existed), *modified*, 104 F.T.C. 617 (1984), *and modified*, 107 F.T.C. 310 (1986).

market."[66] Following a critical review of the Supreme Court opinions discussed above, Chief Judge Tjoflat also concluded, "Thus, evidence that a proposed acquisition would create significant efficiencies benefiting consumers is useful in evaluating the ultimate issue—the acquisition's overall effect on competition. We think, therefore, that an efficiency defense to the government's prima facie case in section 7 challenges is appropriate in certain circumstances."[67]

Notwithstanding these cases, which have at least reflected favorably on efficiencies and the possibility of an efficiencies defense, there has also been continued doubt about the defense. For example, in *United States v. Rockford Memorial Corporation*[68] the Court cited *Philadelphia National Bank* as authority for the proposition that its "exclusive role is to evaluate the merger's effect on competition for the relevant market and no more."[69] The Court nonetheless reviewed the efficiency arguments advanced by the defendants, and concluded that most of these claimed efficiencies should be rejected because they could be realized by means other than merger.[70]

Thus, the judicial treatment of efficiencies and the notion of an efficiencies defense is inconclusive. On closer examination, earlier Supreme Court opinions, while suggestive of a bias against efficiencies, may not preclude the possibility of the defense. The most recent decisions generally reflect a willingness to explore efficiencies. However, it seems likely that judicial uncertainty will remain until such time as the Supreme Court provides a definitive ruling on the defense.

III. THEORETICAL FOUNDATIONS

A. *Efficiency as a Goal*

Assuming that the defense is not precluded, it is next appropriate to consider its theoretical foundations. The logical starting point is to consider the relationship of the defense to the goals of antitrust. There

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66. 938 F.2d at 1222.

67. *Id.* The Court did qualify this proposition to some extent by stating that it was unnecessary to define the parameters of the defense because the appellees had failed to demonstrate significant efficiencies. The Court did note, however, that some limit may need to be placed on the defense, such as the need to establish that the efficiencies could not be achieved by other means. *Id.* at n.30.

68. 717 F. Supp. 1251 (N.D. Ill. 1989), *aff'd*, 898 F.2d 1278 (7th Cir.), *cert. denied*, 111 S. Ct. 295 (1990).

69. *Id.* at 1288-89. *See also* United States v. Rice Growers Ass'n, 1986-2 Trade Cas. (CCH) ¶ 67,287, 61,458 (E.D. Cal. Jan. 31, 1986) (containing arguments relating to beneficial effects rejected on the basis of *Philadelphia National Bank*).

70. *Rockford Memorial Corp.*, 717 F. Supp. at 1290-91.

has been considerable debate on the goals of antitrust. Much of this debate has centered upon the place of efficiency in the scheme of antitrust.[71] While it is generally agreed that antitrust laws are designed to promote competition, questions remain about why the competitive process is valued as highly as the ultimate goals of antitrust. Various goals have emerged over the first one hundred years of antitrust law in the United States, and there is, no doubt, considerable wisdom in the recent reflections of Professor Milton Handler that "eternal verity cannot, in an ever-changing world, be ascribed to any one school."[72]

A detailed discussion of the goals of antitrust is beyond the scope of this Article. Rather, the issue is significant in the present context because of its importance to the theoretical foundations of the efficiencies defense. If efficiency is accepted as a proper goal of antitrust, then it is logical that the efficiencies defense should be acceptable in theory. However, the recognition of other goals will clearly impact on the treatment of efficiencies claims in certain cases. Where efficiencies and the other goals are not in conflict, no theoretical problems appear to emerge. But an inherent conflict frequently exists between efficiencies and the other recognized goals. In such circumstances, which values should prevail?

While the advocates of the efficiency school of thought have proclaimed victory in the debate,[73] such pronouncement is premature. A brief outline of the interpretative problems relating to the antitrust statutes and, in particular to section 7 of the Clayton Act, demonstrates why this is so.

In assessing the goals of antitrust law in the United States, the matter is not exclusively one of economic theory. Rather, the relevant inquiry has its genesis in the open-ended provisions of the antitrust statutes. Fundamental terms such as "competition," "restraint of trade," "monopolize," and "unfair methods of competition" are, without further definition, inherently vague. In such circumstances, principles of statutory

71. For discussions of a range of views about the goals for antitrust, see Harlan M. Blake et al., *The Goals of Antitrust: A Dialogue on Policy*, 65 COLUM. L. REV. 363 (1965); John J. Flynn, *Antitrust Jurisprudence: A Symposium on the Economic, Political and Social Goals of Antitrust Policy*, 125 U. PA. L. REV. 1182 (1977). *See also Symposium on Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485 (1980).

72. Milton Handler, *Antitrust Exchange*, 66 N.Y.U. L. REV. 1257 (1991).

73. *See, e. g.*, ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF ix-xiv, 426-29 (1993 ed.).

interpretation require analysis of legislative history to ascertain Congressional intent. Furthermore, where appropriate, such principles also require a prediction of what Congress would have wished had it considered a particular issue.[74] These interpretative issues are important in the present context because, when Congress first enacted antitrust laws in 1890, efficiency considerations did not receive any particular attention. The subsequent enactment of antitrust laws similarly did not focus on efficiencies. Indeed, Congress could not have had any appreciation of the new economic theories at the time it enacted these laws. Against this background, it is not surprising that conflicting views have emerged regarding the goals of antitrust.

Notwithstanding certain "populist" goals, such as the protection of small businesses and the dispersion of economic power, which have figured in the legislative history of the antitrust laws, particularly in relation to the merger laws,[75] the current debate about the goals of antitrust focuses upon two economic goals. One school of thought, commonly referred to as the "Chicago school," states that antitrust laws should promote allocative efficiency.[76] Many scholars of this persuasion view allocative efficiency to be an absolute goal.[77] Recently, a rival theory has emerged that antitrust laws should primarily be viewed to further what may be called a distributive goal which would prevent

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74. *See, e.g.*, Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir. 1975), *cert. denied*, 423 U. S. 1018 (1975) where it was noted: "We freely acknowledge that if we were asked to point to language in the statutes, or even in the legislative history, that compelled these conclusions, we would be unable to respond . . . . Our conclusions rest on case law and commentary . . . and on our best judgment as to what Congress would have wished if these problems had occurred to it." *Id.* at 993. Robert Bork states that "A legislature may never address the issue of ultimate policy goals and yet write a law whose various categories and distinctions can be explained only by a particular policy. That policy may then quite legitimately be said to have been intended by the legislature, even though not a single member articulated it even to himself." BORK, *supra* note 73, at 57. Professors Areeda and Turner state:

> [I]n formulating rational antitrust rules and presumptions concerning various kinds of business conduct and market structures, one must pay close attention to what developing economic analysis and empirical studies have to say about them. Rational antitrust interpretation must be prepared to modify, retract, or expand its prohibitions when new economic insights strongly suggest that past rules no longer serve antitrust objectives.

1 AREEDA & TURNER, *supra* note 31, at 31.

75. For a discussion of the populist goals relating to the Celler-Kefauver amendments to section 7 of the Clayton Act, see Bok, *supra* note 29, at 233-38.

76. *See infra* part III.B. for a discussion of this concept.

77. *See, e.g.*, BORK, *supra* note 73, at 50-89; RICHARD A. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 8 (1976); 1 AREEDA & TURNER, *supra* note 31, at 7-33.

the unfair acquisition of consumers' wealth by firms with market power.[78] This school of thought views consumers' surplus[79] as the rightful entitlement of consumers.

The division between these schools of thought centers, in large part, upon their different interpretation of what Congress meant when it referred to the concept of consumer welfare.[80] While this debate has concentrated on the Congressional concerns leading to the enactment of the Sherman Act in 1890, the same policy issues were discussed in the deliberations leading to the enactment of the Federal Trade Commission Act and the Clayton and Celler-Kefauver Acts.[81]

Those who advance allocative efficiency as the exclusive goal of antitrust assert that "the only legitimate goal of antitrust is the maximization of consumer welfare."[82] In this context it is suggested that:

> Consumer welfare is greatest when society's economic resources are allocated so that consumers are able to satisfy their wants as fully as technological constraints permit. Consumer welfare, in this sense, is merely another term for the wealth of the nation. Antitrust thus has a built-in preference for material prosperity, but it has nothing to say about the ways prosperity is distributed or used. Those are matters for other laws.[83]

However, in more recent times the legislative justification for this view has been challenged on the basis that "[g]iven the state of economic theory at that time, the assertion that legislators supporting the Sherman Act were influenced by considerations involving allocative efficiency is without credibility."[84] Rather, it has been suggested that a proper review of the Congressional debates discloses a condemnation

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78. *See, e.g.*, Robert H. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 HASTINGS L.J. 65 (1982).

79. *See infra* part III.C. for a discussion of this concept.

80. The term "consumer welfare" has been referred to as "the most abused term in modern antitrust analysis." Joseph F. Brodley, *The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress*, 62 N.Y.U. L. REV. 1020, 1032 (1987). It can have a variety of meanings. It can refer to economic efficiency (in which case the term seems unnecessary). It can also refer to some other undefined consumer interest or to consumers' surplus.

81. *See* Lande, *supra* note 78, at 106-42.

82. BORK, *supra* note 73, at 7. *See also* 1 AREEDA & TURNER, *supra* note 31, at 7.

83. BORK, *supra* note 73, at 91. *See also* POSNER, *supra* note 77, at 8-18.

84. Lande, *supra* note 78, at 89. *See also* Louis Kaplow, *Antitrust, Law & Economics, and the Courts*, LAW & CONTEMP. PROBS., Autumn 1987, 181, 207-08.

of trusts and monopolies because of their ability to use market power to raise prices and extract wealth from consumers. Thus, in considering the concept of consumer welfare as Congress would have understood it back in 1890, it has been suggested that the primary concern was to ensure that consumers received the benefit of consumers' surplus.[85]

Ultimately, in determining the goals of antitrust, the courts will need to recognize the "dynamic potential" of the legislation.[86] They will also need to objectively assess likely economic consequences having regard to current policies. The most recent commentaries reflect the potential that preference may be given to a consumer surplus-based standard.[87] If greater weight is to attach to concerns about wealth transfer than to efficiencies, this need not result in a rejection of the defense. However, as will be discussed later,[88] it will have the potential to impact, in a fundamental way, how the defense may be formulated and how it may apply in situations where the goals of efficiency and wealth transfer are in conflict.

B. Efficiency as a Concept

Before advancing to consider in more detail the specific theoretical foundations and possible elements of the efficiencies defense, it is convenient, by way of background, to reflect on the technical meanings that can be given to the concept of efficiencies. There are two key issues relevant to the present inquiry. First, what are the recognized components of efficiency, and second, what comparative weight should attach to each of these components?

The concept of efficiency has received some analysis in the industrial organization economics literature. However, such analysis of this fundamental economic concept is not as advanced as may be expected. Generally speaking, economists view economic efficiency as referring to an event that increases the total value of all economically measurable assets in society. Economists divide the concept of efficiency into three components: Productive, allocative, and innovative efficiencies. These categories assist in recognizing the different efficiency qualities that may result from events such as horizontal mergers.

Productive efficiency can best be explained with reference to the ratio of a firm's output to its inputs. Thus, if two firms are selling the same

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85. Lande, *supra* note 78, at 93-96.
86. *See* Business Elec. Corp. v. Sharp Elec. Corp., 485 U.S. 717, 732 (1988).
87. *See, e.g.*, ROSS, *supra* note 12, at 8-11; Herbert Hovenkamp, *Legislation, Well-Being, and Public Choice*, 57 U. CHI. L. REV. 63, 74-94 (1990); HOVENKAMP, *supra* note 12, at 48-71.
88. *See* discussion *infra* parts III.C., IV.C.2.

product at $100, one will be more efficient than the other if it functions on a lower level of inputs. Within the horizontal merger context, productive efficiency will be achieved if the merger results in a more cost-effective combination of productive resources of the merging firms than would be the case should they remain independent. A common example may be the merger of two firms each operating below minimum efficient scale. The merger of such firms may result in the reduction of long run average costs and this may lead to higher returns and the potential for the merged firm to become a more potent competitive force through, for example, reorganization of its plant. It was this category of efficiency which appeared to be the focus of attention in *Brown Shoe* and *Procter & Gamble*.

Allocative efficiency is a more theoretical concept and is not self-defining in the same way as productive efficiency. It refers to the welfare of society as a whole in the sense of the placement of resources in the economy where consumers will most value their output. The concept can be explained in terms of a pricing system whereby the output of resources will be allocated to those buyers who value them most in terms of willingness to purchase the output or forego other consumption.[89] Allocative efficiency is achieved when output is priced at marginal cost. There are two critical components in assessing the impact of an horizontal merger in allocative efficiency terms. The first is the elasticity of demand, and the second relates to the ability of the merged entity to reduce output or raise price. As will be discussed later, these variables give rise to serious measurement concerns.[90]

The final category, innovative efficiency, relates, as its language suggests, to achievements that will be made through invention, research and development, and the like.[91] In the horizontal merger context, the question to be posed is "How does the proposal enhance innovative efficiency?"

From this brief outline of the three recognized components of efficiency, it will be obvious that comparative assessments about the importance of each is likely to involve theoretical controversy. For

89. *See* BORK, *supra* note 73, at 91-104; SCHERER & ROSS, *supra* note 2, at 19-29.
90. *See* discussion *infra* part IV.C.1.
91. In this context, it is interesting to note the recent argument of Pitofsky that there is the need for a new research and development defense to otherwise unlawful mergers. *See* Pitofsky, *supra* note 7, at 240-44.

example, Professor Joseph F. Brodley has recently challenged the traditional wisdom that allocative efficiency is the primary efficiency goal. While recognizing that such efficiency does maximize social wealth at a given point in time, he argues that innovative and productive efficiencies provide "a more powerful contribution to social wealth because they comprise the growth factors by which social wealth increases over time."[92] This debate serves to illustrate the problems that would be inherent in any attempt to define an efficiencies defense based on differently weighted efficiency components. However, it is a debate which need not take place in the framing of any judge-made efficiencies defense. First, the categories of efficiency are not necessarily in conflict,[93] and second, rules can evolve without any need to resolve this debate. Each recognized form of efficiency will be considered in assessing the aggregate level of efficiencies, and there is no apparent need in this exercise to prefer one form of efficiency over another. In any event, and particularly in the case of premerger analysis, the likely efficiency claims will be exclusively productive and innovative in character.[94]

C. *Efficiencies Defense in Principle*

Having outlined the relationship of the efficiencies defense to the goals of antitrust, and having considered the general characteristics attributable to efficiencies claims, it is next appropriate to consider the specific theoretical foundations which may apply to the defense in the merger context.

The issue of the efficiencies defense will arise in cases where the combined market shares of the merging firms will be presumptively unlawful, and where such illegality is further indicated by existing concentration levels and the absence of other factors which may rebut the presumption, such as low entry barriers. Theoretically, where such mergers are also likely to result in significant efficiency gains, competi-

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92. Brodley, *supra* note 80, at 1027.

93. The concepts of allocative and productive efficiency co-exist in that "[t]he whole task of antitrust can be summed up as the effort to improve allocative efficiency without impairing productive efficiency so greatly as to produce either no gain or a net loss in consumer welfare." *See* BORK, *supra* note 73, at 91. The concepts of productive and innovative efficiency are also compatible to the extent they relate to the growth of future social wealth. *See* Brodley, *supra* note 80, at 1026-28.

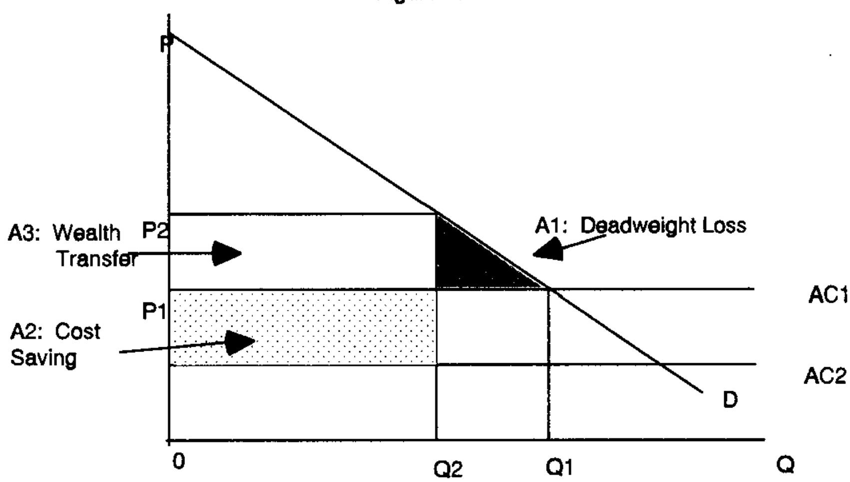
94. For example, that the merger will: (a) Involve plant rationalization; (b) result in the reduction of long run average costs; (c) combine head office and related functions; and (d) enhance research and development opportunities. Other claims such as distribution savings (and presumably enhanced export distribution opportunities), reductions in the cost of capital, and superior management will also be frequently made.

tion may be enhanced, prices may not rise and there may be an improvement in resource allocation. However, viewed from a premerger perspective, such predictions will be difficult to make. Not surprisingly, the scholarship relating to the efficiencies defense has concentrated on the situation where there may be an increase in market power which may result in a reduction in output and an increase in price.

Two divergent views have emerged in relation to this difficult theoretical question. The conflict between these views centers upon whether allocative efficiency or the prevention of wealth transfers is the preferred goal of antitrust. Economists have developed a model which adopts the former goal. However, the potential application of this model to provide a legal solution has been challenged in terms of its failure to account for issues relating to consumers' surplus and its inability to provide a practical framework for legal application.

The economic analysis centers upon Williamson's tradeoff model, which can be explained with reference to Figure 1.[95]

Figure 1.



95. *See* Williamson, *Economies/Welfare Tradeoffs, supra* note 6, at 21; Williamson, *Defense Revisited, supra* note 6, at 707.

This diagram illustrates the effects of a postmerger increase in market power. As a result of this increase, the firm will reduce its output from Q1 to Q2, and price will correspondingly increase from P1 to P2. Triangle A1 represents the deadweight loss which will result from this reduction in output and increase in price.

However, at the same time, the merger produces theoretically measurable economies, which result in a reduction in the firm's costs from AC1 to AC2. Rectangle A2 represents the cost savings to be achieved from these economies. Williamsonian analysis asserts that if A2 is larger than A1, the merger will produce a net efficiency gain, even though it permits the firm to raise its price above its marginal cost. A2 will often be larger than A1 because the efficiency gains illustrated by A2 are spread over the entire output of the firm postmerger. In contrast, the deadweight losses in A1 are spread over only the reduction in output. Williamson calculated that in a market with average elasticities of demand and supply, a merger that produced "non-trivial" economies of 1.2% would be efficient, even if it resulted in an increase in price of 10%.[96]

Williamson's model has become recognized as the appropriate economic analysis of the tradeoff between efficiencies and market power. In essence, the framework is the standard economic methodology of maximizing economic efficiency. Thus, the gains from a merger are the decreases in resource costs of the merged firm and the losses are the standard deadweight losses of monopoly. The deadweight loss arising from decreased production can usually be outweighed by the cost savings that will extend to all products actually manufactured. The model, while attractive for its simplicity, is not however without significant qualification. Indeed, Williamson himself referred to it as "naive" and stated a range of qualifications.[97]

Much has been written about the accuracy and workability of the Williamson model.[98] Such qualifications impact in a significant way on the utility of the model in the legal context. For present purposes, the most critical qualifying factor relates to Williamson's terms of reference concerning income distribution. Williamson refers to the

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96. Williamson, *Economies/Welfare Tradeoffs*, *supra* note 6, at 22-23; Williamson, *Defense Revisited*, *supra* note 6, at 708-09.

97. Williamson, *Economies/Welfare Tradeoffs*, *supra* note 6, at 23-33; Williamson, *Defense Revisited*, *supra* note 6, at 710-13.

98. *See, e.g.*, BORK, *supra* note 73, at 109-15; Muris, *supra* note 26, at 388-93; HOVENKAMP, *supra* note 12, at 425-55; Fisher & Lande, *supra* note 26, at 1624-51; Alan A. Fisher et al., *Price Effects of Horizontal Mergers*, 77 CAL. L. REV. 777, 794-809 (1989).

distribution of profits between consumers and producers as "a matter of indifference"[99] and asserts that the "transformation of benefits from one form (consumers' surplus) to another (profit) is treated as a wash under the conventional welfare economics model."[100] While there may be strong support for such a notion if economic efficiency is the sole goal of antitrust,[101] such proposition clearly strikes difficulties within the legal context if this is not the case. If the courts consider that they should take wealth transfer issues into account, questions must inevitably be asked about how such wealth transfers or consumers' surplus (represented by rectangle A3) should be factored into the equation. That Williamson's analysis does not account for income distribution renders his model potentially redundant if this approach is adopted.

Some consideration has been given to how the model may be adjusted to account for this factor, but such attempts have failed to find an appropriate solution.[102] The most obvious solution would be to require that the tradeoff be calculated on the basis that the cost savings (represented by rectangle A2) will outweigh both the deadweight loss and consumers' surplus (represented by rectangles A1 and A3). However, because of the likely magnitude of consumers' surplus in any given case, and the corresponding impact that this would have on the equation, this approach has not yet been advocated.[103] It has, however, been suggested that a price standard can be applied to the Williamson model whereby efficiency gains may be taken into account in circumstances where they are sufficient to prevent prices from rising.[104]

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99. Williamson, *Economies/Welfare Tradeoffs*, *supra* note 6, at 27.

100. Williamson, *Defense Revisited, supra* note 6, at 711.

101. *See, e.g.*, BORK, *supra* note 73, at 110-12 (explaining that the Williamson model addresses the total welfare of consumers as a class, noting that shifts in income distribution do not lessen total welfare and suggesting that decisions about the beneficiaries of wealth should be made by the legislature rather than the judiciary).

102. *See* Fisher & Lande, *supra* note 26, at 1631-34; Fisher et al., *supra* note 98, at 794-809.

103. *See* Paul S. Crampton, *The Efficiency Exception for Mergers: An Assessment of Early Signals from the Competition Tribunal*, 21 CAN. BUS. L.J. 371, 389 n.56 (1993).

104. *See* Fisher et al., *supra* note 98, at 796. A further theory which is currently being developed, and which has the potential to impact significantly on this question of consumers' surplus if it is accepted, is that efficiency improvements may offset the loss of consumers' surplus resulting from an increase in price. Professors Gary Roberts and Steven Salop argue that rivals will attempt to overcome the competitive advantages created by merger-specific efficiencies by attempting to imitate those efficiencies or by attempting to emulate them by achieving other efficiencies. For a discussion of the

However, this proposition is questionable in circumstances where the merged firm will have the ability to reduce output. Furthermore, it is difficult to imagine that such a price standard, which in essence requires the maintenance of price at level P1, is capable of forming the basis of a workable legal rule. Difficult questions will emerge concerning the time frame for monitoring the price standard and the circumstances, if any, in which upward adjustments may be made.

There are other significant qualifications to the Williamson model, apart from wealth transfer considerations. Detailed discussion of these is beyond the scope of this Article, but several examples illustrate the point. The model assumes a static context which does not account or provide for changes in product quality, or an accurate analysis over an appropriate length of time.[105] Wider industry analysis will also be required to assess the net social costs or benefits of a merger. Such analysis could either support or detract from the tradeoff calculation. For example, if the merged firm was large relative to the industry, it may provide a price structure under which others would be required to behave competitively.[106] But equally, significant concentration could raise the probability of industry-wide collusion.[107]

IV. TOWARDS A DEFENSE

A. *Outline*

Against the background of the uncertain theoretical foundations to the efficiencies defense, attempts to formulate the structure and elements of the defense will involve a number of complex issues. While there may be no necessity to distinguish between the various forms of efficiency, the major concern is how to accommodate the situation where efficiency and the transfer of consumers' wealth are in conflict. No matter how compelling the efficiencies claims may be, it is difficult to imagine that courts will neglect consumers' surplus concerns having regard to the legislative history of the antitrust laws. But, how to account for such concerns and balance these with the efficiency claims will prove a

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unpublished draft study of Roberts and Salop, see Joseph Kattan, *Efficiencies and Merger Analysis*, 62 ANTITRUST L.J. 513, 522-27 (1994). The argument has certain attractions in the context of developing an appropriate economic framework. However, its translation into a test of legal application has the potential to involve insurmountable problems because it will be impossible to predict, let alone attempt to calculate, the likely imitation and emulation responses of rivals.

105. *See* Fisher & Lande, *supra* note 26, at 1634-36.

106. *See* Williamson, *Economies/Welfare Tradeoffs*, *supra* note 6, at 27.

107. *See* Fisher & Lande, *supra* note 26, at 1636-38.

difficult task. There is no clear solution to how these conflicting values can be accommodated in a test of universal application.

There are two structural options for the efficiencies defense, namely a net efficiencies test and an absolute test. This section considers whether a net efficiencies test or an absolute test should be adopted. It then addresses three problems which are likely to be most controversial in relation to the defense, whether it be a net efficiency or an absolute defense. These issues are: (1) Whether the defense should be rejected because of measurement ambiguities; (2) whether the defense should set a distributional standard requiring that cost savings be passed on to consumers; and (3) whether the defense should be available if the claimed efficiencies can be achieved by other means such as internal expansion or joint ventures. Finally, consideration will be given to the role of enforcement discretion, a matter which will assume particular significance if judicial treatment of the defense does not advance beyond the current position.

B. *Structure of the Defense*

If the defense is adopted by the courts, the initial debate is likely to relate to its structure. This issue is allied to questions about measurement ambiguity.[108] The various qualities of a net efficiency and an absolute defense will require consideration. The distinction between these tests may not always be clear in their formulation,[109] but the two approaches clearly have the potential to apply in different ways.

The net efficiency test is likely to be open-ended in its application.[110] Under this test concentration levels significantly in excess of

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108. *See infra* part IV.C.1.

109. It is interesting to note that there is still debate about the nature of the failing company defense, whether it be absolute or a factor to be weighed against the test of presumptive illegality, notwithstanding that the defense was first recognized by the Supreme Court back in 1930. *See* Walthall, *supra* note 24, at 59-62; Friedman, *supra* note 24, at 1398-99.

110. Different versions of net efficiency tests are to be found in some foreign jurisdictions. For example, (a) Canada: § 96 of the Competition Act 1986 (Can.) prevents the Competition Tribunal from making an order in respect of a merger if it "has brought about or is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger." Competition Act 1986 § 96 (Can.). For a discussion of the elements of this provision see PAUL S. CRAMPTON, MERGERS AND THE COMPETITION ACT 495-554 (1990). To date, § 96 considerations do

those which raise presumptive illegality concerns under the *Merger Guidelines* may be lawful because the magnitude of the claimed efficiencies will rebut the presumption of illegality. Some may prefer this approach because it will provide courts with greater flexibility. But equally, it may increase business uncertainty in circumstances where widely divergent outcomes have the potential to emerge. Such uncertainty may well raise compliance costs as firms endeavor to identify mergers which will be acceptable under the antitrust laws. Attempts to analyze such issues may also, in the context of a broad net efficiency test, present insurmountable problems for the firm and its advisers. Ultimately, such uncertainty may also deter firms from engaging in merger activity.[111] Depending upon the caution with which the courts may apply a net efficiencies defense, there is also the potential for considerable debate to emerge about the levels of market power which may be permitted to result from mergers.

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not appear to have been particularly influential in the few cases which have considered them. See Donald G. McFetridge, *The Prospects for the Efficiency Defence*, 26 CAN. BUS. L.J. 321 (1996). (b) Germany: Section 24(3) of the Gesetz gegen Wettbewerbsbeschraenkungen provids that the Federal Minister of Economics may permit mergers which have been vetoed by the Federal Cartel Office where "the restraint of competition is outweighed by advantages to the whole economy resulting from the merger or if the merger is justified by a predominating public interest." The Minister has intervened in very few cases. *See* James F. Ponsoldt and Christian Westerhausen, *Competition and/or Efficiency: A Review of West German Antimerger Law as a Model for the Proposed Treatment of Efficiency Promotion Under Section 7 of the Clayton Act*, 9 NW. J. INT'L L. & BUS. 296, 326-31 (1988). (c) Australia and New Zealand: In both Australia and New Zealand mergers that would otherwise breach the relevant competition thresholds may be authorized on public benefit grounds by the Australian Trade Practices Commission and the New Zealand Commerce Commission. *See* Trade Practices Act 1974 § 90(9) (Austl.); Commerce Act 1986 § 67 (N.Z.). The concept of public benefit has been held to include efficiencies considerations in both jurisdictions. *See In re* Queensland Coop. Milling Ass'n Ltd., 8 A.L.R. 481, 516 (1976); Telecom Corp. of N.Z. Ltd. v. Commerce Commission, 3 New Zealand Bus. L. Cases (CCH) ¶ 99-239, at 102,385 (Dec. 10, 1991). Sec. 3A of the Commerce Act 1986 (N.Z.) further provides that efficiencies must be taken into account in determining the public benefit. Nine mergers have been authorized on public benefit grounds in Australia. For a discussion of these decisions, see Australian Trade Pracs. Rep. (CCH) ¶¶ 8-637 to 8-642 and 8-644 to 8-646 (1995). Six mergers raising dominance concerns have also been authorized in New Zealand on public benefit grounds. *See In re* New Zealand Coop. Dairy Co. Ltd - Auckland Coop. Milk Producers Ltd. 1 New Zealand Bus. L.Cases (CCH) ¶ 99-518 (Commerce Commission Apr. 26, 1988); *In re* Natural Gas Waikato Limited, Commerce Commission Decision 217 (May 24, 1988); New Zealand Coop. Dairy Co. Ltd. v. Commerce Commission 3 New Zealand Bus. L. Cases (CCH) ¶ 99-219 (Aug. 7, 1991); *In re* Kiwi Coop. Dairies Ltd., Commerce Commission Decision 267 (Apr. 9, 1992); *In re* Natural Gas Corp. of N. Z. Ltd., Commerce Commission Decision 269 (Oct. 29, 1992); Enerco New Zealand Ltd., Commerce Commission Decision 272 (Dec. 22, 1993).

111. *See* Fisher & Lande, *supra* note 26, at 1654-56.

In contrast, the defense in an absolute form will, while limiting its potential scope, result in greater certainty and preclude the potential for the defense to have sweeping application. Several attempts have been made at formulating an absolute efficiencies defense. For example, Professors Areeda and Turner suggest the following absolute defense:

> 1. The defense should not be available where market demand is growing substantially, unless entry clearly is easy.
> 2. The defense should be limited to cases in which both merging firms suffer from substantial cost disadvantages of 5 percent, or more, from diseconomies of scale.
> 3. The defense should be limited to economies in (a) plant size, (b) plant specialization, where there is product complementarity and the diseconomies extend to 70-80 percent of the firm's output; and possibly economies in (c) distribution, (d) research and development, and (e) promotion, though in each of the last three instances, the case is weak and there are qualifications.[112]

The approach suggested by Areeda and Turner has not been embraced in subsequent suggested formulations of an absolute defense.[113] Rather, given the difficulties in recognizing the impact of efficiencies, the view is emerging that it will be most appropriate to implicitly incorporate efficiencies into the analysis by raising the market share thresholds of presumptive illegality.[114] Clearly, such an approach will not be capable of properly recognizing and giving appropriate weight to all relevant efficiency gains. However, from the point of view of certainty and predictability the approach will have its advantages, depending on how readily the relevant market may be identified. Furthermore, such an approach has the potential to simplify the litigation process and generally to reduce compliance costs. Professor Robert Pitofsky has provided the most recent suggestion of an absolute formulation of the efficiencies defense. He submits that:

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112. 4 AREEDA & TURNER, *supra* note 31, at 147-48. Certain other proof requirements also form part of this test. *Id.* at 148.

113. Indeed, certain aspects of the Areeda and Turner formulation have been questioned. It has been suggested that it is inappropriate to limit the application of the defense to markets that are declining, stable or expanding very slowly. *See* Pitofsky, *supra* note 7, at 221. In this context the Areeda and Turner test may be challenged by its implicit recognition that the possibility of internal expansion may preclude the application of the efficiencies defense. It has also been suggested that the defense should be available where the potential cost savings are at a lower level than five percent, such as one to two percent. *See* Muris, *supra* note 26, at 418.

114. *See* Fisher & Lande, *supra* note 26, at 1669-77. Areeda and Turner reject the need for market shares to be factored into the formulation of any absolute efficiencies defense. *See* 4 AREEDA & TURNER, *supra* note 31, at 197.

> In any market where postmerger concentration is moderate, and the combined company after the merger would hold less than thirty-five percent of the market, a horizontal merger should be legal if the defendants can clearly support the claim that production efficiencies leading to a substantial reduction in unit costs will result and these efficiencies could not be achieved through a much less restrictive alternative.[115]

Given the complexity of the efficiencies defense and the uncertainty that may attach to any unlimited formulation of the defense it seems likely that, if the defense is to develop, it will do so in some absolute form. The Pitofsky formulation provides a suitable starting point if this approach is adopted, although the question will inevitably arise whether the thirty-five percent market share level is appropriate. Such an approach is likely to be viewed as the best practical option, although clearly it will be open to criticism to the extent that it may not give appropriate weight to claimed efficiencies in any given case.

C. Three Problems

1. Measurement Ambiguities

Judge (then Professor) Posner has referred to efficiencies as "an intractable subject for litigation."[116] This is the generally acknowledged view,[117] and indeed, problems surrounding the measurement of efficiencies have even caused leading Chicago school scholars to reject the efficiencies defense.[118]

To begin, there are information problems. The merging firms may be the only potential source of information about the claimed efficiencies. Clearly, they will have the incentive to exaggerate their efficiency claims and to ignore any potential diseconomies or other costs. Confidentiality issues may also impact upon the flow of information and the weight that

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115. Pitofsky, *supra* note 7, at 218. It is also possible to interpret one other suggested formulation of the defense as absolute. Muris suggests that measurement difficulties should not preclude the application of the defense and that the merger should be judged to be procompetitive in a showing of "nontrivial economies." This seems an extreme formulation which is unlikely to receive judicial acceptance. *See* Muris, *supra* note 26, at 419-26.

116. POSNER, *supra* note 77, at 112.

117. Some economists may suggest that efficiencies are quantifiable. *See, e.g.*, Avi Weiss, *Using the Efficiencies Defense in Horizontal Mergers*, 37 ANTITRUST BULL. 123 (1992). However, such attempted formulations of the defense do not provide an appropriate framework for legal analysis.

118. BORK, *supra* note 73, at 124-29; POSNER, *supra* note 77, at 112.

can be attached to it.[119] A further problem is the speculative nature of the claims. Such claims will typically be made in a premerger context in which the decision-makers can do no more than predict future industry outcomes.[120] It is, therefore, inevitable that efficiency claims should be viewed with skepticism and treated with caution.

Different levels of measurement ambiguities arise in relation to the net efficiency and absolute defense tests suggested above. Indeed, the absolute defense proposals have been advanced in large part for the reason that they will lead to greater certainty in the decision-making process.

It is generally acknowledged that the Williamson tradeoff model does not have practical application in analyzing individual merger proposals. Professor Robert H. Bork states the reasons for this:

> Possibly accurate measurement of the actual situation [involving the measurement of efficiencies and deadweight loss] is not even a theoretical possibility; much less is there any hope of arriving at a correct estimate of the hypothetical situation. Consider two of the factors that would have to be known: The demand curve over all possible relevant ranges of output and the marginal cost curve over those same ranges. Only by knowing where marginal cost and demand intersect could one know whether there was a restriction of output and what its size was. Nobody knows these curves. Even the companies involved do not . . . .
>
> There is a good reason why firms do not know these things, and it is the same reason why they cannot be known through an antitrust trial. The demand curve is not known because it changes continually and because the company is not constantly plotting it by running its prices up and down. The attempt to do so might make a minor contribution to science, but quite a research grant would

119. For further discussion of information problems, see Dennis A. Yao & Thomas N. Dahdouh, *Information Problems in Merger Decision Making and Their Impact on Development of an Efficiencies Defense*, 62 ANTITRUST L. J. 23, 28-35 (1993).

120. Such problems may be overcome under a regime, such as Canada's, where mergers may be conditionally cleared and then subsequently reviewed to determine if the claimed efficiencies have eventuated. However, there is strong opposition to such an approach in the U. S. Postmerger evidence may not be reliable, because the merged firm can manipulate prices and costs. Market outcomes, such as the departure of a rival, are also beyond the control of the merged firm. There is also a strong judicial reluctance to supervising future industry conduct and a concern that a policy of postmerger analysis may discourage firms from engaging in merger activity. For further discussion of the case against postmerger review, see Pitofsky, *supra* note 7, at 222-27. *Cf.* Brodley, *supra* note 80, at 1048-53 (arguing that there should be a two-stage procedure: First, analyze whether the efficiencies were plausible; second, an ex post inquiry to determine if, in fact, the promised efficiencies had resulted).

be required, since the losses incurred in an attempt by a major company might make serious inroads on the resources of even the Ford Foundation.[121]

But allocative efficiency claims are seldom likely to be advanced in justification of a merger, particularly in the premerger setting. Rather, a range of productive and innovative efficiency claims will typically be advanced. The most compelling claim for the efficiencies defense arises where each of the merging firms is operating below minimum efficient scale and where there is product complementarity. While there may not be definitive data available to prove that each firm's plant is substantially below the size necessary for minimum cost production, it has been suggested that sufficiently reliable information should be available and that "the practical problems in proving diseconomies of plant size do not appear to be sufficiently serious to warrant disregarding the defense on that score alone."[122]

Other less compelling efficiency claims are also likely to emerge such as distribution economies, promotional economies, economies in research and development, capital cost economies, and the introduction of superior management. Apart from the validity of, and qualifications which may need to be attached to, a number of these claims in the context of an efficiencies defense,[123] they each (with the possible exception of capital cost economies) raise complex issues of proof. Distribution economies involve economies of integration of a transaction cost variety, and these are typically difficult to quantify.[124] In the case of promotional economies, the relationship between promotional expenditure and revenue returns is uncertain.[125] Research and development economies are particularly problematic from a proof point of view,[126] as are claims about superior management.[127]

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121. BORK, *supra* note 73, at 125-26.

122. 4 AREEDA & TURNER, *supra* note 31, at 176. Areeda and Turner also suggest that a strong claim of efficiency can be made based on plant specialization economies where product complementarity requires offering a range of products and where small firms suffer diseconomies over a high proportion of their output. They do not envision significant proof problems attaching to such claims. *Id.* at 178-81.

123. Areeda and Turner challenge the validity of claims about capital cost economies because they are likely to be either small or realizable by other means; they also submit that claims about superior management cannot be accepted in the context of the defense. They attach a range of prerequisites to their acceptance of claims about distribution economies (e.g., there will be economies in integration). Areeda and Turner view claims about the promotional efficiencies to be relatively weak, but conclude that they should not be rejected in principle. They also attach a set of prerequisites to such claims (e.g., the merging firms should be operating at a substantial disadvantage which cannot be overcome by means other than horizontal merger). *Id.* at 181-99.

124. *Id.* at 184.

125. *Id.* at 188.

126. *Id.* at 189-90.

Measurement ambiguities will be most significant in the case of a net efficiency test. Such a test is likely to be based upon some broad formulation under which the merger may be permitted if the claimed efficiencies are of such magnitude as to outweigh the detriments likely to result from the attainment or strengthening of market power.[128] However, such methodology will be without analytical rigor,[129] and it will be exceedingly difficult under this approach for firms and their advisers to predict the outcome of any given case. Further problems also inevitably arise in this context about the ability of the Antitrust Division, the Federal Trade Commission, and the courts to perform the balancing test accurately. For these reasons, it has been strongly urged that such case-by-case analysis be avoided.[130]

Measurement ambiguities will also attach to absolute formulations of the defense. For example, under the Areeda and Turner formulation the calculation of "substantial cost disadvantages" and the diseconomies of plant size and plant specialization may not be straightforward.[131] Similarly, the Pitofsky formulation does not define in further detail what is meant by "production efficiencies leading to a substantial reduction in unit costs." However, these measurement difficulties are likely to be much less severe than those which may arise under a net efficiency test. Further, concerns about measurement ambiguities are reduced under an absolute formulation of the test, such as that provided by Pitofsky, where there is some restriction placed on the likely postmerger power which the merged firm will enjoy. These reasons reflect that an absolute formulation of the defense is preferable and that the defense need not be rejected because of measurement ambiguities.

2. *Distributional Issues Relating to Cost Savings*

In formulating the elements of an efficiencies defense, the question arises whether the merging firms should be required to demonstrate that

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127. *Id.* at 193-94. *See also* Pitofsky, *supra* note 7, at 209.

128. For a discussion of foreign jurisdictions which have adopted such an approach, see *supra* note 110.

129. As Pitofsky observes: "It is difficult to trade off the advantages of lower unit costs against the disadvantages of reduced competition as a result of the merger." Pitofsky, *supra* note 7, at 210.

130. *See* Fisher & Lande, *supra* note 26, at 1652-59.

131. Areeda and Turner have outlined the problems of proof inherent in their formulations. *See supra* text accompanying notes 112-14.

the efficiency gains will be passed on to consumers in the form of lower prices. This issue is concerned with cost savings (represented by area A2 in Figure 1) rather than consumers' surplus. The question is whether the merged firm should be required to demonstrate that it will reduce the price for its goods to reflect the reduction in its average costs from AC1 to AC2. While there is some support for such a requirement,[132] the predominant view is against this proposition for both theoretical and practical reasons.

Theoretically, the question can be approached at several levels. Some would argue that antitrust laws are not concerned with the distribution of wealth, and that the question of such distribution is a policy choice to be made by the legislature, rather than the judiciary, pursuant to other policy instruments such as taxation laws.[133] However, the validity of such explanation must be called into question if the transfer of consumers' surplus to firms with market power is considered inappropriate from a policy perspective. There is, simply put, a logical inconsistency between recognizing distributional standards in the case of consumers' surplus, and then rejecting such standards in the case of cost savings. However, there are other theoretical arguments in support of not requiring that cost savings be passed on to consumers, even if consumers' surplus is considered to be the entitlement of consumers. First, notwithstanding that a firm will reap additional rewards as it becomes more efficient, this will not lessen total wealth, and consumers will not be worse off if prices do not rise postmerger. On the contrary, consumers have the potential to be better off if other competitors attempt to "imitate" and "emulate" the advantages achieved by such efficiencies.[134] Second, there is the question of incentives and the need to encourage the achievement of economic efficiency. It is inappropriate to discourage, and in one sense unfair to punish, those who have invested in discovering new and more efficient ways, by requiring them to pass on the rewards to others. Inevitably, society will be better off where there prevails an environment which is conducive to innovation and efficiency.

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132. *See* American Medical Int'l, Inc., 104 F.T.C. 1, 219 (1984); United States v. United Tote, Inc., 768 F. Supp. 1064, 1084-85 (D. Del. 1991). *See also* LAWRENCE A. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST 631 (1977). The *Merger Guidelines* also implicitly adopt this requirement by linking efficiencies to lower prices to consumers. *See* Merger Guidelines, *supra* note 11, § 4.

133. *See, e.g.*, Kenneth G. Elzinga, *The Goals of Antitrust: Other than Competition and Efficiency, What Else Counts?*, 125 U. PA. L. REV. 1191, 1195-96 (1977); 1 AREEDA & TURNER, *supra* note 31, at 18-19; BORK, *supra* note 73, at 110-12.

134. The concepts of competitive "imitation" and "emulation" are those suggested by Roberts and Salop. *See supra* note 104.

A further reason for rejecting the requirement that efficiencies be passed on to consumers relates to problems of proof. It is not apparent that evidence can be introduced in support of this proposition. At best, planning documents estimating a postmerger price reduction or evidence of customers supporting the merger may be introduced. However, these forms of evidence are clearly open to manipulation and it will be exceedingly difficult to distinguish between true and false claims. Pitofsky has suggested that:

> The only sure way of making such a showing [that efficiency gains will be passed on to consumers] would be to prove that the merger is taking place in a near perfectly competitive market, and therefore that market forces would require that the efficiency be passed on to consumers. But if that were the case—if the market were that competitive—the merger would not have been a matter of concern in the first place.[135]

Strictly construed, this qualification to the efficiencies defense has the potential to render it redundant or to frustrate its use. Having regard to questionable theoretical foundations and potentially insurmountable problems of proof,[136] it is inappropriate that the efficiencies defense should be conditioned upon the requirement that the efficiency gains be shown to pass on to consumers.

3. *Internal Expansion and Alternative Forms of Organization*

A further issue requiring consideration in the formulation of an efficiencies defense is whether the merging firms should be required to demonstrate that the claimed efficiencies are not achievable by other means, such as internal expansion or the formation of joint ventures.

It has been suggested that there is a "bias ingrained in section 7 favoring internal expansion."[137] The formulations of the defense contained in the *Merger Guidelines*[138] and the Pitofsky proposal

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135. Pitofsky, *supra* note 7, at 207-08.

136. A suggested solution to the problem of proof is that "rather than an outright ban on consideration of efficiencies for which a pass-through to consumers cannot be strongly guaranteed, a more appropriate approach would value the magnitude of the efficiency and the probability that it will be achieved by the merger." *See* Yao & Dahdouh, *supra* note 119, at 44. This solution appears to be no more than a suggestion that some form of net efficiency defense may be appropriate.

137. Rogers, *supra* note 31, at 525.

138. Merger Guidelines, *supra* note 11, § 4.

expressly recognize this requirement.[139] The formulation suggested by Areeda and Turner also implicitly accommodates this consideration.[140] There is an obvious logic to this requirement. It appears appropriate that courts should, for example, inquire whether the acquiring firm's capital could be used to expand the firm's existing production facilities rather than to purchase the shares or assets of a competitor. However, acceptance of this requirement raises further obstacles to the emergence of a workable efficiencies defense.

First, legal analysis of whether internal expansion is preferable is an exercise which is likely to involve considerable uncertainty. For example, it may be argued that internal expansion is preferable because of the benefits of internal planning and internal implementation, and because the creation of new capacity will increase output and stimulate competition in the market. But it is also not difficult to predict a range of arguments which suggest that merger is preferable to internal expansion. For example, the merger may involve a matching of resources not achievable through internal expansion, internal expansion may be more costly and involve delays and the failure to merge may result in the exit of a competitor from the market.[141]

Secondly, consideration of these issues has the potential to raise difficult matters of proof. There is likely to be a general lack of reliable information. In some cases, the merger and other options may be documented to explain the decision in favor of the merger. However, such exercise is likely to venture largely into the realms of speculation

139. Pitofsky, *supra* note 7, at 218.

140. 4 AREEDA & TURNER, *supra* note 31, at 147-48. There is also some case law to support this requirement that efficiencies claims should be rejected if they are achievable by means independent of merger. *See* United States v. Rockford Memorial Corp., 717 F. Supp. 1251, 1290-91 (N.D. Ill. 1989); United States v. Ivaco, Inc., 704 F. Supp. 1409, 1425-27 (W.D. Mich. 1989).

141. For more detailed consideration of these arguments, see 4 AREEDA & TURNER, *supra* note 31, at 161-69. Areeda and Turner also discuss whether internal expansion is likely to occur having regard to the cost of expansion, the resultant unit cost savings and the likely downward price effect resulting from the additional output. Other variables impact on the equation such as product differentiation, the demand for the product, and the likelihood of new entry or expansion by incumbents. While it is appropriate to recognize the potential impact of these factors in the analysis of whether the efficiencies are achievable by internal expansion, it seems that any attempt to incorporate these factors into the defense is unlikely to succeed because of the widely divergent nature of the facts of each case. *See also* Muris, *supra* note 26, at 389-92. Muris argues that there are at least four reasons why the possibility of internal growth does not rebut the Williamson presumption in favor of efficiency from mergers. First, internal expansion may increase costs relative to production. Second, since cartels are unstable, their market power tends to dissipate. Third, the possibility that collusion will be facilitated is slight. Fourth, where demand is stable, concentration increases just as much with internal growth as with mergers.

and in many cases there will be uncertainty and conflict about how any predicted situation should be analyzed. There may, nonetheless, be some situations where the decision to merge is based upon a sound theoretical basis and the conclusions advanced that such a merger may be the preferred route will be all the more convincing if there is appropriate supporting evidence, such as testimony from suitably qualified independent parties and relevant industry studies.[142] Nonetheless, in most cases there will be information uncertainties and in such circumstances it seems appropriate to impose a relatively weak standard of proof. Otherwise, this requirement would have the potential to make the defense generally unavailable.[143]

The other alternative to a merger which warrants brief consideration is the possibility that the same outcome may be achieved through contractual relations, such as a joint venture. Two firms may, for example, agree jointly to operate the inefficient divisions of their businesses while still competing in all other respects. To this extent, such joint venture arrangements may be preferable to a full merger.[144] However, there are various operational and competitive concerns under the joint venture option which negate its desirability as an element of the efficiencies defense. Significant disputes may arise concerning the operation of a joint venture. It is also inevitable that anticompetitive concerns may arise relating to the operation of joint ventures. For example, products may become standardized and coordination of pricing and marketing may result. These are strong reasons not to advance this form of organization as a preferable option to merger for the purposes of the efficiencies defense.[145]

142. For a general discussion relating to the problems of proof in this situation, see Yao & Dahdouh, *supra* note 119, at 35-41.

143. *Id.* The current *Merger Guidelines* arguably contain such a weak standard of proof by providing that efficiencies will be rejected "if equivalent or comparable savings can reasonably be achieved by the parties through other means." *See* Merger Guidelines, *supra* note 11, § 4.

144. For more detailed discussion of the policy considerations relating to this issue, see John E. Kwoka, Jr. & Frederick R. Warren-Boulton, *Efficiencies, Failing Firms, and Alternatives to Merger: A Policy Synthesis*, 31 ANTITRUST BULL. 431, at 438-41 (1986).

145. For further discussion on the operational and competitive concerns relating to joint ventures and the efficiencies defense, see 4 AREEDA & TURNER, *supra* note 31, at 169-71.

D. *Enforcement Discretion*

The discussion thus far has focused upon problems that the courts will face in the formulation and application of an efficiencies defense. In many cases, such problems will have the potential to make the defense either unavailable or difficult to satisfy. In such circumstances, enforcement discretion will be an issue which will assume considerable importance. In appropriate cases, the relevant authorities may elect to permit and not to challenge mergers involving market power concerns on the basis of convincing efficiencies, even though there may be questions about whether such efficiencies may satisfy the courts.

Various factors will impact upon the significance and effectiveness of such discretionary powers. Obviously, the policies of the relevant authorities will dictate their approach to the defense. Other factors may be equally critical, such as the extent to which the agencies will test the evidence of efficiencies. Close scrutiny may result in greater delays and uncertainty than would be the case under the normal judicial process. The information problems are likely to be significant given that the agencies will be relying upon the evidence of the merging firms, and it may be particularly difficult to evaluate this evidence in many cases.[146] The effectiveness of this option will also depend upon the confidence that the business community has in the process. This will depend in large part on the perceived reliability of the enforcement agencies, as well as their predictability and consistency. This final point leads conveniently into a brief consideration of the current policies of the relevant U.S. agencies towards the efficiencies defense. The positions taken by the federal antitrust agencies, the Department of Justice and the Federal Trade Commission, and the State Attorneys General are potentially in conflict on the question of how efficiencies should be analyzed.

The *Merger Guidelines,*[147] which were adopted jointly for the first time by the Department of Justice's Antitrust Division and the Federal Trade Commission in 1992, reflect that the agencies clearly recognize

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146. *See* Fisher & Lande, *supra* note 26, at 1665-66. Situations may nonetheless arise where efficiency claims can be independently verified. For example, the recent report of the Defense Science Board Task Force suggested that the Department of Defense could play a constructive role in substantiating efficiencies claims advanced in support of defense industry consolidations. *See* DEFENSE SCIENCE BD. TASK FORCE, DEP'T OF DEFENSE, REPORT OF THE DEFENSE SCIENCE BOARD TASK FORCE ON ANTITRUST ASPECTS OF DEFENSE INDUSTRY CONSOLIDATION 28-31 (April 1994).

147. Merger Guidelines, *supra* note 11.

efficiencies as a mitigating factor in the evaluation of mergers involving market power. The *Merger Guidelines* provide in pertinent part that:

> The primary benefit of mergers to the economy is their efficiency-enhancing potential, which can increase the competitiveness of firms and result in lower prices to consumers . . . .
>
> Some mergers that the Agency otherwise might challenge may be reasonably necessary to achieve significant net efficiencies. Cognizable efficiencies include, but are not limited to, achieving economies of scale, better integration of production facilities, plant specialization, lower transportation costs, and similar efficiencies relating to specific manufacturing, servicing, or distribution operations of the merging firms. The Agency may also consider claimed efficiencies resulting from reductions in general selling, administrative, and overhead expenses, or that otherwise do not relate to specific manufacturing, servicing, or distribution operations of the merging firms, although, as a practical matter, these types of efficiencies may be difficult to demonstrate. In addition, the Agency will reject claims of efficiencies if equivalent or comparable savings can reasonably be achieved by the parties through other means. The expected net efficiencies must be greater the more significant are the competitive risks identified . . . .[148]

Certain familiar themes emerge from this test. A net efficiencies approach is adopted which is based upon the balancing of productive efficiencies and competitive risks. The test also requires that the efficiencies be merger-specific. Although the *Merger Guidelines* no longer refer to the onus and burden of proof, it appears that no change was intended to the prior position, namely that the merging firms must

148. *Id.* § 4. For a discussion of the historical approach to efficiencies in the Merger Guidelines, see Steve Stockum, *The Efficiencies Defense for Horizontal Mergers: What is the Government's Standard?*, 61 ANTITRUST L.J. 829, 831-34 (1993). The 1968 and 1982 Merger Guidelines reflected an hostility to efficiency claims. They would only be entertained in "exceptional circumstances" and "extraordinary cases" where there was "convincing evidence" that the merger would produce substantial cost savings. A significant shift in attitude occurred under the 1984 Merger Guidelines in which it was accepted that some mergers "may be reasonably necessary to achieve significant net efficiencies." *Id.* at 832. The burden of proof under the 1984 Merger Guidelines required "clear and convincing evidence" that the merger would achieve the claimed efficiencies, and that these could not reasonably be achieved through other means. *Id.* The adequacy of the current Merger Guidelines provisions concerning efficiencies has been recently re-examined by the Federal Trade Commission. The Commission has proposed that it should establish a joint task force, together with the Antitrust Division of the Department of Justice, to consider how the Merger Guidelines can be further clarified to provide an efficiency justification. For discussion of the Commission's proposals regarding how efficiencies may be analyzed, see FTC REP., *Anticipating the 21st Century: Competition in the New High-Tech, Global Marketplace*, vol. 1, ch. 2, pp. 2-3 (May 1996).

establish the efficiencies with clear and convincing evidence.[149] While there are certain strict elements to this test which may be difficult to establish (such as clear and convincing efficiencies, merger-specific efficiencies, and lowering of prices to consumers), it nonetheless reflects an increasing tolerance on the part of these federal antitrust agencies to the possibility that efficiencies may be a mitigating factor.[150] Nonetheless, the strictness of the test in the longer term will depend on the manner in which these agencies may exercise their discretion in any case.

In contrast, the State Attorneys General view efficiencies with greater skepticism. This is hardly surprising given their incentives to protect local firms. The recently released Horizontal Merger Guidelines of the National Association of Attorneys General[151] reflect an hostility to efficiencies claims. Notwithstanding that the *NAAG Merger Guidelines* conclude that there is no efficiencies defense,[152] they set forth a stringent test for the consideration of efficiencies claims. Efficiencies will be considered in "rare situations . . . when the merging parties can demonstrate by clear and convincing evidence that the merger will lead to significant efficiencies."[153] Further, it must be "demonstrate[d] that the efficiencies will ensure that consumer prices will not increase," that "equivalent or comparable [cost] savings cannot be achieved through other means and that [the] cost savings will persist over the long run."[154] While it has been suggested that the degree to which the *NAAG Merger Guidelines* will be followed may vary substantially across the states,[155] it appears that given the strict requirements of this test the State Attorneys General will rarely be influenced by efficiencies claims in their enforcement decisions.

149. Stockum, *supra* note 148, at 833-35; Yao & Dahdouh, *supra* note 119, at 28-29.

150. A recent example reflecting that these agencies may be influenced by efficiencies considerations is the FTC's *Honickman* opinion. *See* Harold A. Honickman, [1987-93 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 23,286 (Nov. 16, 1992) (FTC denied Honickman's request to acquire certain Seven-Up franchises in New York because the claimed efficiencies did not outweigh the significant anticompetitive risks, but granted approval for the acquisition of various New Jersey County franchises because the competitive risks were smaller than those identified in New York, and there was also "a greater likelihood of net efficiencies in New Jersey").

151. The National Association of Attorneys General Horizontal Merger Guidelines (1993), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,406 (March 30, 1993) [hereinafter NAAG Merger Guidelines].

152. *Id.* § 5.3. The *NAAG Merger Guidelines* rely upon *Procter & Gamble* and *Philadelphia National Bank* as authority for this proposition.

153. *Id.*

154. *Id.*

155. *See* Stockum, *supra* note 148, at 836.

V. CONCLUSION

In recent times there has been a crescendo of academic support for the emergence of an efficiencies defense in the case of horizontal mergers involving market power. The motivation for this support is understandable given the importance of efficiency to the competitive process. However, the development of the defense will involve a complex range of issues.

While the legislative history relating to, and the judicial treatment of, efficiencies do not appear to preclude the emergence of the defense, there remains a pivotal concern about the circumstances in which the goals of economic efficiency and the unfair transfer of consumers' wealth are in conflict. There is no clear answer to how this issue may be resolved. The legislative history suggests that greater weight should attach to wealth transfer concerns. Further, even taking into account the dynamic potential of the legislation, it is difficult to envision that an appreciable shift in attitude on this issue is likely to occur until there is compelling evidence that the vast majority of mergers are inherently efficiency-enhancing or that the emergence of the defense is critical to the economy. Such matters may be difficult to demonstrate, particularly in light of the contrary conclusions of earlier studies.[156] It may nonetheless be predicted with some confidence that the judicial hostility to efficiencies reflected in the Supreme Court decisions of the 1960s has subsided. The pro-competitive characteristics of efficiencies are now more clearly understood than they were at the time of the enactment of section 7 and at the time that they were considered by the Warren Court.

It follows that the recent trend of lower courts to at least view efficiencies favorably is an encouraging development. However, there remains a quantum leap that will need to be made from this point to the emergence of a judge-made efficiencies defense. There does not appear to be an appropriate theoretical framework to balance wealth transfer and efficiencies considerations where they are in conflict. This is not to say that the defense cannot emerge. But, absent some price standard in the formulation of the defense, it will continue to be plagued with uncertainty about the unfair transfer of consumers' wealth.

156. *See, e.g.*, RAVENCRAFT & SCHERER, *supra* note 1.

Should a judge-made efficiencies defense emerge, it should be framed in absolute terms. An absolute formulation, such as that advanced by Pitofsky, has the following benefits. Measurement ambiguities may be reduced to tolerable levels and this may result in greater certainty in the application of the defense, with all of its attendant benefits. Further, a ceiling will be placed on the level of market power that may be achievable. Turning to the controversial elements of the defense, the merging firms should not be required to demonstrate that the efficiency gains will be passed on to consumers. Further, while there should be at least some requirement that the merging firms demonstrate that the efficiencies are not achievable by other means, this inquiry should be limited to the possibility of internal expansion.

If progress in the development of the defense remains slow or does not eventuate, the question of enforcement discretion will become all the more important. The recognition of efficiencies in this way has certain attractions, assuming that there is confidence and reasonable certainty in the process. Under this approach efficiencies can be recognized in appropriate cases without the need to satisfy a rigorous defense. However, the potential for conflicting views to be taken by the federal antitrust agencies and the State Attorneys General is a matter of concern. Ultimately, pragmatism will need to prevail if the exercise of enforcement discretion is to provide the solution.