New U.S. Merger Guidelines Suggest Increased Focus on Deals in High Tech and Pharmaceutical Sectors

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In August 2010, the U.S. antitrust agencies released the final version of their revised Horizontal Merger Guidelines, which they use to analyze the competitive implications of mergers between competitors. Whereas the prior (1992) version of the Guidelines had sought to provide a precise, step by step framework for analyzing horizontal mergers — centered around defining a "relevant market" and measuring market concentration — the new Guidelines embody a much more flexible approach. The new Guidelines place less emphasis on market definition and can be likened to a "tool box" of techniques for analyzing the competitive implications of horizontal mergers. The new analytical approach has important implications for analyzing mergers, and in particular indicates closer scrutiny of M&A transactions in markets characterized by differentiated products and high levels of R&D spending – such the high tech and pharmaceutical industries.

Importantly, the methods for analyzing horizontal mergers and acquisitions that are set forth in the new Guidelines are not new — they reflect U.S. agency practice as it has developed over the prior two decades. As a result, the new Guidelines are more of an effort at transparency than to effect fundamental future change. Additionally, the impact of the Guidelines will also be restrained by the fact that U.S. courts hearing merger challenges will likely continue to consider market definition central to the antitrust assessment of mergers. Indeed, the final version of the Guidelines contains a statement emphasizing that the Agencies will ordinarily rely on market definition arguments in a merger challenge.

Below I describe several changes to the U.S. Guidelines that indicate grater scrutiny of transactions in high tech and pharmaceutical markets.

1. *Focus on Direct Evidence of Competitive Effects*

Applying traditional market definition analysis to markets with highly differentiated products is frequently like fitting a square peg into a round hole. Different products typically are positioned by their manufacturers along a competitive continuum, and compete with one another to varying degrees. Trying to draw a clear line as to which products are "in" and which are "out" of the market can be arbitrary. The new Guidelines recognize this, explaining that setting a precise boundary for the "market" results in an oversimplification that "cannot capture the full variation in the extent to which different products compete against each other." (Guidelines § 4.) On the other hand, the use of the market definition paradigm has been useful, among other reasons, to provide a discipline for the competitive analysis.

The new Guidelines' de-emphasis of market definition provides increased legitimacy to a trend at the U.S. agencies to focus mainly on the likely real-world "competitive effects" of mergers and acquisitions. For example, if a software company seeks to acquire a company with a software product that addresses some, but not all, of the same needs as the acquirer's product, the new Guidelines indicate that the U. S. antitrust agencies are likely to focus on whether the acquisition may harm competition for customers whose top two choices are the merging parties' products. (Guidelines §§ 2.1.4, 3.) Similarly, if a pharmaceutical company seeks to acquire a drug that competes closely with one of its drugs, but there are several competing drugs manufactured by others to treat the same condition, the U.S. agencies might consider whether the two drugs at issue are close substitutes for at least some types of patients. The new Guidelines allow the U.S. agencies to pursue these types of theories of competitive harm without being required to explain why the "relevant market" should be defined to exclude other competitively important products manufactured by third parties others. Of course, the agencies would still need to explain the competitive significance of these other competing products, and why competition from these products would not be sufficient to counteract any attempt by the merging parties to increase prices post-merger.

2. *Expanded Discussion of Price Discrimination*

In a similar vein, the revised Guidelines illustrate a greater willingness on the part of the Agencies to pursue theories of competitive harm based on alleged effects on narrow categories of customers that can be specifically targeted for a price increase. The Guidelines provide that "[w]here price discrimination is feasible, adverse competitive effects on targeted customers can arise, even if such effects will not arise for other customers." (Guidelines § 3.) They continue: "[w]hen discrimination is reasonably likely, the Agencies may evaluate competitive effects separately by type of customer." (Id.) (emphasis added). This suggestion that the U.S. antitrust agencies might focus on narrow categories of customers in markets characterized by price discrimination is important for high tech and pharmaceutical companies that operate in markets with high R&D costs and relatively low manufacturing costs. In such markets, there is frequently a strong incentive to supply product to as many customers as possible, and this can lead manufacturers to try to "price discriminate" by providing special discounts to customers unwilling to pay the prices paid by others. The new Guidelines suggest that the U.S. agencies will examine the impact of any transaction on the prices paid by each category of customers.

3. *Shift in Emphasis from "Coordinated Effects" to "Unilateral Effects"*

Competitive harm from "coordinated effects" occurs where the higher market concentration post-merger leads to a greater chance of concerted action between the firms remaining in the market. Competitive harm from "unilateral effects" relates solely to a reduction in competition between the merging parties. Because high tech and pharmaceutical markets are often characterized by highly differentiated products and fierce competition between competitors, mergers and acquisitions in these markets more frequently raise issues of unilateral effects than coordinated effects — especially if the firm is acquiring a close substitute. While prior versions of the Guidelines emphasized "coordinated effects" as a central concern of merger review, the new Guidelines place much more emphasis on "unilateral effects."

4. *High Margins*

In evaluating the potential for post-merger "unilateral effects," the new Guidelines explain that the Agencies will consider whether a merger is likely to lead to "upward pricing pressure" on the price of one (or both) of the merging parties' products. (Guidelines § 6.1.) One key technique described in the Guidelines for assessing the potential for upward pricing pressure is to calculate the amount of revenue that a merging party could recapture from the second party's product in the event that the first party raised its price. This amount is highly influenced by the size of the margins earned by the second party on its product.

In high tech and pharmaceutical markets, products are frequently sold at high margins because most of the costs of selling a product come from R&D costs, not manufacturing costs. These high margins typically have nothing to do with whether a particular market is competitive or not. Even the most highly competitive markets, for example, will include numerous competitors that are earning apparently high margins (not taking into account R&D costs). But because the technique described in the Guidelines will indicate greater "upward pricing pressure" for products with higher margins, this technique (if applied mechanically) is more likely to suggest competitive problems with mergers and acquisitions in high tech and pharmaceutical markets as compared to many other industries.

5. *Effects on Innovation*

Although the U.S. antitrust agencies have regularly focused on how a proposed merger or acquisition might affect innovation, that concept was not well articulated in the 1992 Guidelines. The Guidelines specifically identify innovation as an issue to be addressed in the merger review. The Guidelines note that in some transactions, a merger may reduce incentives to continue with existing product development efforts and thereby reduce innovation, while in other cases, it may bring together complementary capabilities that may spur greater innovation. Obviously, these issues are frequently important in analyzing high tech and pharmaceutical transactions, where innovation plays a key role in competition and the business rationale for M&A transactions. As in all issues in merger analysis, the outcome will be highly fact-specific.

For these reasons, the new Guidelines therefore indicate a tendency on the part of the U.S. antitrust agencies to define narrower markets, and a willingness to challenge horizontal mergers or acquisitions based on an alleged impact on a narrow set of customers. These and other changes indicate increased U.S. agency scrutiny of M&A transactions in high tech and pharmaceutical markets, although that does not mean that the Guidelines portend a dramatic change in future enforcement levels. As noted, these changes to the Guidelines reflect current U.S. agency practice as it has evolved over the past two decades.