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Client Alert

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What the New Merger Guidelines Mean for Technology Companies

"The new Merger Guidelines could subject high margin businesses to significantly greater scrutiny — even if those firms operate in highly competitive markets."

On April 20, 2010, the Federal Trade Commission (FTC) and the Antitrust Division of the United States Department of Justice released new Horizontal Merger Guidelines for public comment. (click here) The new Guidelines, which — once adopted — will replace the 1992 Horizontal Merger Guidelines, are not merely a maintenance update. They are a major revision, affecting virtually all parts of the merger analysis.

In this *Alert*, we focus on three significant changes that will disproportionally impact high technology industries, including software and Internet-based businesses.

It's All About "Closeness of Competition" and "High Margins"

Most high technology products are differentiated, that is, the products are identical in some respects but not in others. Word processors have different features, databases are designed for different workloads, online advertising networks focus on brand or performance campaigns, Web sites target different audiences, etc. For mergers between vendors of differentiated products, the new Guidelines mark a sharp departure from the past. The Agencies would say the changes are evolutionary, in that the seeds of this were contained in the existing Guidelines, but this is such a large evolutionary step with such dramatic consequences that revolutionary seems the better term.

Market definition, the traditional battleground of merger analysis, gets a complete makeover and a far less prominent role. The market definition exercise is now "useful [only] to the extent it illuminates the merger's likely competitive effects." (§4 of the Guidelines)

Under the new Guidelines, the competitive effects evaluation depends primarily on whether the loss of competition between the merging firms alone creates an incentive to raise the price of its products. This turns mostly on two factors: how much business the firms take from one another and their gross margins on such business. Consider a merger of firms that make competing products A and B. The greater the percentage of customers diverted from product A to product B (the "diversion ratio") and the higher the gross margins of product B, the greater the value of the diverted sales and the potential for a substantial lessening of competition. The Guidelines could not be clearer about how this new unilateral effects paradigm

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trumps market definition. "Diagnosing unilateral price effects based on the value of diverted sales need not rely on market definition or the calculation of market shares and concentration." (§6.1). Unilateral effects analysis for differentiated products is thus reduced to two factors: the diversion ratio and the gross margins of the products involved. High diversion and high margins become the hallmarks of an anticompetitive merger.

As if that were not enough, the Guidelines make clear that a relevant antitrust market need not include all consumer substitutes at prevailing prices — a concept that many have assumed is beyond debate. In substance, the competitive effects analysis is merged with the identification of a relevant market so that existing competitors who divert less business from the merging firms than they take from one another can be dropped from the market. Only firms who divert more sales are clearly included in the market — although that is largely ceremonial since once the competitive effects analysis indicates a price increase nothing else really matters.

Whatever its theoretical basis, this has stark consequences when applied to firms with high fixed costs and low variable costs such as software and Internet businesses, and also more generally to firms with high upfront R&D expenditures. Developing a new database takes years and millions of dollars in investment. But once the first copy is paid for and shipped, gross margins are high. In fact, gross margins of 50 percent or greater are the norm, not the exception for many high technology products. With such margins, even relatively distant substitutes are likely to fail the diversion/margin test, irrespective of whether the markets in which the vendors compete are fiercely competitive.

The Guidelines are deeply suspicious of high margins throughout. "[I]f a firm sets price well above marginal cost," the Guidelines explain, "that normally indicates either that the firm is coordinating with its rivals or that the firm believes its customers are not highly sensitive to price." (§2.2.1) The reality of competition in technology markets calls this presumption into question. Every software firm sets license prices well above marginal costs (open source licensing being a notable exception), but usually this is neither a sign of collusion nor of price insensitivity on the part of the customer, but rather the consequence of successful differentiation, of responsiveness to customer demand, and of out-innovating the competition — however temporarily. For products requiring significant upfront investments, some measure of cost incorporating total cost — properly depreciated over time — would be a more sensible margin baseline than incremental or marginal cost. Otherwise it becomes very difficult to obtain approval for a merger in a high margin business.

In addition, the new Guidelines relax the requirement that the products of the merging parties be particularly close substitutes. While the Guidelines acknowledge that unilateral concerns "normally require[] that a significant fraction of the customers purchasing [the] product formerly sold by the other merging firm [view it] as their next choice," the authors hasten to add that a "significant fraction need not approach a majority." (§6.1). In fact, the Guidelines explain that with sufficiently high gross margins, the merger of firms that are not each others' closest rivals can still be anticompetitive. This arguably goes far beyond what the courts have recognized, and it remains to be seen whether a litigated challenged based on these principles would be successful.

Where There is Harm, There is a Market

The Guidelines devote significant attention to "targeted customers," that is, customers upon whom the merging firm could impose a 5-10 percent price increase without losing other non-targeted customers. (§4.1.4). This type

of customer-specific price discrimination is commonly feasible in many technology markets, where arbitrage is naturally limited (*e.g.*, because of licensing restrictions) and contracts are individually negotiated (*e.g.*, a bundled price for the delivery and service of a custom chipset). (§3) In those situations, relevant markets may be "as narrow as individual customers." (§4.1.4) And even where the agencies define markets "for groups of targeted customers," market shares are "based on [each firm's] actual or projected revenues from the targeted customers." (§5.2). In practice, this means that the agencies will be able to identify those customers for whom the products of the merging firms are particularly good alternatives, group them together, and then more or less axiomatically conclude that in this "market" the merging parties have high "market shares."

The problem with this "no harm without a market" approach is that virtually *every* horizontal merger will leave some customers worse off. But that alone does not make mergers illegal. Section 7 does not prohibit mergers that "lessen competition," but only those that are likely to "*substantially* lessen competition." This, in fact, has been a core point in nearly every case the government has brought and lost, most notably its 2004 challenge to Oracle's acquisition of PeopleSoft. It is, of course, difficult to calibrate a threshold for substantiality, but courts have traditionally used the legal concept of a relevant market as the denominator against which the effects of the concentration must be assessed. The highly targeted approach laid out in the Guidelines runs the risk of making the statutory substantiality criterion irrelevant.

Increased Focus on Orphaned Products and R&D Projects

The Guidelines express a clear preference for building versus buying. "Competition usually spurs firms to achieve efficiencies internally," not through acquisition. And even where an acquisition would be efficient, "the antitrust laws give competition, not internal operational efficiency, primacy in protecting customers." (§10) As a result, mergers that reduce the combined firm's "incentive to continue with an existing product-development effort" are inherently suspect. In practical terms, if a merger would lead a buyer to cancel its ongoing R&D efforts to develop a product competitive to that of the target, the transaction lessens competition even if the buyer has not yet made a single sale. That may not be new, as shown by the experience in pharma and biotech mergers, where the FTC frequently demands divestitures of redundant pipeline products. But the practice has now grown up into a principle, and a distinct basis for objecting to a merger.

The Guidelines include another theory of how innovation competition may be lessened by an acquisition, namely by reducing the "incentive to *initiate* development of new products." (§6.4). This "longer-run effect is most likely to occur if at least one of the merging firms has capabilities that are likely to lead it to develop new products in the future that would capture substantial revenues from the other merging firm." Here, the market impact of the R&D effort appears to be twice removed. The offense consists of diminishing incentives that could lead a firm to (i) initiate R&D efforts that, if successful, could (ii) take share from the other party to the merger. It is questionable that any such effects can be predicted with the "reasonably likelihood" required to prove a Section 7 offense. Given the high-risk nature of much R&D, diminishing incentives to undertake such R&D in the first place are probably in the realm of "ephemeral possibilities," which are insufficient to sustain a challenge.

None of this is meant to deny that the new Guidelines have value. They most certainly do, and the exposition of the concepts is masterfully clear. The discussion of evidence in merger cases provides much needed clarification. The market concentration measures

have been increased to better reflect the reality that even markets with higher concentration ratios tend to be competitive. And the arbitrary focus on two years to show entry that is "timely, likely, and sufficient" has been removed to finally harmonize the timeframes for the projection of harms with the projection of benefits from the acquisition. That said, there are certain industries — software, Web, R&D intensive technologies — for whom the Guidelines as written will mean increased scrutiny and possibly a significant methodological departure of Agency analysis on the one hand and analysis by the courts on the other. As a result, the Guidelines may well result in increased merger litigation.

If you have any questions about this *Client Alert*, or are interested in submitting a public comment to the Guidelines before the end of the 30 day comment period on May 20, 2010, please contact one of the authors listed below:

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