The Yale Law Journal

Volume 87, Number 1, November 1977

Potential Competition Mergers: A Structural Synthesis*

Joseph F. Brodley†

TABLE OF CONTENTS

Introduction	3
I. The Foundations of Present Policy	5
A. <i>From Horizontal Merger Policy to Potential Competition</i>	5
1. <i>Potential Competition in the Supreme Court</i>	10
2. <i>Potential Competition in the Lower Courts after</i> <i>Marine Bancorporation</i>	19
a. <i>Oligopolistic Behavior in the Target Market</i>	20
b. <i>Effect of Merger on Market Performance and</i> <i>Conduct</i>	22
B. <i>Theoretical Weaknesses in Present Policy</i>	25
1. <i>Economic Theory</i>	26
a. <i>Entry Theory in the Supreme Court</i>	26
b. <i>Recent Developments in Entry Theory</i>	31
2. <i>Nonefficiency Values</i>	33
C. <i>Legislative History and Potential Competition</i>	40
D. <i>Judicial Doubts as to Clayton Act Applicability</i>	45
II. Formulating an Effective Legal Rule	53
A. <i>Performance and Conduct Approaches</i>	54
1. <i>Mixed Performance-Conduct Standard</i>	54
2. <i>Conduct Standard</i>	54
a. <i>Full-Fact Analysis</i>	56

* I am much indebted to Donald Dewey, Eleanor Fox, and Stephen Trattner, Esq., for comments on this article and to Louis B. Schwartz for reviewing the section on non-efficiency values (errors mine); and for research assistance from Linda S. Chapman, V. James Dixon, Hugh A. Sanders, and, at an earlier stage, Eric B. Brown and Bradley L. Williams.

† Professor of Law, Indiana University (Bloomington).

b. <i>Simplified Objective Tests</i>	58
i. <i>The Turner Approach</i>	58
ii. <i>The Pitofsky Approach</i>	60
B. <i>A Proposed Structural-Presumptive Approach</i>	63
1. <i>Probable Future Entry and the Concept of Market Proximity</i>	65
2. <i>Defining the Proximate Market</i>	68
a. <i>Market Extensions</i>	69
b. <i>Product Extensions</i>	69
3. <i>One of Few Most Significant Entrants</i>	75
4. <i>Elements Excluded from the Presumptive Rule</i>	77
5. <i>Proposed Presumptive Rules</i>	80
a. <i>Market Extensions</i>	80
b. <i>Product Extensions</i>	82
6. <i>Possible Efficiency Loss</i>	83
7. <i>Rebuttal Evidence</i>	85
Conclusion	88

Potential Competition Mergers

Introduction

The subject of potential competition mergers, far from being of interest only to antitrust specialists, touches one of the deepest concerns of economic policy—industrial concentration. Containment of industrial concentration is at the heart of the strong national policy restricting horizontal mergers, a policy articulated by the Supreme Court in the 1960s.¹ The Court's interpretation of a broad statutory mandate effectively eliminated the danger of increased market concentration through horizontal mergers. Potential competition doctrine extends that basic anticoncentration policy by preserving the force of potential competition where actual competition lags. In its attempt to sustain the long-run impact of potential competition, the doctrine, alone among currently accepted antitrust policies, has the potential to serve as a feasible legal instrument for reducing concentration in American markets.²

But the potential competition doctrine has led a troubled life and faces an even more uncertain future. Its development has been crippled by the courts' failure to face realistically the limits of judicial competence in economic regulation and by their apparent inability to devise effective rules satisfying both the goal of economic efficiency and the social and political values embodied in the antitrust laws. This article attempts to develop a more broadly based yet workable theory of potential competition, resting on the thesis that such a theory must necessarily be structural and must prescribe presumptive legal rules.

Structural analysis is one of three alternative approaches to antitrust; the others focus on performance and conduct, respectively.³

1. See p. 9 *infra*.

2. Neither litigation brought under § 2 of the Sherman Act, 15 U.S.C. § 2 (Supp. V 1975), nor legislative approaches, such as the late Senator Hart's proposed Industrial Reorganization Act, S. 1167, 93d Cong., 1st Sess. (1973), reprinted in *INDUSTRIAL CONCENTRATION: THE NEW LEARNING* app. at 444-48 (H. Goldschmid, H. Mann & J. Weston eds. 1974) [volume hereinafter cited as *INDUSTRIAL CONCENTRATION*], is a feasible policy alternative. Section 2 cases have proved administratively unmanageable and profligate of legal and managerial resources. See, e.g., N.Y. Times, July 17, 1977, § 3, at 1, col. 1 (detailing difficulties of suit against oil companies). Indeed, a recent report estimated that the average § 2 case now takes 20 years to litigate. *ANTITRUST & TRADE REG. REP.* (BNA) § AA, at 17 (Oct. 26, 1976). Moreover, both § 2 litigation and legislative approaches may pose risks to economic efficiency. For discussion of efficiency concerns in merger policy, see pp. 83-85 *infra*.

3. J. BAIN, *INDUSTRIAL ORGANIZATION* 7-13 (2d ed. 1968).

Much of the courts' difficulty in shaping an effective rule for potential competition mergers reflects the struggle among these alternative views. The structural approach bases policy on long-term structural variables, such as seller concentration, and leads to highly operational legal rules that can be activated by relatively simple facts, such as market share. In contrast, the performance and conduct approaches require extensive inquiry into a wide range of economic facts, for they attempt to assess the performance or conduct of an individual firm in a particular environment. This necessarily results in legal rules of great complexity and low predictability.

Following the amendment of section 7 of the Clayton Act in 1950,⁴ the Supreme Court adopted a structural policy for horizontal mergers. In *United States v. Philadelphia National Bank*,⁵ the Court enunciated a rule of presumptive illegality for such mergers in concentrated markets. This decisive step provided the focus and simplification that has permitted effective enforcement of the merger law. With even small increases in concentration blocked in numerous markets, the spotlight turned to markets already highly concentrated. The Supreme Court spoke of the desirability of deconcentrating such markets,⁶ and it seemed anomalous to block even small increases in concentration in moderately concentrated markets while doing nothing about much higher sustained concentration in other markets. But proposals for direct deconcentration raised concern as to the costs and equity of imposing radical change on existing firms.⁷

The potential competition doctrine emerged in this setting.⁸ If direct reorganization of concentrated markets might imperil economic efficiency, at least the full impact of outside market forces on the

4. The Celler-Kefauver Act, ch. 1184, 64 Stat. 1125 (1950) (codified at 15 U.S.C. § 18 (1970)), passed the Senate by a 55-22 vote, 96 CONG. REC. 16508 (Dec. 13, 1950), and the House by 223-92, 95 CONG. REC. 11507 (Aug. 15, 1949). The measure extended the Clayton Act to mergers accomplished through acquisition of assets as well as of stock and expressed a broad congressional consensus in favor of an invigorated antimerger policy. For discussion of the legislative history, see pp. 40-45 & note 161 *infra*.

5. 374 U.S. 321 (1963).

6. *Id.* at 365 n.42 ("if concentration is already great, the importance of preventing even slight increases in concentration and so preserving the possibility of eventual deconcentration is correspondingly great") (quoted in *United States v. Continental Can Co.*, 378 U.S. 441, 461-62 (1964), and in *United States v. Aluminum Co. of America (Alcoa-Rome)*, 377 U.S. 271, 279 (1964)).

7. See, e.g., Posner, *Problems of a Policy of Deconcentration*, in *INDUSTRIAL CONCENTRATION*, *supra* note 2, at 393, 394-400.

8. The doctrine received Supreme Court recognition in three decisions of the October 1963 Term, which extended the Court's development of horizontal merger theory. *United States v. Continental Can Co.*, 378 U.S. 441, 458 (1964); *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 173 (1964); *United States v. El Paso Natural Gas Co.*, 376 U.S. 651, 660-61 (1964).

Potential Competition Mergers

concentrated industries could be preserved. Toward this end, probable or potential entrants were seen to play a critical role: by merely threatening to enter the market, potential entrants might restrain monopoly or oligopoly behavior; by actually entering they would add a new competitor to the market and thereby raise the prospect of deconcentration. Both beneficial effects—the first called the “perceived” effect, the second the “actual” or “future entry” effect—would be lost if a potential entrant acquired a large firm in a concentrated market, a loss all the more serious in the absence of alternative methods to achieve deconcentration.

In applying the concept of potential competition, however, the Supreme Court turned from the path of its past success in merger policy. Rather than develop structural criteria that generate clear and predictive legal doctrine, the Court has increasingly relied on an economic theory unsuitable for judicial use and has embraced rules of such fearsome complexity that they obstruct enforcement efforts. And the Court has forsaken nonefficiency values altogether, thereby slighting the legislative history of the amended section 7. Part I of this article attempts to sustain this critique, and Part II attempts to show that a better alternative exists in the form of a structural-presumptive rule.

I. The Foundations of Present Policy

A. *From Horizontal Merger Policy to Potential Competition*

When the decision in *United States v. Marine Bancorporation, Inc.*,⁹ was announced in 1974, it became clear that the Supreme Court had forsaken its *Philadelphia Bank* approach for potential competition mergers. To understand the full import of this shift, it is necessary to examine the fundamental issue of merger policy, an issue that *Philadelphia Bank* resolved for horizontal mergers and that *Marine Bancorporation* raised for potential competition acquisitions: the extent to which legal rules requiring prolonged inquiry should be replaced with simplified standards.

In amending the Clayton Act in 1950, Congress sought to give vitality to merger policy, but established no clear standards for assessing the legality of a merger. Instead, Congress reenacted the test contained in the original Clayton Act by prohibiting any merger that would “substantially . . . lessen competition, or . . . tend to

9. 418 U.S. 602 (1974).

create a monopoly."¹⁰ On the eve of *Philadelphia Bank*, it was not clear whether this statutory standard required an extended, rule-of-reason inquiry or whether it could be simplified by a presumptive rule.¹¹ The Court thus had to choose between a legal rule based on market structure alone—that is, one that could be applied presumptively—and a more complex legal rule that also included market conduct and performance.

Effective antitrust rules, like the per se rule against price fixing and the presumptive rule for horizontal mergers,¹² have almost invariably been presumptive. The reason for this is not difficult to see. Antitrust policy succeeds to the extent that it changes business behavior at the planning stage, since relatively few transactions in this complex area can be challenged in court. To influence the planning function, legal standards should be clear and precise. But in potential competition merger cases, the current legal standard—focusing on future competitive performance and behavior—is hopelessly imprecise, the facts highly complicated, and the litigation resources of the parties typically enormous.¹³ The legal result in such cases becomes essentially ad hoc unless the litigation is constrained by a presumption based on severely limited facts.¹⁴

An antitrust rule may be based on a market's performance, conduct, or structure, or on any combination of these factors. Market performance is the end result of business operations and is typically de-

10. Clayton Act, ch. 323, § 7, 38 Stat. 731-32 (1914), 15 U.S.C. § 18 (1970). Due to infrequent enforcement, the original Act accumulated no well-articulated legal gloss.

11. The issue was left unresolved by *Brown Shoe Co. v. United States*, 370 U.S. 294, 321-22 (1962).

12. See R. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 105 (1976) (*Philadelphia Bank* rule "precise and objective, and thus workable"); G. STIGLER, THE ORGANIZATION OF INDUSTRY 269-71 (1968) (per se rule for price fixing has probably discouraged collusion); L. SULLIVAN, ANTITRUST 194 (1977) (per se rules convert private bar into instrument of law enforcement through advice to clients); 3 STAFF OF JOINT ECONOMIC COMM., ACHIEVING THE GOALS OF THE EMPLOYMENT ACT OF 1946—THIRTIETH ANNIVERSARY REVIEW, 94th Cong., 2d Sess. 17 (Paper No. 2, Antitrust Law and Administration: A Survey of Current Issues, 1976) (reviewing per se rules and noting "consensus that certain anti-competitive practices have been effectively stopped").

13. Moreover, although the benefits to the firm of a proposed merger are apt to be large, there is effectively no statutory penalty to be applied against mergers held illegal. Although in theory damages are available in a § 7 case, in practice such recovery has been all but impossible to obtain. See ABA ANTITRUST SECTION, MERGERS AND THE PRIVATE ENFORCEMENT OF SECTION 7 OF THE CLAYTON ACT 7-13 (Monograph No. 1, 1977). Managers are not likely to forgo large benefits that are anticipated from a questionable merger in the face of a legal standard whose violation does not entail significant costs.

14. Cf. W. HAMILTON & I. TILL, ANTITRUST IN ACTION 60 (TNEC Monograph No. 16, 1940) (difficulty of trying antitrust cases under rule of reason approach); Brodley, *Industrial Deconcentration and Legal Feasibility: The Efficiencies Defense*, 9 J. Econ. Issues 365-66 (1975) (problems of litigating complex antitrust issues in court) [hereinafter cited as Brodley, *Efficiencies*].

Potential Competition Mergers

scribed in terms of full and efficient use of scarce resources, technological progressiveness, responsiveness to consumer demands, and quality of output.¹⁵ Desirable market performance under these criteria should lead to profit-maximization, the hypothesized goal of private business firms in a competitive economy.¹⁶ But as Learned Hand noted in *United States v. Aluminum Co. of America (Alcoa)*, market performance is a difficult standard for a legal proceeding.¹⁷

Market conduct refers to the behavior of firms within a market in responding to market conditions. Competitive, as distinct from collusive, conduct is preferred because it should lead to better economic performance.¹⁸ Antitrust seeks to induce competitive behavior by making collusive conduct more costly. To the extent that collusion is easily identifiable, an effective legal rule can be conduct-oriented, as demonstrated by the per se rules against price fixing and market division conspiracies.¹⁹ Mergers pose a particular problem for either a performance or conduct standard, however, since at the critical point when the firm must appraise the legal standard—the time of the merger—no merger-induced performance or conduct can yet have occurred.²⁰

The third type of economic measure is market structure, which, as will become clear, is alone suitable as a basis for a presumptive merger rule. Market structure refers to the relatively permanent organizational characteristics of the market, including seller concentration, buyer concentration, product differentiation, and other barriers to entry.²¹ While structural measures are not immutable, they are subject to change only by long-run, usually gradual developments.²²

Prior to *Philadelphia Bank*, the proof offered in lower court and

15. See F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 3-6 (1970).

16. But see note 142 *infra*.

17. 148 F.2d 416, 427 (2d Cir. 1945) (Second Circuit hearing appeal by designation; Supreme Court lacked quorum).

18. See G. STIGLER, *supra* note 12, at 5 ("The economic role of competition is to discipline the various participants in economic life to provide their goods and services skilfully and cheaply.")

19. See, e.g., *United States v. Topco Assocs., Inc.*, 405 U.S. 596, 611 (1972) (division of territories); *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 218 (1940) (price-fixing agreements).

20. As the Supreme Court recently noted, § 7 is "a prophylactic measure, intended 'primarily to arrest apprehended consequences of intercorporate relationships before those relationships could work their evil. . .'" *Brunswick Corp. v. Pueblo Bowl-O-Mat Inc.*, 97 S. Ct. 690, 695 (1977) (quoting *United States v. E.I. DuPont de Nemours & Co.*, 353 U.S. 586, 597 (1957)).

21. J. BAIN, *INDUSTRIAL ORGANIZATION* 7 (2d ed. 1968).

22. See p. 9 *infra*. Market structure is an ingredient in all approaches to merger policy. But a structural rule is distinct in that it relies entirely on structural factors. See, e.g., note 55 *infra*.

Federal Trade Commission (FTC) proceedings under the amended section 7 had ranged widely. Evidence as to performance and conduct was freely admitted, including such factors as barriers to entry, price leadership, long-run supply and demand conditions, predicted effects of the merger on buyers and sellers, anticipated advertising and distributional economies for the merging firms, and post-acquisition behavior of the firms and the market (for example, whether profits were too high or too low).²³ All were urged as germane to the difficult question of assessing the future effects of a merger, and the leading antitrust writing of the period, the 1955 Report of the Attorney General's Committee to Study the Antitrust Laws, called for consideration of many such factors in order to reach a "reasonable conclusion as to . . . probable economic effect."²⁴

At this point one of the rare breakthroughs in legal analysis occurred. In a penetrating article on merger policy, Derek Bok demonstrated that the problem of predicting the future competitive effects of a horizontal merger, based on consideration of the relevant economic factors, is intractable.²⁵ Examining in detail the trial record of one merger case, Bok demonstrated the futility of attempting to assess the future effects of a merger on the basis of present market performance and conduct. Not only is the significance of each factor debatable, but the combination of disparate factors into a single index of future market performance is subject to no rational protocol. Rather than improving the assessment of future competitive impact, the use of multiple guides for decision in a contested judicial proceeding simply increases the risk of error in logic or inference and leads to erratic and ultimately nonrational decisionmaking.²⁶ Bok concluded that the only effective foundation for horizontal merger policy was a structural-presumptive rule. Although he conceded that such a rule

23. See Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 260-66, 332-39 (1960).

24. REPORT OF THE ATTORNEY GENERAL'S NATIONAL COMM. TO STUDY THE ANTITRUST LAWS 123 (Gov't Printing Office 1955) [hereinafter cited as ATTORNEY GENERAL'S REPORT]. The Report conceded that not all facts could be investigated in each case, but provided only general guidelines for screening out the most relevant facts. *Id.* at 126.

25. Bok, *supra* note 23, at 349, states:

There is undoubtedly a point in human understanding where information can be said to bear upon a situation without being understood well enough to assist in predicting the course of future events. We have argued that much of the relevant economic theory has reached this point and that to use such doctrine in attempting elaborate predictions under section 7 will cause confusion rather than enlightenment.

26. Nor, according to Bok, can a more effective rule be based on consideration of a partial set of conduct and performance factors, for the elements of greatest relevance would vary from case to case, and in any event would lead to no clear result when they pointed in opposite directions. *Id.* at 292-93.

would sometimes lead to inequality in result, since some inoffensive mergers would be barred, such inequality could not be avoided by a more complex rule. And under a complex rule the inequality would also be influenced by judicial misapprehension, ingenuity of counsel, and sheer bulk of the litigation war chest.²⁷

Bok's powerful demonstration has never been refuted,²⁸ and it was specifically endorsed by the Supreme Court in *Philadelphia Bank*. The Court declared that applying section 7 on a case-by-case basis would logically require "not merely an appraisal of the immediate impact of the merger upon competition, but a prediction of its impact upon competitive conditions in the future."²⁹ This would force the courts to attempt to assess "complex and elusive" economic data³⁰ and would possibly make the legal consequences of a merger so uncertain as to retard "sound business planning."³¹ Such a course would also run the risk of "subverting congressional intent by permitting a too-broad economic investigation."³² The Court then concluded with the words that became the theme of horizontal merger policy: "And so in any case in which it is possible, without doing violence to the congressional objective embodied in section 7, to simplify the test of illegality, the courts ought to do so in the interest of sound and practical judicial administration."³³ The structural-presumptive rule for horizontal mergers, adopting seller concentration and market share as primary decisional criteria, was built on this analytic foundation.³⁴

In *Marine Bancorporation*, eleven years later, the Supreme Court clearly indicated that the legal doctrine for potential competition mergers was to be fundamentally different. Embracing difficult tests of conduct and performance, the Court reintroduced the complexities

27. *Id.* at 298-99.

28. Indeed, it seems generally to have been accepted. See Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313, 1318 (1965) (Bok's arguments "remain virtually unanswered"). See also Posner, *Antitrust Policy and the Supreme Court*, 75 COLUM. L. REV. 282, 313 (1975) (approving of presumptive rules for horizontal mergers) [hereinafter cited as Posner, *Antitrust Policy*].

29. 374 U.S. at 362.

30. *Id.* (citing Bok, *supra* note 23).

31. *Id.*

32. *Id.*

33. *Id.* The Court also cited C. KAYSER & D. TURNER, ANTITRUST POLICY 133 (1959), Stigler, *Mergers and Preventive Antitrust Policy*, 104 U. PA. L. REV. 176, 182 (1955), and Bok, *supra* note 23, at 308-16, 328, for the proposition that a simplified test is supported by economic theory. 374 U.S. at 363 n.38.

34. Implicit in the rule against horizontal mergers is the assumption that the social gains from limiting market power and aggregate concentration outweigh possible losses from forgoing scale or other economies. See generally W. BOWMAN, PATENT AND ANTITRUST LAW 7-8 (1973); Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 AM. ECON. REV. 18 (1968) [hereinafter cited as Williamson, *Economies*].

that *Philadelphia Bank* had wisely avoided.³⁵ Any doubt that a distinct standard was established for potential competition mergers was put to rest by the post-*Marine Bancorporation* decisions in the lower courts, as will be discussed below.³⁶ To see how this came to pass, and to put *Marine Bancorporation* in its proper setting, the judicial development of potential competition must be traced.

1. *Potential Competition in the Supreme Court*

The complexities of a conduct-performance standard for potential competition mergers were not at first apparent. In its early potential competition decisions, particularly in *United States v. El Paso Natural Gas Co.*³⁷ and *United States v. Continental Can Co.*,³⁸ the Supreme Court viewed potential competition as a unitary concept, like the notion of competition.³⁹

"Competition," the bedrock concept of antitrust policy, is a summary term for a complex bundle of properties, including both the actuality and the perception of market rivalry.⁴⁰ Actual market rivalry can be seen when a firm initiates a competitive program, such as the introduction of a new product, in the expectation that it will gain an advantage—even if only temporary—over its competitors; perceived rivalry arises when a firm refrains from making a competitive move, like a price cut, because it anticipates that competitors will respond in kind.⁴¹ The courts have not in general attempted to measure separately these two aspects of firm rivalry or the many additional elements of competition that could be identified.⁴² Instead,

35. In *United States v. General Dynamics Corp.*, 415 U.S. 486 (1974), a decision contemporaneous with *Marine Bancorporation*, the Supreme Court may have reopened the door to broad factual inquiry in horizontal merger cases, a door once closed by *Philadelphia Bank*. Although *General Dynamics* was arguably based on very special facts relating to market definition in an industry where competition focused almost entirely on long-term commitments of natural resources, the courts have not interpreted the decision that narrowly. See, e.g., *United States v. Citizens & S. Nat'l Bank*, 422 U.S. 86 (1975) (banking); *United States v. Amax, Inc.*, 402 F. Supp. 956, 970-74 (D. Conn. 1975) (copper mining and refining). Thus there is a danger that *Marine Bancorporation's* weakening of the structural-presumptive approach will spill over into horizontal merger doctrine.

36. See pp. 19-25 *infra*.

37. 376 U.S. 651 (1964).

38. 378 U.S. 441 (1964).

39. To a lesser degree this view is also reflected in *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 580-81 (1967).

40. See J. CLARK, *COMPETITION AS A DYNAMIC PROCESS* (1961).

41. Cf. *id.* at 14 (distinguishing "active" and "latent" rivalry).

42. As summarized by the 1935 Attorney General's Report, these include relative size of firms, opportunity for entry, independence of rivals, predatory practices, rate of industry or market growth, market incentives to competitive moves, product differentiation, long-run price rigidity, and magnitude and duration of excess capacity. ATTORNEY GENERAL'S REPORT, *supra* note 24, at 324-36.

Potential Competition Mergers

courts have simply used market definition to determine the economic zone in which competitive rivalry is present. This approach was essential to the development of effective antitrust policy, because courts lack the capacity to measure the individual properties of competition.⁴³

The early cases approached the definition of potential competition from a similar unitary perspective. Potential competition was simply the nearness of the state of actual competition. According to this view, probable future entry and perceived entry are not distinct theories, but differing manifestations of the market rivalry that an out-of-the-market firm might offer over time. In *Continental Can* the Court described the potential competition between firms producing non-competing metal and glass containers, respectively, in terms both of perceived and of future entry effects, but did not distinguish between the two effects.⁴⁴ In *El Paso* the Court described the effect of potential competition in a particular market as determined "by the nature or extent of that market and by the nearness of the absorbed company to it, that company's eagerness to enter . . . , its resourcefulness" and similar factors.⁴⁵ A unitary approach to both competition and potential competition is preferable because it better recognizes the dynamic and intermittent character of market rivalry. Under such an approach less weight is placed on particular market behavior at a given moment (such as perceived entry) and more attention is fo-

43. See J. CLARK, *supra* note 40.

44. 378 U.S. 441, 465-66 (1964). The Court barred the proposed merger of a metal-container firm with a glass-container manufacturer, even though the firms did not then compete. The Court ruled that the potential competition posed by either firm would deter "attempts by the dominant members of either industry to reap the possible benefits of their position by raising prices above the competitive level" (perceived effect) and would preserve the "dynamic long-run potential" of competition (future entry effect). *Id.* Under this unitary approach, the Court did not sharply differentiate between the two effects. This may explain why later, after the potential competition doctrine had been bisected into the perceived and future entry effects, the justices disagreed on the interpretation of *Continental Can*. Compare *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 537 n.14 (1973) (majority opinion) (*Continental Can* involved only perceived effect) with *id.* at 562 (Marshall, J., concurring in the result) (case turned on probable future entry).

45. 376 U.S. at 660. In *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 623 (1974), the Court, following suggestions by commentators, described *El Paso* as "in reality . . . an actual-competition rather than a potential-competition case" (citing *Turner, supra* note 28, at 1371), because at the time of acquisition the target firm was actually attempting market entry. But this does not explain the *El Paso* Court's reliance on potential competition analysis. The Court in *El Paso* viewed both potential and horizontal competition as unitary concepts that overlap at the margin. As potential competition becomes more and more probable it gradually merges into actual competition. A firm attempting market entry can thus be characterized as either an actual or a potential competitor, depending on whether one looks primarily at its past history or future prospects.

cused on longer-run factors.⁴⁶ In the cases after *Continental Can* and *El Paso*, however, the courts abandoned the unitary approach and split the concept of potential competition into two disjointed parts—separate, but unequal.

The Court's first major thrust toward conduct and performance standards began with *United States v. Penn-Olin Chemical Co.*,⁴⁷ which involved a joint venture to enter the highly concentrated sodium chlorate market in the southeast. Even though by definition the joint venture precluded individual entry by the parent firms, the lower court, delving at length into the conduct and motivation of the firms, concluded that in the absence of the venture *both* parents would *not* have entered the market, and hence there was no injury to potential competition.⁴⁸

The Supreme Court was clearly unhappy with this result, which relied heavily on testimony by managers of the parents as to the firms' lack of intent to enter the market individually.⁴⁹ The Court was not prepared to upset the lower tribunal's findings of fact, however, so the reversal was based on the lower court's failure to consider the perceived effect of potential competition.⁵⁰ Although the district court had found that both parents would not have entered the market, the district court had not determined whether one of the parents might have been perceived as a potential entrant while the other remained a probable market entrant. The trial court had thus erred in failing to consider the possible competitive injury from removing as a potential entrant a firm that otherwise might have "remained

46. Analytically, the scope of both competition and potential competition turns fundamentally on the time frame within which they are viewed and the distance between firms in product, technological, and geographic terms. See J. CLARK, *supra* note 40, at 16-17 (time and distance); G. STIGLER, *supra* note 12, at 8-9 (time).

As the time frame extends, the likelihood of competitive behavior increases. In potential competition terms, the probability of both perceived and actual entry increases with time. Less obviously, the same principle often holds true with horizontal competition.

Conversely, as the market distance between firms shrinks, the likelihood of competitive interaction increases. The market distance consideration is reflected in the traditional definition of the product and geographic market in antitrust cases involving measurement of horizontal market power. The concept of market distance, or proximity, underlies this article's proposal for a structural test for potential competition mergers. See pp. 65-68 *infra*.

47. 378 U.S. 158 (1964).

48. 217 F. Supp. 110 (D. Del. 1963).

49. *Id.* at 128-30 & nn.22-23.

50. There seems little doubt how the Court would have ruled had it not been bound by the "clearly erroneous" rule in reviewing lower court findings, for the evidence disclosed an "array of probability [that] certainly reaches the prima facie stage" that either joint venturer might be a future entrant. *Id.* at 175.

Potential Competition Mergers

at the edge of the market, continually threatening to enter.”⁵¹ Such a presence at the market’s edge could “restrain producers from overcharging.”⁵² Thus was born the perceived effect as an independent source of potential competition.

In remanding to the district court, however, the Supreme Court offered no guidance as to how the evidence in such a case might differ from that in an actual entry effect case. Instead, the Court merely noted some criteria that the trial court might consider, presumably as to both potential competition effects. These criteria were a witches’ brew of performance and conduct ingredients, including “the setting in which the joint venture was created,” the “reasons and necessities for its existence,” the “potential power of the joint venture,” “appraisal of what the competition in the relevant market would have been if one of the joint venturers had entered alone,” and, after listing twelve items, “such other factors as might indicate potential risk to competition.”⁵³ There was no indication of the theoretical justification for reviewing such factors or of how they might be evaluated and weighted.

The search for a workable standard of potential competition was not advanced in the next major decision, *FTC v. Procter & Gamble Co.*,⁵⁴ which affirmed the FTC’s finding that Procter’s acquisition of the dominant firm in the oligopolistic liquid bleach industry violated section 7. By implication, the Court seemed to favor a conduct-based rule, since the evidence cited by the Court as supporting the FTC decision centered on such questions.⁵⁵ *Procter & Gamble* was not the ideal case for a clarification of standards, however, since the potential competition issue was clouded by findings of an “entrenchment effect” based on the theory that entry by one of the nation’s industrial giants into an industry populated by Lilliputians might intimidate rivals and entrench the acquired firm.⁵⁶

51. 378 U.S. at 173.

52. *Id.* at 174 (quoting C. WILCOX, COMPETITION AND MONOPOLY IN AMERICAN INDUSTRY 7-8 (TNEC Monograph No. 21, 1940)).

53. *Id.* at 177.

54. 386 U.S. 568 (1967).

55. The Court cited evidence of Procter’s diversification program, its recent entry into a similar industry, the close proximity between Procter’s existing product lines and the liquid bleach industry, Procter’s manufacturing, advertising and marketing capability, and its prior consideration of unilateral entry. *Id.* at 580. Of course some of these factors are structural, but every merger rule has a structural component; the *Procter & Gamble* rule is conduct-oriented because it incorporates significant conduct issues that inevitably become the focal point of litigation.

56. *Id.* at 578-79 & n.3. See note 340 *infra*.

In a powerful concurrence that articulated several of the ideas adopted by the Court in *Marine Bancorporation*, Justice Harlan outlined a proposed approach to potential

*United States v. Falstaff Brewing Corp.*⁵⁷ and *Marine Bancorporation* represent the Court's major efforts to frame a legal standard for potential competition mergers. *Falstaff* attempted a conduct-based approach, while *Marine Bancorporation* used a mixed conduct-performance standard. In both cases the chasm widened between the perceived and future entry effects. In neither decision did a workable approach to potential competition emerge, though it is *Marine Bancorporation* that is primarily responsible for the present plight of potential competition merger policy.

In *Falstaff* the nation's fourth largest brewer of beer acquired Naragansett, the largest brewer in the New England region. Although *Falstaff* held only six percent of the national market, it was the largest beer firm not yet in the New England market. Naragansett controlled over twenty percent of the concentrated regional market, and the number of firms in the market was declining rapidly. As in *Penn-Olin*, the lower court heeded managerial testimony and found no likelihood of independent entry.⁵⁸ With injury to competition through loss of probable future entry ruled out, the concrete issue in *Falstaff* was whether existing firms in the New England beer market *perceived* *Falstaff* as a probable future market entrant through internal expansion. Cognizant of the difficulties inherent in resolving the issue, the Court attempted to devise an objective legal standard for potential competition. This took shape in a new legal abstraction, the "rational beer merchant," which the Court set forth in these words:

The specific question with respect to this phase of the case is . . . whether, given [*Falstaff's*] financial capabilities and conditions in the New England [target] market, it would be reasonable to consider it a potential entrant into that market . . . and if it would appear to rational beer merchants in New England that *Falstaff* might well build a new brewery to supply the northeastern market then its entry by merger becomes suspect under § 7.⁵⁹

The majority apparently devised this new abstraction to ensure that proof would rest more heavily on objective economic facts, not

competition. 386 U.S. at 589-99. Harlan's analysis differed significantly from that later applied by the Court in *Marine Bancorporation*, however, since he would have considered conduct and performance evidence only in rebuttal of a presumption resting on a limited set of structural factors. 386 U.S. at 592. Indeed, Harlan noted, "only by focusing on market structure can we begin to formulate standards which will allow the responsible agencies to give proper consideration to . . . mergers and allow businessmen to plan their actions with a fair degree of certainty." *Id.* at 592.

57. 410 U.S. 526 (1973).

58. 332 F. Supp. 970, 972 (D.R.I. 1971).

59. 410 U.S. at 533 (citation omitted).

Potential Competition Mergers

on subjective evidence of managerial intention. There is no indication that a radically different theory of liability was being promulgated.⁶⁰ Under *Falstaff* a perceived effect case need not turn on whether target market firms actually perceived the acquiring firm as a potential market entrant, but on whether a rational firm knowing all the economic facts would have so perceived the acquiring firm. This approaches a conduct standard, since the ultimate issue to be ascertained under the rational beer merchant test is entry probability, a well-defined future event.⁶¹

If the underlying event were a simpler phenomenon, this would be an excellent resolution. The problem is that the facts relevant to an assessment of entry probability by a large, complex organization, subject to uncertainty and acting through staff, committees, officers, and directors, are inherently obscure.⁶² In addition, with objective evidence typically pointing in several directions, subjective testimony is apt to remain highly influential.⁶³ Moreover, articulation of the *Falstaff* test in terms of the perceptions of a rational target market firm unavoidably opens the proof to the subjective testimony of a whole new set of witnesses—the managers of other target market firms—who can scarcely be excluded on the claim that they are less than rational.⁶⁴ As competitors of the acquired firm, such managers may have a strong interest in the litigation's outcome, and their perceptions

60. The Court stated that "[t]he District Court should therefore have appraised the economic facts about Falstaff and the New England market in order to determine whether in any realistic sense Falstaff could be said to be a potential competitor on the fringe of the market with likely influence on existing competition." *Id.* at 533-34 (citation omitted). Under the standard all the evidence admissible on the actual entry phase of the case would be admissible on the perceived effect issue, *id.* at 534 n.13, and a bare allegation in the complaint that the merger would injure potential competition was held sufficient to raise issues as to both the actual entry and perceived effects. *Id.*

61. An issue of market performance, by contrast, requires a characterization of a whole stream of conduct, e.g., "progressiveness" or "low prices." The rational firm standard also tends to reunite the two effects of potential competition, since what the rational firm would perceive (perceived effect) is presumably that which appears most likely to occur (future entry effect).

62. The complexity and uncertainty of large corporation decisionmaking is scarcely a new insight. See M. DIMOK & H. HYDE, BUREAUCRACY AND TRUSTEESHIP IN LARGE CORPORATIONS 25-26 (TNEC Monograph No. 11, 1940); Timberg, *Corporate Fictions*, 46 COLUM. L. REV. 533, 559-66 (1946). See also Brodley, *Oligopoly Power Under the Sherman and Clayton Acts—From Economic Theory to Legal Policy*, 19 STAN. L. REV. 285, 357-58 (1967) (divining corporate intent involves "vast labyrinth of evidence") [hereinafter cited as Brodley, *Oligopoly Power*].

63. See, e.g., *FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 297 (4th Cir. 1977) (discussed in note 100 *infra*).

64. 410 U.S. at 534 n.13 ("[t]he Government did not produce direct evidence of how members of the New England market reacted to potential competition from Falstaff, but circumstantial evidence is the lifeblood of antitrust").

are obviously subjective.⁶⁵ Under these conditions the prospects were not bright that the *Falstaff* conduct approach would lead to a consistent, workable rule for potential competition. But before the standard could be fully tested, it was changed by *Marine Bancorporation*.

More than any other single decision, *Marine Bancorporation* is responsible for the present breakdown in potential competition merger enforcement. In that decision the Court introduced new and unmanageable issues of economic performance and conduct, deepened the confusing dichotomy between the two types of potential competition, and came closer than it ever had before to rejecting directly the congressional goal of controlling excessive economic concentration.

The acquisition in *Marine Bancorporation* involved a market extension by a leading firm into a highly concentrated market. The second largest bank in the state of Washington acquired the third largest bank in Spokane, the major city in eastern Washington. Three banks in the Spokane market held no less than ninety-two percent of total deposits. Injury to potential competition seemed at least presumptively present since the target firm held 18.6% of total bank deposits in a concentrated local market, and the acquiring firm was the largest bank in the state not having an office in Spokane.⁶⁶ Prevention of the merger would therefore have preserved the possibility of unilateral entry by the largest eligible entrant. But the Supreme Court, affirming the lower court ruling and approving the merger, found that state restrictions on bank expansion severely limited the application of the potential competition doctrine to banking.⁶⁷ By impeding entry and branching, the Court said, state regulation eliminated any real possibility that the acquiring bank could achieve significant market penetration in Spokane other than by acquisition of the target bank. State restrictions also prevented the perception of the acquiring bank as a market entrant, the Court ruled, for "[r]a-

65. See, e.g., *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449, at 71,702 n.18 (D.D.C. 1977) (testimony of senior vice president of leading target market competitor).

More generally, Justice Rehnquist, arguing against any exclusion of subjective evidence, has challenged the whole dichotomy between subjective and objective evidence as "largely illusory," since "any economic decision is largely subjective." *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 575-76 (1973) (dissenting opinion). But this misses the point of the distinction. The advantage of an objective fact approach is not the elimination of human observation, but the insistence that evidence be gleaned from disinterested observers, not from interested insiders. See F. MACHLUP, *THE ECONOMICS OF SELLER COMPETITION* 58-59 (1952). See also H. SIMON, *MODELS OF MAN* 278 (1957) (distinguishing "objective" and "subjective" economic rationality).

66. 418 U.S. at 607, 609.

67. *Id.* at 626-30.

Potential Competition Mergers

tional commercial bankers in Spokane, it must be assumed, are aware of the regulatory barriers.”⁶⁸

The significance of *Marine Bancorporation* extends beyond regulated industries, however, for the Court developed a general analytical framework for potential competition. Concentrating on the perceived effect as “the principal focus of the doctrine,”⁶⁹ the Court enumerated the elements it deemed essential to the proof of a potential competition case: (1) the target market is highly concentrated and therefore market behavior is presumptively (but not conclusively) oligopolistic; (2) the acquiring firm is a probable market entrant; (3) entry by the acquiring firm would have significant procompetitive impact; and (4) the acquiring firm is perceived as a potential entrant and such perception in fact “tempered” behavior in the target market.⁷⁰

Requiring proof of these elements in any literal sense would introduce impossible litigation issues. The Court may have appreciated the difficulties it was creating, because it permitted a presumption that a highly concentrated market behaves oligopolistically, and suggested that proof of “parallelism” or other suspect market practices could establish oligopolistic behavior.⁷¹ But the solution will not hold. When the presumption from high concentration is challenged, as increasingly it is,⁷² there is no effective legal standard for establishing oligopolistic behavior. Proving even the existence of market parallelism can be difficult. Identity of quoted price and terms does not necessarily demonstrate actual parallelism, for there may be discounting or secret price shading.⁷³ Significant parallelism in itself does not establish oligopolistic collusion; it may just as plausibly reflect competitive behavior by firms with similar cost conditions that are constrained from independent initiative by a highly competitive market. Further, markets cannot be neatly classified into those that exhibit parallel behavior and those that do not, because the degree of parallelism varies across a wide continuum.⁷⁴ Indeed, if markets that be-

68. *Id.* at 639.

69. *Id.* at 624.

70. All four elements are required in a perceived entry case, while only the first three are necessary in a future entry case.

71. *Id.* at 630-31.

72. See pp. 20-22 *infra*.

73. See G. STIGLER, *supra* note 12, at 241-44 (large deviation between quoted and actual price).

74. See J. BAIN, *INDUSTRIAL ORGANIZATION* 308-11 (2d ed. 1968). Bain distinguishes four types of “incomplete collusion”: incompletely observed collusion, collusion with indefinite terms of agreement, collusion with incomplete participation of industry members, and interdependent action without agreement. But within each type, he notes, “there can be a wide range of different subpatterns.” *Id.* at 310.

have "oligopolistically" could be reliably distinguished from those that behave competitively, there would be a basis for a much stronger policy response than application of the antimerger provisions of the Clayton Act.⁷⁵

The Court's new criteria of proof sharply distinguished between the perceived and future entry effects for the first time. No longer were these effects differing manifestations of a single phenomenon; they became two separate theories subject to proof by distinct evidence. Having breathed independence into the two theories, the Court then declared its doubt that the second theory could by itself provide the basis for a section 7 violation, since a merger injures no existing competition if it only forecloses future entry.⁷⁶

The difficulty of litigating the issues raised by *Marine Bancorporation* need not be left to speculation, for subsequent lower court decisions provide examples of the criteria in application, and they strongly confirm the diagnosis of trouble.⁷⁷ Perhaps this negative result is acceptable to a Court that views the goals of section 7 narrowly. The aim of the statute, the Court said in *Marine Bancorporation*, is to correct present economic abuse by intervening "where there are dominant participants in the target market engaging in interdependent or parallel behavior," for only then is there cause to be concerned over the preservation of perceived entrants or reason to strive for long-term deconcentration.⁷⁸ Such a premise probably justifies narrow rules for potential competition mergers, but is hardly

75. Although writers disagree on the difficulty of proving oligopolistic behavior, the inquiry is surely complex. See Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 635 (1962); Posner, *A Program for the Antitrust Division*, 38 U. CHI. L. REV. 500, 514-25 (1971); Markovits, *A Response to Professor Posner*, 28 STAN. L. REV. 919 (1976). The clearest proposal for detecting such behavior is Posner's, but he concedes its difficulties in proof, and Markovits feels even this is an understatement. A single example illustrates the problem. Under Posner's analysis, a classic case of parallel oligopolistic behavior, *American Tobacco Co. v. United States*, 328 U.S. 781 (1946), becomes arguably nonoligopolistic, while the classic case of nonoligopolistic parallel behavior, *Theatre Enterprises, Inc. v. Paramount Film Distributing Corp.*, 346 U.S. 537 (1954), becomes arguably oligopolistic. See Posner, *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 STAN. L. REV. 1562, 1584-87 (1969). But see R. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 73 (1976) (*Theatre Enterprises* nonoligopolistic after all). While the issue is scintillating for legal scholarship, it would be premature for courts to attempt to introduce such new criteria into the decision of cases. See Scherer, Book Review, 86 YALE L.J. 974, 982-83 (1977). See generally ATTORNEY GENERAL'S REPORT, *supra* note 24, at 39-42 (diverging views on significance of "uniform action" by firms); Sherman, *Competition Over Competition*, 20 PUB. POL'Y 545, 559 (1972) (difficulty of defining "competitive behavior" in oligopoly situation).

76. 418 U.S. at 639. See pp. 45-52 *infra*.

77. See pp. 19-25 *infra*.

78. 418 U.S. at 630.

Potential Competition Mergers

a sympathetic reading of the legislative history of section 7 or of prior cases.⁷⁹

2. *Potential Competition in the Lower Courts after Marine Bancorporation*

In seven subsequent lower court and FTC cases,⁸⁰ the *Marine Bancorporation* standards for potential competition mergers have required detailed assessments of market performance and conduct. It will be recalled that *Marine Bancorporation* established four elements of proof for a potential competition case; these in turn relate to one of two basic issues: (1) whether target market performance and conduct are presently deficient, or (2) whether the merger will have adverse effects on present or future performance and conduct.⁸¹

The evidence introduced and considered at the trial level touched almost every conceivable aspect of performance and conduct. Elaborate trial records were one clear result;⁸² consistent losses by the government were another.⁸³ Review of the types of evidence considered in these cases illustrates both the growing intricacy of potential competi-

79. See pp. 40-52 *infra*; cf. *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 653 (1974) (White, J., dissenting) (policy of § 7 is to bar mergers contributing to future concentration).

80. *FTC v. Atlantic Richfield Co.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,241 (4th Cir. 1977); *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449 (D.D.C. 1977); *United States v. Hughes Tool Co.*, 416 F. Supp. 637 (C.D. Cal. 1976); *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033 (D. Md. 1976); *British Oxygen Co.*, 86 F.T.C. 1241, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063 (1975), *rev'd and remanded sub nom. BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977); *The Budd Co.*, 86 F.T.C. 518, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,998 (1975); *Beatrice Foods Co.*, 86 F.T.C. 1, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,944 (1975), *aff'd sub nom. Beatrice Foods Co. v. FTC*, 540 F.2d 303 (7th Cir. 1976).

81. Thus the first *Marine Bancorporation* element, an oligopolistic target market, relates to the first of these issues. The remaining three elements under *Marine Bancorporation*—probable entry, significant procompetitive impact, and conduct-changing perception of entry—relate to the second issue.

82. In *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,565 (D. Md. 1976), the trial record contained 5,000 pages and 10,000 exhibits; in *Beatrice Foods Co.*, 86 F.T.C. 1, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,944 (1975), *aff'd sub nom. Beatrice Foods Co. v. FTC*, 540 F.2d 303 (7th Cir. 1976), the record was over 3,500 pages, 86 F.T.C. at 10 (initial decision); and in *United States v. General Dynamics Corp.*, 415 U.S. 486 (1974), *aff'g* 341 F. Supp. 534 (N.D. Ill. 1972), a horizontal merger case applying similar conduct-performance standards, the trial record exceeded 17,500 pages, Brief for Appellee at 2, footnote 2. This is scarcely an improvement over the 2,600 pages that constituted the government's case in the *Brillo* proceeding, the litigation on which Derek Bok based his 1960 article on horizontal merger standards. See Bok, *supra* note 23, at 266.

83. The only case in which the government prevailed at trial, *British Oxygen Co.*, 86 F.T.C. 1241, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063 (1975), was reversed on appeal, *sub nom. BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977).

tion litigation and the questionable nature of judgments based on such evidence.

a. *Oligopolistic Behavior in the Target Market*

In most of the cases the target markets were highly concentrated,⁸⁴ and thus under *Marine Bancorporation* a presumption of oligopolistic behavior was available. Defendants nevertheless typically challenged the presumption by introducing evidence to show that market performance was competitive rather than oligopolistic. Evidence was proffered to show (1) technological progressiveness and product improvement, (2) moderate or declining prices, (3) moderate profits, (4) use of "informational" advertising rather than less desirable "persuasive" advertising, (5) countervailing market power of buyers, including threats of backward integration, (6) competition posed by private label brands, (7) low entry barriers, (8) lack of parallelism of pricing behavior, and (9) existence of vigorous competition, based on direct testimony by industry witnesses.⁸⁵

The difficulty of evaluating evidence on each factor, much less reaching a final judgment of market "competitiveness," is illustrated

84. The four-firm concentration ratio was approximately 60% or greater in five of the cases. See *FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 291 (4th Cir. 1977) (three-firm ratio 60% in refined copper industry); *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449, at 71,700 (D.D.C. 1977) (four-firm ratios in excess of 83% and 88% in two relevant markets); *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,577 (D. Md. 1976) (four-firm ratio 77.5%); *British Oxygen Co.*, 86 F.T.C. 1241, 1363-64, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,918-19 (1975), *rev'd and remanded sub nom.*, *BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977) (four-firm ratio 70%); *The Budd Co.*, 86 F.T.C. 518, 574-77, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,998, at 20,854 (1975) (four-firm ratio of 57% to 61% in years preceding merger).

85. See *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,579-83 (D. Md. 1976) (private-label brands; informational advertising; product improvement; price-competitiveness); *British Oxygen Co.*, 86 F.T.C. 1241, 1364-67, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,919-20 (1975), *rev'd and remanded sub nom.* *BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977) (lower prices; vigorous competition); *The Budd Co.*, 86 F.T.C. 518, 577-79, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,998, at 20,854-55 (1975) (low entry barriers; moderate profits).

In the *Tenneco* case, the basic thrust of the performance evidence was misinterpreted. Evidence of high entry barriers, according to the district court, did not justify protection of potential competition. Rather, so far as the future entry effect was concerned, high barriers were deemed a reason for *not* applying the potential competition doctrine. The court observed that such barriers, combined with high concentration, make future entry improbable and thereby undermine that portion of the doctrine. At the same time, the court acknowledged that if entry barriers are low, there is no need to apply the antimerger law to protect potential competition. Thus, the doctrine was held to be self-contradictory. *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449, at 71,699 & n.5 (D.D.C. 1977). See note 119 *infra* for the origin of this incorrect analysis.

Potential Competition Mergers

by *British Oxygen Co.*⁸⁶ The defendants sought to demonstrate market competitiveness by showing that the price of industrial gases had declined for several years. The FTC met this claim by pointing out that only the prices on some products had fallen, while other prices had increased, and that in any event a price drop was to be expected since costs had been reduced. The defendants countered by urging that, although costs had decreased, the lower prices demonstrated that the decreases had been passed on to consumers. The FTC replied that the record did not show whether *all* of the cost reductions had been passed on.⁸⁷ Similarly, the parties joined issue on the significance of profits. The defendants urged that profits were moderate because the rate of return on investment did not exceed three percent. This was not a valid statistic, the FTC retorted, because the investment base on which the return was calculated excluded depreciation,⁸⁸ and profits on sales had risen from 4.92% to 7.17%.⁸⁹ The rebuttal to this might have been that increased profits on sales is exactly what one would expect in a competitive market during a period of rising demand and short supply.

All of this rhetorical thrust and parry seems highly unsatisfactory and could become even more intricate if the parties probed deeper into the issues. Ascertaining cost would require highly complicated explorations of such issues as the allocation of overhead and other indirect costs in diversified firms, proper valuation of assets, and the relation of supply and demand conditions to price levels. Even with the data established, the court would have to identify the norm for a workably competitive industry with equivalent risk characteristics under similar supply and demand conditions. So extended, the analysis resembles a public utility rate hearing, since it involves all the difficulties of establishing a reasonable rate of return on investment.

This discussion has touched but a single issue of competitive performance—prices. The problem intensifies when factors must be balanced against each other—for example, prices versus product innovation—in order to reach an overall assessment of competitiveness.⁹⁰

86. 86 F.T.C. 1241, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063 (1975), *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977).

87. *Id.* at 1364-65, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,919.

88. *Id.* at 1366 n.27, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,920 n.27. See Brief for Petitioner at 47-48; Brief for Respondent at 35-36 (depreciation issue argued).

89. 86 F.T.C. at 1366 n.27, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,920 n.27.

90. *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,575-83 (D. Md. 1976), illustrates the difficulty in reaching a balanced judgment on competitive-

The core difficulty is that the *Marine Bancorporation* standards force the courts to assess the performance of an industry as a preliminary issue in a merger case.⁹¹

b. *Effect of Merger on Market Performance and Conduct*

Given an oligopolistic target market, proof of the anticompetitive effect of a merger requires a showing of (1) probable market entry by means other than the merger, (2) significant procompetitive effect of independent entry, and (3) a perceived or "edge" effect on the target market. Under *Marine Bancorporation* proof of the first two elements is necessary in an actual entry case and proof of all three is required in a perceived effect case.

A necessary foundation for any finding of anticompetitive effect under either theory is a showing that the acquiring firm is a probable market entrant.⁹² The decisions have approached probable market

ness. The evidence showed that increased demand had been followed by new entry, but that the market remained concentrated. There were substantial entry barriers in terms of technological requirements, the need for marketing outlets, and advertising intensity. On the other hand, product improvement showed competitive performance, and advertising was informational, not merely persuasive. While private label sales challenged the industry brands, their market share was not growing. Prices had fallen, but not necessarily because original profit margins had been excessive, since smaller, lower-priced models had been introduced by competitors. *Id.* at 69,582. The Court aptly summarized the evidence as offering "conflicting considerations" on competitiveness and adhered to the presumption drawn from the concentration ratios. *Id.* at 69,583. This is perhaps an inevitable result.

91. The lower court development may have gone beyond anything the Supreme Court intended, for in *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 624-25 (1974), the Court spoke of oligopolistic behavior, not deficient performance, and thus implied a standard limited to market conduct. The only tangible piece of evidence the Court mentioned as relevant, absence of parallelism, *id.* at 630-31, was conduct-oriented. The lower court decisions reveal very little development of this kind of evidence and perhaps reflect the difficulty of distinguishing oligopolistic parallelism from competitive parallelism. See pp. 17-18 *supra*.

When the parallelism issue did arise in *British Oxygen*, its resolution was highly unsatisfactory. The FTC concluded that there were "indications" of parallel pricing based on a single instance in which the largest firm increased prices and another followed "within a day or so." 86 F.T.C. at 1365 n.26, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,919 n.26. But this action followed a sudden increase in demand that had created a shortage, so that a price increase would be expected even in the most competitive market. Moreover, six or seven years earlier the same firm had unsuccessfully attempted to raise price only to lose market share when other firms failed to follow. *Id.* The harsh reality may be that only by assessing overall market performance is it possible to distinguish between parallel-oligopolistic and parallel-competitive conduct.

92. Conceivably, a firm could be perceived as an entrant even though it was in fact not a probable entrant, but given the difficulty of proving entry perceptions, such a case seems extremely unlikely. In any event, lower courts have quite properly viewed the *Marine Bancorporation* elements as preconditions to perceived as well as future entry cases. See, e.g., *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,574 (D. Md. 1976); *United States v. Hughes Tool Co.*, 415 F. Supp. 637, 645 (C.D. Cal. 1976) (dictum).

Potential Competition Mergers

entry by establishing whether the acquiring firm had the capability, interest, and incentive to enter the market by alternative means, and whether such alternative entry was feasible.⁹³ Inviting virtually open-ended inquiry into a broad spectrum of financial, technological, and marketing issues, the question has provided resourceful counsel with a plenitude of issues to litigate. Among the issues explored in recent cases are technological capability, capital availability, marketing and advertising abilities, market overlap between the target and acquiring firms, predicted returns from entry as compared with benchmark or target returns, other incentives or disincentives to entry (such as diversification needs), growth patterns of the acquiring firm (including past entry into similar markets), growth of demand in the target market, availability of smaller or "toehold" acquisitions at prices acceptable to both buyer and seller, specific entry barriers (such as scale economies, product differentiation, and high absolute cost requirements), and managerial interest and intentions as to entry.⁹⁴

Since the courts have generally found a failure of proof on the issue of probable market entry,⁹⁵ there has been less development of the question of the procompetitive impact of entry. The courts have considered evidence of continuing concentration in the market following entry by other firms, and lesser technological capability of the acquiring firm as compared with other entrants.⁹⁶ Also logically falling under this issue and generally reviewed in the cases are the existence of other equally probable potential entrants and the market share of the target firm.⁹⁷

93. See, e.g., *British Oxygen Co.*, 86 F.T.C. 1241, 1351-56, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,911-14, *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977).

94. See *FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 297-98 (4th Cir. 1977) (managerial interest); *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449, at 71,699-702 (D.D.C. 1977) (managerial interest; technical capacity; market overlap; marketing ability; product differentiation); *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,583-85 (D. Md. 1976) (incentives to entry; demand growth); *Beatrice Foods Co.*, 86 F.T.C. 1, 63-65, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,944, at 20,791-92 (1975), *aff'd sub nom.* Beatrice Foods Co. v. FTC, 540 F.2d 303 (7th Cir. 1976) (managerial interest); *British Oxygen Co.*, 86 F.T.C. 1241, 1351-60, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,193-96 (1975), *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977) (technological skill; capital availability; managerial interest; toehold entry; reasonable profits; increased demand; past entry).

95. See note 94 *supra* (citing cases). But see *British Oxygen Co.*, 86 F.T.C. 1241, 1351, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,911, *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977) (FTC found proof of probable market entry sufficient).

96. See *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,594-95 (D. Md. 1976).

97. *FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 294 n.8 (4th Cir. 1977); *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449, at 71,701 & n.9

Proof of a perceived effect case requires, in addition to the two issues so far discussed, evidence that the acquiring firm was perceived as a potential entrant and that such perception tempered or altered behavior in the target market. Evidence presented on this issue has included direct testimony by executives in the target market that they viewed the acquiring firm as a likely entrant and that such perceptions affected their business decisions. In addition, target market executives have been permitted to testify that they perceived other firms as *more* likely entrants and defendants have attempted to prove the existence in fact of other equally likely entrants. Indeed, on the not unreasonable theory that perceptions may have accorded with reality, courts have generally considered on the issue of perceived entry all the evidence admitted to show probable future entry.⁹⁸

By embarking headlong into the assessment of market performance and conduct, the courts are entering the very evidentiary thicket that, following Bok's admonition, they skirted when dealing with horizontal mergers. The lists of factors considered in the post-*Marine Bancorporation* cases reveal no less than twenty-nine separate items of proof, and this reflects but three years' experience. Nor is there any feature of potential competition mergers that makes evaluation of specific competitive effects more tractable than in horizontal merger cases; if anything, the converse is true, since predicting the competitive effects of new market entry seems even more elusive than predicting the effects of combining existing firms. Faced with inherently complex and uncertain issues, the judicial outcome has in almost all cases followed the burden of proof. On the issue of present market competitiveness, the defendants have uniformly failed to sustain the burden of proving competitiveness where concentration was high and a presumption of oligopolistic behavior could be drawn. On the question of the anticompetitive effect of the merger, however, the government, unaided by a presumption, has consistently failed to meet

(D.D.C. 1977); *United States v. Hughes Tool Co.*, 415 F. Supp. 637, 646 (C.D. Cal. 1976); *British Oxygen Co.*, 86 F.T.C. 1241, 1351, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,911 (1975), *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977); *Beatrice Foods Co.*, 86 F.T.C. 1, 62, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,944, at 20,790 (1975), *aff'd sub nom.* Beatrice Foods Co. v. FTC, 540 F.2d 303 (7th Cir. 1976).

98. *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449, at 71,703-04 (D.D.C. 1977) (reviewing both objective and subjective evidence); *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,695-98 (D. Md. 1976) (objective facts "confirm" evidence of perceptions); *United States v. Hughes Tool Co.*, 415 F. Supp. 637, 645-46 (C.D. Cal. 1976) (same); *British Oxygen Co.*, 86 F.T.C. 1241, 1351-56, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,911-14 (1975), *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977) (evaluating entry likelihood on basis of subjective testimony and economic facts).

Potential Competition Mergers

its burden of proof. The single exception is an FTC decision involving a large market-extension acquisition by the second largest producer of industrial gases in the world—and the FTC was reversed on appeal.⁹⁹ The post-*Marine Bancorporation* cases sustain the thesis that effective merger enforcement is impossible under current potential competition doctrine.¹⁰⁰

B. Theoretical Weaknesses in Present Policy

Much of the present difficulty in the potential competition doctrine can be traced to two basic conceptual weaknesses. First, the economic theory underlying the legal policy is unsuitable for judicial use. Second, legal policy has failed to incorporate nonefficiency values, especially the value of limiting discretionary economic authority, into potential competition policy. An alternative approach is suggested be-

99. *British Oxygen Co.*, 86 F.T.C. 1241, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063 (1975), *rev'd and remanded sub nom. BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977). The Second Circuit held that the FTC had applied an incorrect legal standard in finding that foreclosure of future entry injured potential competition where the evidence did not show that such entry would occur in the relatively near future. 557 F.2d at 29-30. See note 204 *infra*.

100. A further indication of the problems in current enforcement is the continued heavy reliance on subjective testimony, exemplified recently in *FTC v. Atlantic Richfield Co.*, 549 F.2d 289 (4th Cir. 1977). Atlantic, a major petroleum company, acquired Anaconda, the third-ranking firm in the highly concentrated copper mining industry. The court looked beyond objective economic evidence, however, to managerial intent. While the case concerned a request for a preliminary injunction and thus is incomplete in factual development, it illustrates the difficulty of proving subjective intent. Documentary evidence taken from Atlantic's files pointed strongly toward market entry, demonstrating, in the court's words, a "continuing interest" by Atlantic in entering the copper industry. *Id.* at 296. More particularly, the evidence showed direct evaluation of entry by the company's Minerals Division in the early 1970s, a specific recommendation by a company task force that the firm explore for nonenergy materials including copper, approval in 1975 by the board of directors itself of diversification into the copper industry without limitation as to the form of entry, and senior management directives (both before and after the board action) calling for study of copper exploration and the acquisition of copper reserves. *Id.*

Although this documentary evidence seems as strong an indication of interest in expansion as one is likely to find in a merger case (given competent legal advice), the court deemed the evidence insufficient to prove likelihood of entry. The documentary evidence, according to the court, failed to show "a specific commitment at Arco's top managerial level to enter the copper markets by original entry or by toehold acquisition." *Id.* at 297. The proof revealed no more than "suggestions and ideas" advanced at lower levels. Top management, speaking, as the court noted, after litigation had begun, declared authoritatively in affidavits that the company would under no circumstance consider market entry by either original entry or toehold acquisition. *Id.* at 297-98. It followed that the subjective evidence failed to show Atlantic to be a reasonably probable potential entrant.

It is an interesting exercise to view the decision through the eyes of corporate counsel and to consider what advice one might give senior management contemplating a merger apt to create potential competition issues. *Cf.* Cowen, *Corporate Antitrust Compliance Programs*, at 12-13 (10th New England Antitrust Conference, 1976) (advising care in making statements of corporate intent to enter market in event merger is not consummated).

low, but first the present debility of the theory supporting potential competition policy should be explored.

1. *Economic Theory*

Horizontal merger policy drew much of its strength from the underlying economic theory of oligopolistic interdependence (or joint profit-maximizing). Under this theory, market concentration significantly increases the probability of noncompetitive behavior.¹⁰¹ Its theoretical simplicity and practical measurability provided the foundation for clear and effective legal policy.

Potential competition merger policy, by contrast, has increasingly sought to rest on a quite distinct economic foundation—entry theory. Many of the difficulties of current policy stem from the unsuitability of this economic theory for legal use. In simplest terms, entry theory holds that firms in concentrated markets are restrained by their anticipations that should they raise price sufficiently, new firms will enter the market. The implication for legal policy is that potential entrants should be preserved because of the beneficial influence they exert on existing firms. The reader will recognize the striking similarity between entry theory and the perceived effect of potential competition. Unfortunately for legal policy, entry theory, unlike the theory of oligopolistic interdependence, contains no simple, operational variable that can form the basis for an effective legal rule, or by which an entry effect can be traced to a particular potential entrant. Instead, entry theory identifies numerous variables that are exceedingly difficult to measure and the theory is both theoretically unsettled and without substantial empirical support.

a. *Entry Theory in the Supreme Court*

Entry theory became crucial to merger policy when the doctrine of potential competition was bifurcated into the future entry effect and the perceived effect. Had potential competition remained a unitary concept, or had the future entry effect been declared primary, entry theory might simply have supplied an additional rationale for preserving potential entrants. The trouble began when the perceived effect was declared preeminent, for the economic theories supporting

101. See E. CHAMBERLIN, *THE THEORY OF MONOPOLISTIC COMPETITION* 46-55 (8th ed. 1962); W. FELLNER, *COMPETITION AMONG THE FEW* 3-50 (1949). The theory was used explicitly as a basis for decision in *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 363-64 & nn.38, 39 & 41 (1963), and importantly, if less explicitly, in subsequent decisions.

the two effects of potential competition are logically distinct.¹⁰² The future entry effect is supported by the same theory of oligopolistic interdependence that underlies horizontal merger policy: market concentration is highlighted as the crucial variable. The perceived effect, strictly considered, stands on a different economic theory, however, for by definition the perceived effect involves no change in current market concentration.

Justice Harlan's concurrence in *Procter & Gamble* and the Supreme Court's majority opinion in *Marine Bancorporation* attempted to rest the perceived effect of potential competition explicitly on entry theory.¹⁰³ That the results are unsatisfactory reveals not an absence of judicial effort, but rather the theory's unsuitability for courtroom use.

Entry theory is an attempt to amplify a basic economic postulate: when price rises above the competitive level, new firms will be attracted into the industry and the added competition they provide will force price back down. In a perfectly competitive market, the supply of potential entrants is virtually unlimited, so the loss of any particular potential entrant is without economic significance. If it is assumed, however, that the market is imperfectly competitive and that entry is limited, then the loss of a particular potential entrant is more serious, particularly if other entrants face high entry barriers.¹⁰⁴ The identifying characteristic of such a market, Justice Harlan pointed out, is "pricing power" or the ability to raise price "in the long run over competitive prices."¹⁰⁵

Entry theory becomes relevant at exactly this point, for it focuses explicitly on the relation between entry and pricing power. Both Justice Harlan in *Procter & Gamble* and the Court in *Marine Bancorporation* relied directly on Professor Bain's pioneering studies of

102. See *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 585-86, 593-96 (1967) (Harlan, J., concurring).

103. See *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 628 n.32 (1974); *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 589-604 (1967) (Harlan, J., concurring). There was also a brief, but elliptical, reference to entry theory in *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 174 (1964). The *Penn-Olin* Court defined potential competition as including the procompetitive effect exerted by a firm "waiting anxiously to enter an oligopolistic market." In support of this position, however, the Court cited only a short passage from a Temporary National Economic Committee (TNEC) monograph stressing the importance of maintaining freedom to enter or leave the market, since in the absence of economic or legal barriers to entry, the forces of potential competition will operate to supplement actual competition. *Id.* at 174 (citing C. WILCOX, *COMPETITION AND MONOPOLY IN AMERICAN INDUSTRY* 7-8 (TNEC Monograph No. 21, 1940)).

104. Bain identifies three main types of barriers: product differentiation, absolute cost advantages of current market participants (e.g., patented technology), and economies of scale. J. BAIN, *INDUSTRIAL ORGANIZATION* 255 (2d ed. 1968).

105. *FTC v. Procter & Gamble Co.*, 386 U.S. 586, 596 (1967) (concurring opinion).

entry theory.¹⁰⁶ Both opinions attempt to relate legal policy to the key variable identified by Bain, the "condition of entry," for this "'determines the relative force of potential competition.'"¹⁰⁷ Bain's condition of entry, however, is no simple concept, but a theoretical construct designed to express in quantitative terms "the advantage of established sellers in an industry over potential entrant sellers."¹⁰⁸ More precisely, it measures "the percentage by which established firms can raise price above a specified competitive level without attracting new entry."¹⁰⁹ Its value would be zero in a perfectly competitive market, as market participants would have no cost advantage over outsiders. As a matter of logic it follows that where the condition of entry is of high magnitude—that is, where pricing power is great—the forces of potential competition should be nurtured.¹¹⁰

Bain's analysis permits the problem to be expressed with even greater refinement. Not all potential entrants are equally well situated. Some firms are more favorably placed in the sense that the barriers to entry are lower for them. Such firms will enter the market at a price level lower than that necessary to attract less well-situated firms.¹¹¹ Although Bain's thrust was to attack economic barriers to entry, such as product differentiation,¹¹² the analysis would also support a policy of preventing mergers that diminish the force of potential competition. The merger most damaging to competition for Bain would be an acquisition that raises barriers to entry in a market where the condition of entry is of significant magnitude and where the acquiring firm is more favorably situated than other firms for entry.¹¹³

106. *Id.* at 586 n.4, 593 n.12, 596, 602 (in all instances citing J. BAIN, *BARRIERS TO NEW COMPETITION* (1956)); *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 628 n.32 (1974) (citing J. BAIN, *INDUSTRIAL ORGANIZATION* (2d ed. 1968)). Other relevant works by Bain include *Condition of Entry and the Emergence of Monopoly*, in *MONOPOLY AND COMPETITION AND THEIR REGULATION* 215 (E. Chamberlin ed. 1954), and *A Note on Pricing in Monopoly and Oligopoly*, 39 AM. ECON. REV. 448 (1949).

Entry theory, however, has earlier historical roots. See J. CLARK, *THE CONTROL OF TRUSTS* 26-29 (1901); A. MARSHALL, *Some Aspects of Competition*, in *MEMORIALS OF ALFRED MARSHALL* 256, 269-70 (A. Pigou ed. 1925).

107. *United States v. Marine Bancorporation, Inc.*, 418 U.S. at 628 n.32 (quoting J. BAIN, *INDUSTRIAL ORGANIZATION* 8 (2d ed. 1968)).

108. J. BAIN, *BARRIERS TO NEW COMPETITION* 3 (1956) (emphasis omitted) [hereinafter cited as J. BAIN, *BARRIERS*].

109. *Id.* at 4.

110. *Id.* at 206.

111. *Id.* at 9.

112. *Id.* at 205-20. This appears to be quite similar to the approach of the TNEC study of competition. See C. WILCOX, *COMPETITION AND MONOPOLY IN AMERICAN INDUSTRY* (TNEC Monograph No. 21, 1940).

113. J. BAIN, *BARRIERS*, *supra* note 108, at 33-41. See Markovits, *Potential Competition, Limit Price Theory, and the Legality of Horizontal and Conglomerate Mergers Under the American Antitrust Laws*, 1975 WIS. L. REV. 658, 664-66 (description and critique of Bain's theory).

Potential Competition Mergers

In the most rigorous judicial attempt to date utilizing entry theory, Justice Harlan based his *Procter & Gamble* concurrence on the presence of the elements highlighted by Bain.¹¹⁴ Because he could rely on prior FTC findings, Harlan did not confront the dilemma of how factors such as the height of entry barriers, condition of entry, or identity of the most favorably located entrant are to be ascertained in a judicial proceeding. Deciding any of these issues is a complex undertaking; deciding all three simultaneously presents unmanageable difficulties. Consider the condition of entry. Unlike seller concentration, it cannot be measured by a simple, relatively unambiguous statistic. Designed to explicate a theoretical model, not to serve as an element in a legal rule, it is, as Bain states, "intrinsically a very complex idea."¹¹⁵ The variables underlying the concept are numerous, and the condition of entry "can assume a wide range of significantly different 'values' with significantly different probable effects" leading to "a very considerable variety of formal theoretical models."¹¹⁶ Similarly, identification of the most favorably situated potential entrant requires a comparative evaluation of relative entry probabilities for an array of firms, of which only one, the acquiring firm, will be a party to the litigation.

In short, there is no way the judicial process can directly handle concepts of this complexity and indeterminacy. The only feasible approach is to find simple determinants or proxies for such factors, and some efforts in this direction can be seen in the opinions of both Justice Harlan in *Procter & Gamble* and the majority in *Marine Bancorporation*. Both permit a presumption of pricing power based on high market concentration. Recognizing, however, that the relationship between pricing power and concentration is not inevitable, and perhaps sensing the underlying weakness of entry theory as a basis for legal policy, both opinions allow the assumption to be defeated

114. *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 595-97, 601-02 & n.17 (Harlan, J., concurring). Specifically, Harlan concurred in finding § 7 liability because (1) Procter's relative size and position in other markets would raise entry barriers, increasing the condition of entry, (2) existing concentration justified the inference that the market was "oligopolistic," in other words the condition of entry was already of significant magnitude, and (3) Procter was "the most favorably situated potential entrant."

115. J. BAIN, *BARRIERS*, *supra* note 108, at 19. See pp. 31-32 *infra*.

The condition of entry cannot be equated with accounting profit, a figure that may cause understatement of the condition of entry because it is both subject to all the vagaries and discretionary allocations permitted by accounting practices and potentially reflective of deliberate policies of price restraint or cost inflation. See L. WEISS, *ECONOMICS AND AMERICAN INDUSTRY* 200-04 (1966), for an analysis of how Alcoa's accounting practices could have understated its pricing power before the government's attempt to break up the firm in the 1940s.

116. J. BAIN, *BARRIERS*, *supra* note 108, at 19.

by a showing of nonoligopolistic behavior.¹¹⁷ The difficulties of proving this qualification, as previously discussed,¹¹⁸ are legion. And the search for the best located firm has been replaced by the attempt to discover if the perceived entry effect was present in the market. The perceived entrant whose presence at the market's edge has actually "tempered" market behavior is presumably best placed, or at least well placed, for entry. But it is hardly a simplification to direct the legal system to detect the impact of the perceived effect on the target market.

There is nothing surprising in these problems. Complex concepts, such as the condition of entry, could scarcely be expected to lead to anything other than legal perplexities and increasing probability of judicial error.¹¹⁹

117. *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 598-99 (1967) (Harlan, J., concurring); *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 631 (1974).

118. See pp. 17-18 *supra*.

119. An illustration of such an error can be found in *Marine Bancorporation*. Citing Professor Bain, the Court sought to explain the basic flaw in the Government's approach to bank mergers:

The conceptual difficulty with the Government's approach . . . is that it fails to accord full weight to the extensive federal and state regulatory barriers to entry into commercial banking. This omission is of great importance, because ease of entry on the part of the acquiring firm is a central premise of the potential-competition doctrine.

418 U.S. at 627-28 (footnote omitted). Examining bank regulation in Washington, the Court found entry "far from easy" and significant entry impossible because of restrictions on branching. *Id.* at 628, 638 (citing and quoting *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 367 & n.44 (1963)). Since the "central premise" of the potential competition doctrine was missing, the Court accordingly concluded that no "significant procompetitive effect" could result from preserving the acquiring bank as a potential entrant. *Id.* at 638-39.

As a matter of economic theory, the Court's conclusions would be correct only under a very special condition, which was not shown: if existing banks had such an advantage over a new entrant that they could charge the full monopoly price without suffering diversion of appreciable business. That is to say, the Court's position is correct only in the event entry was totally blockaded, see J. BAIN, *BARRIERS*, *supra* note 108, at 40-41, so that potential entry could not restrain market behavior because the price necessary to induce entry exceeded the full monopoly price. But such a situation is most unusual, and there was no showing that it was present in *Marine Bancorporation*. The Court, after all, did not find that entry was totally blockaded, but only that because of branching restrictions *Marine Bancorporation* would not have a significant competitive impact on the market following entry. Assuming that this conclusion was true under then-prevailing market conditions, there was no showing that it would remain true if existing banks were to raise prices to the full monopoly level. Assume, for example, that *Marine Bancorporation* entered the Spokane market with a single office, and that thereafter all previously existing banks raised prices to the monopoly level. Is there the slightest doubt that the new bank, despite its single facility, would do a land-office business, diverting patronage from existing banks? But since other banks in Spokane would appreciate the potential impact of *Marine Bancorporation* as an entrant, they would be deterred by such knowledge (if by nothing else) from monopoly pricing.

The Court failed to see that because the restrictions on branching may have increased the pricing power of existing banks, the preservation of potential entrants became all the

b. *Recent Developments in Entry Theory*

Judicial attempts to utilize entry theory have not built on economic work supplementing Bain's original formulation. Yet entry theory is an active area of contemporary research, and the question naturally arises whether additional theoretical insights and findings now available might provide a more solid base for legal policy.¹²⁰ Far from improving the prospects for a workable rule of potential competition, however, recent developments only indicate more strongly than ever the basic unsuitability of entry theory for legal policy. Among the insights suggested by writers subsequent to Bain are the increased difficulty of constructing a predictive economic theory when the expected actions of a particular firm *outside* the market must be considered;¹²¹ the consequent lack of a received model of entry-related behavior;¹²² the abundance of possible explanatory economic vari-

more vital. Under these conditions the continued presence of the second largest banking organization in the state as a potential entrant, even though limited to a single office, may well have provided one of the few outside checks on existing banks in Spokane.

The same error is repeated in *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449, at 71,699 n.5 (D.D.C. 1977). See note 85 *supra*.

120. For general surveys, see D. NEEDHAM, *ECONOMIC ANALYSIS AND INDUSTRIAL STRUCTURE* 97-111 (1969); F. SCHERER, *supra* note 15, at 219-34 (1971). For a brief but more recent (and non-mathematical) survey, see Joskow, *Firm Decision-making Processes and Oligopoly Theory*, in *Papers and Proceedings of the 77th Annual Meeting of the American Economic Association*, 65 AM. ECON. REV., May 1975, at 270-74 (1975).

121. It is difficult enough to predict the behavior of firms within a market when the participants are few, for in the interaction of two or more centers of consciousness there is always a behavioral indeterminacy. See T. SCHELLING, *THE STRATEGY OF CONFLICT* 163-64 (1960). Still, through interaction over time firms within a market eventually gain some knowledge of each other, perhaps sufficient to decipher weak signals and act to mutual advantage. *Id.* at 53-80. But anticipation of what a firm *not* in the market will do—whether it will enter the market and how it will behave if it does—is unlikely to rest on any previous interactive experience; indeed, even the identity of the future entrant may be unknown. See Sherman & Willett, *Potential Entrants Discourage Entry*, 75 J. POLITICAL ECON. 400, 403 (1967) (as number of potential entrants increases, so does uncertainty as to their strategies).

122. There are several competing entry models, which make quite different behavioral assumptions. The best-known model, based on the "Sylos Postulate," assumes that in the event of new entry, existing firms will inflexibly maintain pre-entry output. See Modigliani, *New Development on the Oligopoly Front*, 66 J. POLITICAL ECON. 215, 216-20 (1958).

But other theorists challenge this model. See Wenders, *Collusion and Entry*, 79 J. POLITICAL ECON. 1258, 1276-77 (1971) (collusive oligopolists will reduce output when entry takes place, thereby allowing entry without price decline); Wenders, *Excess Capacity as a Barrier to Entry*, 20 J. INDUS. ECON. 14, 18-19 (1971) (oligopolistic firms will either expand or contract output but not keep it level). See also D. NEEDHAM, *supra* note 120, at 104-05 (Sylos Postulate valid only in atomistic markets); G. STIGLER, *supra* note 12, at 19-22 (questioning plausibility and explanatory power of postulate). Thus the Sylos Postulate rests on only one of several possible behavioral assumptions. See D. NEEDHAM, *supra* note 120, at 103-05; Bhagwati, *Oligopoly Theory, Entry-Prevention, and Growth*, 22 OXFORD ECON. PAPERS 297 (1970).

ables;¹²³ and the inability of present entry theory to account for the added complexity of oligopoly.¹²⁴

Professor Stigler may go too far in asserting that no empirical evidence has been offered for entry theory, that the theory lacks explanatory power, that it raises more questions than it answers, and that, by ignoring market structure, it solves the oligopoly problem "by murder."¹²⁵ But entry theory has indeed generated no simple,

123. Variables identified as relevant to entry probability, even under simplifying behavioral assumptions, have included: (1) scale economies of existing firms, J. BAIN, *Barriers*, *supra* note 108, at 13; Osborne, *The Role of Entry in Oligopoly Theory*, 72 J. POLITICAL ECON. 396, 399 (1964); (2) growth of demand, Duetsch, *Structure, Performance, and the Net Rate of Entry into Manufacturing Industries*, 41 S. ECON. J. 450, 451 (1975); Kamien & Schwartz, *Limit Pricing and Uncertain Entry*, 39 ECONOMETRICA 441, 452-53 (1971); Orr, *The Determinants of Entry: A Study of the Canadian Manufacturing Industries*, 56 REV. ECON. & STATISTICS 58, 60 (1974); Osborne, *supra* at 399; (3) elasticity of demand, Bhagwati, *supra* note 122, at 306-07; Modigliani, *supra* note 122, at 220; (4) high capital requirements, Mansfield, *Entry, Gibrat's Law, Innovation, and the Growth of Firms*, 52 AM. ECON. REV. 1023, 1043 (1962); Orr, *supra* at 61; (5) advertising intensity, Lee, *Oligopoly and Entry*, 11 J. ECON. THEORY 35, 36-37 (1975); Orr, *supra* at 61; (6) profitability, Joskow, *supra* note 120, at 271; Mansfield, *supra* at 1043; (7) extent of excess capacity, Blattner, *Domestic Competition and Foreign Trade: The Case of the Excess Capacity Barrier to Entry*, 33 ZEITSCHRIFT FÜR NATIONALÖKONOMIE 403 (1973); Wenders, *Excess Capacity as a Barrier to Entry*, 20 J. INDUS. ECON. 14, 18, 19 (1971); (8) product diversification, Adams, *Market Structure and Corporate Power: The Horizontal Dominance Hypothesis Reconsidered*, 74 COLUM. L. REV. 1276, 1286 n.48 (1974); Baron, *Limit Pricing, Potential Entry and Barriers to Entry*, 63 AM. ECON. REV. 666, 667 (1973); Duetsch, *supra* at 451-52; Hogarty, Book Review, 13 J. ECON. LITERATURE 89, 90 (1975); (9) differing attitudes toward risk, Baron, *supra* at 670; (10) number of potential entrants, Sherman & Willett, *supra* note 121, at 400. But see D. DEWEY, *THE THEORY OF IMPERFECT COMPETITION* 107 n.1 (1969) [hereinafter cited as D. DEWEY, *IMPERFECT COMPETITION*].

124. Typically, entry theory has simplified the problem of reactive behavior by existing in-the-market firms by assuming that the existing firms behave as if they were a single actor, i.e., a monopoly or perfectly collusive oligopoly. But for policy analysis it is necessary to add back the conditions of imperfectly collusive oligopoly, thereby changing the problem in a fundamental way. When a monopolist acts to deter potential entrants, it can confine its consideration to expected actions and reactions of outside firms. But when an oligopolist acts with an eye to deterring potential entrants, it faces the additional problem that a threatened move against an *outsider*, for example a price reduction to deter entry, may be interpreted as an aggressive action against other *insiders*. See F. SCHERER, *supra* note 15, at 228-29. As Scherer notes, *id.*, the problem bears similarities to those encountered in warfare. For example, on the eve of World War I Russia was unable to mobilize against Austria-Hungary to check that nation's threatened aggression against Serbia without implicitly threatening other nations, notably Germany. H. KAHN, *ON THERMONUCLEAR WAR* 363-64 (1960).

125. G. STIGLER, *supra* note 12, at 19-22. Indeed, a recent review of entry theory questions whether anticipated new entry is even a factor in the thinking of existing firms in oligopoly markets, and whether "the realities of bounded rationality make the processing of internal information and the monitoring of a few rivals all that is really possible." Joskow, *supra* note 120, at 274.

Specific instances of "limit pricing" (deliberate action by firms with pricing power to restrain the price level in order to deter new entry) have been observed. See F. SCHERER, *supra* note 15, at 219, 232-33 (citing authorities but suggesting that additional empirical work is needed); Blackstone, *Limit Pricing and Entry in the Copying Machine Industry*, 12 Q. REV. ECON. & BUS., Winter, 1972, at 57 (case study of Xerox's pricing policy). But general empirical support for the theory is lacking since the expected positive relationship between profits and height of entry barriers has not been observed. Instead, the

Potential Competition Mergers

readily measurable indicator of an entry effect; nor has it generated a variable capable of relating such effect to a particular firm on the fringe of the market. It follows that the theory provides no foundation for a legal policy in which the focus is entirely, or primarily, on the perceived effect of potential competition.

2. *Nonefficiency Values*

Horizontal merger policy drew support not only from economic theory, but from political and social values as well. Consistent with the rationale of most antitrust decisions focusing on industrial concentration, at least since *Alcoa*,¹²⁶ the horizontal merger decisions were based both on economic efficiency grounds¹²⁷ and on the broader social and political goal of restraining economic power.¹²⁸

In the potential competition decisions, however, the Supreme Court has eschewed values other than economic efficiency. To be sure, the Court has not said that it rejects broader social values; but such a position is implicit in the emphasis given to the perceived effect doctrine. Considered alone, that doctrine's purpose is limited to a short-run efficiency objective: facilitating "limit pricing"—action by firms with market power to hold down prices in order to deter entry—in concentrated markets.¹²⁹ With good reason, the potential competition decisions are silent as to other antitrust values; by focusing on perceived effect issues, current policy encourages limit pricing and thus tacitly accepts the market structure that lies behind limit pricing.¹³⁰

evidence has shown higher profitability only where entry barriers are very high, *i.e.*, where entry is already effectively blocked without resort to limit pricing. *See Mann, Seller Concentration, Barriers to Entry, and Rates of Return in Thirty Industries, 1950-1960*, 48 *REV. ECON. & STATISTICS* 296, 300 (1966) (no sharp difference in profit rates between substantial and moderate-to-low barrier industries); *cf. Duchesneau, Barriers to Entry and the Stability of Market Structure: A Note*, 22 *J. INDUS. ECON.* 315 (1974) (measured in terms of four-firm concentration stability, similar lack of positive correlation except in high-barrier industries). *But see Orr, supra* note 123, at 65 (positive but weak correlation observed between past profit and entry rate).

126. *United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir. 1945).

127. "Economic efficiency" is used in the broad sense to denote both productive economies and monopoly (output restriction) avoidance. Although the two types of efficiency are not always harmonious, both promote economic welfare as traditionally defined. *See W. Bowman, supra* note 34, at 6-7. Nonefficiency goals promote values other than economic welfare.

128. *See United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 363 (1963); *Brown Shoe Co. v. United States*, 370 U.S. 294, 315-16 (1962). The decisions have also mentioned other social values, including protection of small business and preservation of local control of industry. *See, e.g., Brown Shoe Co. v. United States*, 370 U.S. 294, 315-16 (1962).

129. *F. Scherer, supra* note 15, at 219.

130. *See Note, Telex v. IBM: Monopoly Pricing Under Section 2 of the Sherman Act*, 84 *YALE L.J.* 558, 579-83 (1975) (approving Court's acceptance of limit pricing under

This is perhaps the crucial reason for the poor health of the potential competition doctrine. Supported by a less compelling efficiency rationale than that behind horizontal merger policy, potential competition policy has not received support from broader antitrust goals. This seems an unjustifiable retreat from firmly established judicial and congressional antitrust attitudes, unless a powerful case can be stated that rules out consideration of broader values on some ground peculiar to potential competition.

Few would question that values beyond economic efficiency have provided vital motivation for antitrust enforcement, both historically and in terms of a continuing broad consensus of public support.¹³¹ Nor is there apt to be serious disagreement on the general direction of those values. With perhaps excessive rhetoric, Judge Learned Hand in *Alcoa* referred to "the belief that great industrial consolidations are inherently undesirable" and to the advantage of preserving small

Clayton Act). Justice Harlan also sensed the narrower policy base of the perceived effect, noting that the threat of market entry "merely affects the range over which price power extends" and "does not compel more vigorous striving in the market, nor advance any other social goal which Congress might be said to have favored in passing § 7." *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 596 (1967) (concurring opinion) (footnote omitted).

131. See Hofstadter, *What Happened to the Antitrust Movement*, in *THE BUSINESS ESTABLISHMENT* 113, 149 (E. Cheit ed. 1964):

What makes it possible to institutionalize antitrust activities . . . is not a consensus among economists as to its utility in enhancing economic efficiency, but a rough consensus in society at large as to its value in curbing the dangers of excessive market power. As in the beginning, it is based on a political and moral judgment rather than the outcome of economic measurement or even distinctively economic criteria. "It must be recognized," says Professor Edward S. Mason, "that there is an element of faith in the proposition that maintaining competition substantially improves the efficiency of resource use." The option for a minimal level of competition to be underwritten by public policy, although it can be backed by substantial economic arguments, "rests basically on a political judgment," write Carl Kaysen and Donald F. Turner in their inquiry into trust policy: "In our democratic, egalitarian society, large areas of uncontrolled private power are not tolerated." "We found," write Dirlam and Kahn in their book, *Fair Competition*, "that the decisions [of courts and commissions] could not be fully understood or fairly appraised by economic standards alone. Hence we concluded that the appropriate questions for economists to ask about antitrust policy is not whether this is the most efficient way of structuring or reorganizing the economy, but the inverted one: Does antitrust seriously interfere with the requirements of efficiency?" "The rationale of antitrust," writes A.D. Neale, a British student of the American experience, "is essentially a desire to provide legal checks to restrain economic power and is not a pursuit of efficiency as such."

See Dewey, *The Economic Theory of Antitrust: Science or Religion?*, 50 VA. L. REV. 413 (1964). See generally W. LITWIN, *LAW AND ECONOMIC POLICY IN AMERICA* (1965); D. MARTIN, *MERGERS AND THE CLAYTON ACT* 3-56 (1959); A. NEALE, *THE ANTITRUST LAWS OF THE UNITED STATES OF AMERICA* 225-32 (2d ed. 1970); H. THORELLI, *THE FEDERAL ANTITRUST POLICY* (1954); Elzinga, *The Goals of Antitrust—Other Than Competition and Efficiency, What Else Counts?* 125 U. PA. L. REV. 1191 (1977). But see Bork, *Legislative Intent and the Policy of the Sherman Act*, 9 J.L. & ECON. 7 (1966) (arguing that congressional intent in Sherman Act was limited to efficiency concerns).

producers “for [their] own sake and in spite of possible cost.”¹³² Judge Hand, a master at fathoming legislative and societal values,¹³³ clearly connected antitrust policy with underlying ideals in the American political and social scheme—the distrust of centralized power, the belief in individual initiative and responsibility, the desire to preserve economic opportunity, and the refusal to accept materialistic efficiency as the only goal of our economic system.¹³⁴

The primary nonefficiency value in potential competition policy is an expression of the distrust of centralized power. But this is too general a formulation to be useful. It is subject to the objection that it lacks definable content¹³⁵ and has no inherent stopping place short of atomistic competition.¹³⁶ Advances in the theory of managerial behavior since *Alcoa*, however, permit more explicit statement of the issue. Enforcement of an antitrust policy designed to preserve the potential for new entry into large, concentrated markets can be viewed as an attempt to limit what may be termed “discretionary economic authority” or, in positive terms, as a policy to promote diversity and diffusion of economic decisionmaking. Preventing a potential entrant from acquiring a leading firm in a significant concentrated market increases the number of decisionmaking units in the market if the potential entrant later enters *de novo*. The quantum of discretionary decisions made by leading firms is reduced if the potential entrant gains market share at the expense of those firms either after entry *de novo* or after entry through toehold acquisition.

Discretionary economic authority may be defined as a range of managerial choice not dictated by or fully predictable from pure profit maximizing behavior. In the words of Professor Donald Dewey, discretionary authority is “essentially power to make decisions that affect the lives of other people”:

[D]iscretionary authority and monopoly power are *two different things*. The management of a bankrupt railroad may be utterly

132. *United States v. Aluminum Co. of America*, 148 F.2d 416, 428-29 (2d Cir. 1945). Judge Hand's language describing the nonefficiency motivations of antitrust has been cited with approval several times by the Supreme Court. *United States v. Von's Grocery Co.*, 384 U.S. 270, 274 n.7 (1966); *Brown Shoe Co. v. United States*, 370 U.S. 294, 316 n.28 (1962); *Standard Oil Co. v. United States (Standard Stations)*, 337 U.S. 293, 309 (1949).

133. See Cox, *Judge Learned Hand and the Interpretation of Statutes*, 60 HARV. L. REV. 370 (1947); Shanks, *The Interpretation of Statutes*, in *THE DECISIONS OF JUDGE LEARNED HAND* 157-59 (H. Shanks ed. 1968).

134. Fear of absentee ownership is another value present in some opinions. See *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 542 (1973) (Douglas, J., concurring). *United States v. Von's Grocery Co.*, 384 U.S. 270, 283 (1966) (Stewart, J., dissenting).

135. See Posner, *Antitrust Policy*, *supra* note 28, at 326.

136. See Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, 74 YALE L.J. 775, 831-32 (1965).

unable to obtain a positive return on its capital and still have the power to affect the lives of thousands of individual workers, shoppers, and commuters by its decisions.¹³⁷

Discretionary authority, defined as a significant range of managerial choice, exists even under the narrow assumption of short-run profit maximizing. Existence of discretionary authority follows from the uncertainty in which all firms act¹³⁸ and from the ability, particularly of large and diversified firms, to absorb the results of suboptimal decisions without risk to enterprise survival. Discretionary authority is reflected in the fact that, viewed *ex ante*, a disinterested observer in possession of all information known to management would be unable to predict with certainty the decision the firm would make;¹³⁹ and, viewed *ex post*, more than a single decision could have been made without raising an imminent threat to the survival of the firm.

Under the traditional economic model—with a goal of short-run profit-maximizing and without uncertainty—to speak of discretionary decisions is to describe the irrational. But a wide discretionary zone opens once the certainty postulate is relaxed, even though profit-maximizing remains the business objective. Assessments of future demand, costs, technological innovations, governmental policies, competitive developments, and other imponderables will differ markedly. While managers have an incentive to make the best (profit-maximizing) decision, the optimal course will almost never be definable until after the critical choices are made, if even then. Not only will the penalty for the less-than-best decision rarely be failure, but a firm

137. Dewey, *The New Learning: One Man's View*, in *INDUSTRIAL CONCENTRATION*, *supra* note 2, at 11 & n.18 (emphasis added; footnote omitted). See J. MARKHAM, *CONGLOMERATE ENTERPRISE AND PUBLIC POLICY* 27 n.8 (1973): "The expression 'discretionary power' is perhaps unnecessarily pejorative; . . . What the term usually describes is the situation where management has options in choosing among alternative courses of action and the firm will at least survive, or possibly even be as well off, irrespective of how the options are exercised." See generally O. WILLIAMSON, *THE ECONOMICS OF DISCRETIONARY BEHAVIOR: MANAGERIAL OBJECTIVES IN A THEORY OF THE FIRM* (1964).

138. Cf. D. DEWEY, *IMPERFECT COMPETITION*, *supra* note 123, at 154-64 (analyzing managers' responses to uncertainty). Uncertainty destroys the determinism of the traditional economic model: what firms maximize is not a determined area on a geometric diagram, but anticipated future profit, and anticipations differ. Thus "in objectively similar circumstances, different businessmen will behave differently when a decision involves uncertainty . . ." *Id.* at 158. The zone of uncertainty includes the reactions of other firms. See generally H. RAIFFA, *DECISION ANALYSIS* 14-21, (1970).

139. The *ex ante* condition expresses the fact that managerial decision is crucially dependent (1) on the decisionmaker's probability assessments of uncertain future events (so the outside observer cannot predict the decision the firm *would* make), and (2) on the decisionmaker's risk preferences (so the outside observer is unable even to assert what decision the firm *should* make as a rational profit-maximizer). See H. RAIFFA, *supra* note 138, at 91-92.

Potential Competition Mergers

may never know that there was a better decision unless one of its competitors makes it.¹⁴⁰ Thus even if firm decisionmakers pursue only the goal of short-run profit-maximizing, they act in a wide zone of choice.

The range of choice would be greater still if the assumptions of the economic model were relaxed in favor of a longer, and probably more realistic, time frame,¹⁴¹ or if goals beyond profit-maximizing were recognized.¹⁴² But to exercise no more than the degree of choice open under short-run profit maximizing with uncertainty is to possess significant discretionary power that will have major impact on people, communities, capital, and technology. It has long been a premise of antitrust policy that such power should be reasonably diffused.¹⁴³ To return to *Alcoa*, the essence of the legal offense in that case was not abuse of power, but Alcoa's ability to exercise discretionary decision-making authority over a domestic industry.¹⁴⁴

So defined, a policy of limiting discretionary economic authority supports a potential competition policy aimed at facilitating new entry into highly concentrated markets and at reducing concentration in the long run. Potential competition policy thus viewed conforms with

140. In addition, some managerial decisions, such as plant location as between two equally cost-minimizing sites, may have no profit impact but have large personal impact.

141. See A. KAPLAN, J. DIRLAM & R. LANZILLOTTI, PRICING IN BIG BUSINESS 128-30 (1958); L. WEISS, *supra* note 115, at 189-90 (1961).

142. See Cyert & Hedrick, *Theory of the Firm: Past, Present and Future: An Interpretation*, 10 J. ECON. LITERATURE 398 (1972) (reviewing three major economic journals from 1970-72, authors find trend away from profit-maximizing model); Phillips, *A Theory of Interfirm Organization*, 74 Q.J. ECON. 602-13 (1960) (maximization assumption devoid of content); cf. H. KAHN, *supra* note 124, at 119-20 (search for optimum system in policy analysis at RAND Corporation abandoned in favor of procedure of comparing "a rather small number of different systems under widely varying circumstances").

In the May, 1975 issue of the *American Economic Review*, five separate articles questioned the profit-maximizing assumption. Buchanan, *A Contractarian Paradigm for Applying Economic Theory*, in *Papers and Proceedings of the 87th Annual Meeting of the American Economic Association*, May 1975, 65 AM. ECON. REV. 225; Foley, *Problems v. Conflicts: Economic Theory and Ideology*, *id.* at 231; Joskow, *Firm Decisionmaking Processes and Oligopoly Power*, *id.* at 270; Klevorick, *Law and Economic Theory: An Economist's View*, *id.* at 237; Shubik, *Oligopoly Theory, Communication, and Information*, *id.* at 280. Other constraints on managerial behavior identified by such analyses include bounded rationality (the complexity of problems exceeds human problem-solving capacity) and information impactedness (firms have access to different information). See Williamson, *The Economics of Antitrust: Transaction Cost Considerations*, 122 U. PA. L. REV. 1439, 1440-47 (1974) [hereinafter cited as Williamson, *Transaction Cost*].

143. See Scherer, *supra* note 75, at 980-81.

144. See *United States v. Aluminum Co. of America*, 148 F.2d 416, 424-27 (2d Cir. 1945) (substantial long-term control over aluminum ingot production and marketing). It is possible to disagree on the amount of discretion that Alcoa possessed. Compare Coase, *Durability and Monopoly*, 15 J.L. & ECON. 143 (1972) with L. WEISS, *supra* note 115, at 164-204. But whether the quantum of discretion was correctly estimated in the case takes nothing from the general point that Alcoa clearly had *some* significant discretion in its decisionmaking.

horizontal merger policy as enunciated in *Philadelphia Bank*, where the policy was described as both "consonant with economic theory" and responsive to the concern over "'a rising tide of economic concentration.'" ¹⁴⁵ In *Philadelphia Bank* the market share controlled by the two merging banks and that share held by the other leading banks in the market became the proxies for both the merger's competitive effect and its more general effect on concentration of economic assets (or the discretionary economic authority effect). ¹⁴⁶ Despite its simplicity, this equality holds since, other things being equal, the larger the proportion of sales or assets in a market under single or few firm control, the less diffused will be the sources of business and economic decisions in the relevant market and in the national economy. ¹⁴⁷ Though the immediate increase in concentration from any one horizontal merger may be small, it is not only the present addition to concentration that is of concern, but also the foreclosure of future deconcentration through the growth of the acquired firm. ¹⁴⁸ A similar but not identical approach is suggested for potential competition mergers.

In potential competition mergers two basic indices of discretionary authority seem pertinent: (1) market share and concentration, and (2) gross sales or assets. Large values for both measures would be essential to a finding of significant discretionary authority. The first measure, market share and concentration, is the same as in the horizontal merger situation. In potential competition cases, however, enforcement of the antimerger law would be limited to acquisitions by firms (of substantial size) in markets of sustained high concentration. This would reflect the somewhat weaker public policy supporting potential competition. As in horizontal merger cases, the firm with the largest market share would be presumed to have the greatest discretionary authority. If most of the business in an industry is controlled by one company, it is reasonable to assume that the dominant firm will make the bulk of the discretionary decisions. ¹⁴⁹ This does

145. *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 363 (1963) (quoting *Brown Shoe Co. v. United States*, 370 U.S. 294, 315 & n.27 (1962)).

146. *Id.* at 331, 364-65.

147. The equality would not make sense, however, if the defined market were insignificant or trivial. But then neither would there be grounds for blocking a merger in order to protect competition in such a trivial market. There is no substitute for exercising judgment in market definition.

148. See, e.g., *United States v. Continental Can Co.*, 378 U.S. 441, 461-62 (1964); *United States v. Aluminum Co. of America (Alcoa-Rome)*, 377 U.S. 271, 279-81 (1964).

149. This expectation is intensified if, as some claim, small firms tend to follow a market leader's business decisions because, uncertain as to the leader's full power, they

Potential Competition Mergers

not mean the firm with the largest market share will necessarily earn more money than other firms, although such an outcome is likely.¹⁵⁰ Sustained high market share is a good measure of the firm's overall market influence, because it registers the long-term success of the business in influencing buying decisions in the market.¹⁵¹ The same reasoning applies to other firms with substantial market share, if to a lesser degree.

The second measure of discretionary economic authority, gross sales or assets, is an additional indicator of the scope and impact of the firm's decisions on the various corporate constituencies: labor, consumers, capital, suppliers, and society at large.¹⁵² Under the second measure, a firm can be considered of significant size (but not necessarily holding discretionary authority) if it ranks among the 200 largest industrial corporations in sales or assets or is of equivalent size if not an industrial corporation. This standard would at present include firms having sales of approximately \$1 billion or assets of over approximately \$900 million.¹⁵³

By using both criteria to define discretionary economic authority, the markets with the highest quantum of discretionary authority would be those that are both the most concentrated and the largest in absolute size. This accords well with intuitive judgments that decisions of the leading firms in the largest industries—for example, steel, automobiles, petroleum—do indeed have the largest impact on society.

The assertion that there is an appropriate place for nonefficiency values in potential competition policy does not indicate how far such values should be pursued. Without attempting to specify at this point the precise rules to be suggested for potential competition mergers (to be discussed in Part II), two general considerations can be stated.

are apt to assume that it possesses market power roughly equivalent to its market share. See Bok, *supra* note 23, at 277 (market leader has psychological advantage over competitors).

150. See H. Demsetz, *The Market Concentration Doctrine*, at 19-26 (AEI-Hoover Policy Study 7, 1973). This finding, which Demsetz argues is suggestive of large-firm efficiency, surely does not detract from the concept of discretionary authority. See generally W. SHEPHERD, *MARKET POWER & ECONOMIC WELFARE* 187-91 (1970) (profitability correlated with market share); Weiss, *The Concentration-Profits Relationship and Antitrust*, in *INDUSTRIAL CONCENTRATION*, *supra* note 2, at 184, 231-33 (survey of 37 empirical studies of concentration and profits found that "[b]y and large the relationship holds up").

151. This does not suggest that a firm is not entitled to the full benefit of its success. This article does not present a proposal for divestiture or divorcement of existing business enterprises. The issue is whether a firm is to be permitted to grow larger by merger.

152. This measure was not utilized in the development of horizontal merger doctrine since the basic legal rule was sufficiently strict to block significant additions to gross size in most instances.

153. See FORTUNE, May 1977, at 364-72.

First, the pursuit of nonefficiency goals should be subject to the continuing constraint that there be no substantial efficiency loss.¹⁵⁴ Second, the nonefficiency goal is supplementary: it is an additional effect to be considered in a merger suspect on other grounds, not an independent justification for policy.¹⁵⁵

C. *Legislative History and Potential Competition*

The enforcement policy shaped by the courts for mergers threatening potential competition is thus both ineffectual in practice and based on an incomplete theoretical structure. Further, having identified two separate potential competition effects, the courts have in recent decisions expressed doubt that one of them, the future entry effect, is even covered by section 7.¹⁵⁶ This situation contrasts sharply with the much stronger anticoncentration policy applied to horizontal mergers. Is such a distinction in enforcement consistent with the legislative policy of the amended Clayton Act? A rereading of the legislative history and judicial precedents suggests not. Congressional intentions and attitudes cannot justify the courts' narrow reading of section 7.

The limited view courts have recently taken toward potential competition arises from a double misconception. The courts have focused too exclusively on the short-run benefits of potential competition, and they have restricted these short-run benefits to economic efficiency gains. This self-imposed limitation helps explain the Court's preference for conduct and performance tests for competitive injury, and also helps explain the Court's recent doubt that the future entry effect is covered by the statute. But the twin constraints of the short run and pure efficiency constitute a narrowing of congressional policy that the courts have never adequately explained.

154. The impact of the proposed rules on economic efficiency is discussed at pp. 83-85 *infra*.

155. This accords closely with a recent Supreme Court statement that "[c]ompetitive economies have social and political as well as economic advantages," *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 97 S. Ct. 2549, 2559 n.21 (1977). This case cited with approval an earlier antitrust decision which in expansive language commended the preservation of "democratic political and social institutions" as an antitrust goal, *Northern Pac. Ry. v. United States*, 356 U.S. 1, 4 (1958). The Court noted in *Continental T.V.* that efficiency values are also important, for "an antitrust policy divorced from market considerations would lack any objective benchmarks." 97 S. Ct. at 2559 n.21 (1977). Moreover, the Court explicitly acknowledged the welfare of small business to be a relevant judicial consideration. *Id.* at 2561 n.26. Justice White, however, thought that the Court's decision to reverse the *per se* rule for territorial and customer restrictions in vertical distribution was too strongly influenced by economic efficiency considerations. *Id.* at 2567-68 (concurring opinion).

156. See pp. 45-52 *infra*.

Potential Competition Mergers

The goal of Congress in amending section 7 was to stem a merger trend and thereby to protect and improve competition in the long run.¹⁵⁷ Improving competition required not only the promotion of economic rivalry between firms, but also the prevention of high market concentration.¹⁵⁸ Congress sought to arrest the anticompetitive impact of mergers in its incipency, not simply for present advantage, but to preserve a competitive economy for the future.¹⁵⁹ Had Congress's objective been simply the protection of present or near-term competition, perhaps the Sherman Act would have sufficed, for that statute protects not only actual competition but also sufficiently imminent potential competition.¹⁶⁰ But as the legislative history states clearly, amended section 7 was intended to reach "far beyond the Sherman Act."¹⁶¹

157. H.R. REP. NO. 1191, 81st Cong., 1st Sess. 2 (1949) ("long-term rise in concentration" as object of concern) [hereinafter cited as *House Report*]; S. REP. NO. 1775, 81st Cong., 2d Sess. 4-5 (1950) (need to halt concentration in incipency) [hereinafter cited as *Senate Report*]; 96 CONG. REC. 16306-07 (1950) (Sen. O'Connor); 96 CONG. REC. 16450 (Sen. Kefauver); 95 CONG. REC. 11493 (1949) (Rep. Carroll). See generally Bok, *supra* note 23, at 233-38 (reviewing legislative history).

158. Bok, *supra* note 23, at 234-36. Bok found congressional intent to avoid high concentration to be the one dominant consideration running through the reports and debates on the 1950 amendments. This intent provided "a common definition of the problem at hand, a common philosophy as to its import, and a common notion, on a very general plane, of what the new act could do about it." *Id.* at 234. See *House Report*, *supra* note 157, at 2-5.

159. See *Brown Shoe Co. v. United States*, 370 U.S. 294, 317-18 (1962) (footnote omitted); "Congress saw the process of concentration in American business as a dynamic force; it sought to assure the Federal Trade Commission and the courts the power to brake this force at its outset and before it gathered momentum."

160. The courts have recognized in several Sherman Act cases that a monopoly or cartel destroys not only actual competition but potential competition as well. *Standard Oil Co. v. United States*, 221 U.S. 1, 74 (1911); *United States v. Trenton Potteries Co.*, 273 U.S. 392, 397 (1927); *United States v. Aluminum Co. of America*, 148 F.2d 416, 427-28 (2d Cir. 1945); *American Tobacco Co. v. United States*, 328 U.S. 781, 809 (1946). But these cases involved contemporaneously visible potential competition. The *Standard Oil* trust, for example, was presumptively unlawful for destroying "the potentiality of competition" among the constituent companies; without the trust, competition would have been a clear and imminent reality. 221 U.S. at 72-75. The *House Report* on the amendment to § 7 indicated awareness of this line of cases and quoted *American Tobacco's* definition of monopoly power as the ability "to exclude actual or potential competition." *House Report*, *supra* note 157, at 9 (quoting *American Tobacco Co. v. United States*, 328 U.S. 781, 809 (1946)).

161. *Senate Report*, *supra* note 157, at 5. See Bok, *supra* note 23, at 255.

It has nevertheless been argued that the standard of competitive injury under amended § 7 is essentially a Sherman Act standard. The argument holds that prior to its amendment in 1950 the Clayton Act had been so interpreted, and that Congress did not mean to change the legal standard since it reenacted the competitive injury language of the 1914 Clayton Act; thus the 1950 amendment was essentially technical, closing the asset acquisition and other loopholes. But the argument is not persuasive since, due to the asset acquisition exclusion, there had been little interpretation of the competitive injury test under the original Clayton Act. Also, there is evidence that Congress was specifically dissatisfied with the most recent and important merger precedent under the Sherman

Previous studies of the legislative history have not addressed the question of congressional intent as to potential competition. In part this may be because the words "potential competition" appear only rarely in the legislative history.¹⁶² The reason for this omission is that in then-current legislative usage, as reflected in several key documents, most potential competition mergers were classified as horizontal. It is here that the key to congressional intent concerning potential competition mergers must be found.

Horizontal mergers were the object of greatest congressional concern in the deliberations over amending section 7. While the amended statute was intended to reach all mergers, horizontal acquisitions were the prime target because the contemporary "merger movement" was predominantly horizontal,¹⁶³ and the horizontal merger most impinges upon the values Congress sought to protect.¹⁶⁴ From this it appears that the judicial development of a stringent rule for horizontal mergers was singularly responsive to congressional priorities.

Act, *United States v. Columbia Steel Co.*, 334 U.S. 495 (1948). See *House Report*, *supra* note 157, at 10-11; 96 CONG. REC. 16452-53, 16502 (1950) (Sen. Kefauver); *Amending Sections 7 and 11 of the Clayton Act: Hearings Before Subcomm. No. 3 of the House Judiciary Comm.*, 81st Congress, 1st Sess. 28 (1949) (Herbert A. Bergson, Chief of Antitrust Division). Judicial development of the meaning of identical competitive injury language under § 3 of the Clayton Act, 15 U.S.C. § 14 (1970), had gone significantly beyond Sherman Act tests. See *Standard Oil Co. v. United States* (Standard Stations), 337 U.S. 293, 311-14 (1949). In any event, the 1950 amendment could scarcely be described as merely technical, for it had broader objectives than the original Clayton Act section, which was aimed largely at the narrow problem of secret acquisition by holding companies of the shares of competing concerns. See *United States v. Celanese Corp. of America*, 91 F. Supp. 14, 17 (S.D.N.Y. 1950); H.R. REP. NO. 627, 63d Cong., 2d Sess. (1914); 51 CONG. REC. 9073-74 (1914) (Rep. Webb); *id.* at 9086 (Rep. Kelly); *id.* at 9270-71 (Rep. Carlin); *id.* at 9554 (Rep. Barkley); *id.* at 14226-27, 14457 (Sen. Reed); *id.* at 14316 (Sen. Cummins); *id.* at 14456-57 (Sen. Colt); *id.* at 14465-66 (Sen. Poindexter).

162. But see *House Report*, *supra* note 157, at 9-11 (discussion of Sherman Act cases); 95 CONG. REC. 11490 (1949) (Rep. Michener) (opposing bill for, *inter alia*, its possible application to potential competition cases).

163. *House Report*, *supra* note 157, at 2-3 (horizontal nature of "current merger movement"). More specifically, the highly influential 1948 FTC Report stated:

[H]orizontal acquisitions have been more important during this period than all of the other types combined; no less than 62 percent of all acquisitions have been of the horizontal type.

Moreover, this predominance of horizontal acquisitions prevails throughout the industrial structure. . . . [H]orizontal acquisitions represented the most important type of merger activity in each of the major manufacturing and mining groups FTC, THE MERGER MOVEMENT: A SUMMARY REPORT 29 (1948) [hereinafter cited as FTC REPORT]. Thus the disappearance of "some 2,500 formerly independent manufacturing and mining companies . . . as a result of mergers and acquisitions," which the House Report stressed as demonstrating the need for legislative action, was largely the result of horizontal acquisitions. See *House Report*, *supra* note 157, at 2.

164. As summarized in *Brown Shoe Co. v. United States*, 370 U.S. 294, 315-16 (1962), these included the prevention of market concentration, preservation of local control of industry, and protection of small business. See also *House Report*, *supra* note 157, at 3-5; *Senate Report*, *supra* note 157, at 3. In general, a vertical or pure conglomerate merger would have little or no direct impact on market concentration.

Potential Competition Mergers

The judicial and legislative views gradually diverged, however, on what constitutes a "horizontal merger." For the courts, a horizontal merger came to mean a merger between present, direct competitors.¹⁶⁵ The term had a wider scope in congressional usage and included market extensions and close product extensions, as well as mergers between producers of goods that can be substitutes for each other.¹⁶⁶

165. See, e.g., *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 622 (1974) (relevant geographic market defined as area of direct competition). The constriction of the meaning of horizontal merger developed gradually. At first it was a dissenting view that the term "horizontal mergers" was limited to mergers between direct competitors as distinct from probable future competitors. See *United States v. Continental Can Co.*, 378 U.S. 441, 473 (1964) (Harlan, J., dissenting) (market as defined by majority "nonexistent"); *United States v. Aluminum Co. of America (Alcoa-Rome)*, 377 U.S. 271, 287 (1964) (Stewart, J., dissenting) (acquisition not horizontal, so no relevant market contained both acquiring and target firms). The restrictive definition gradually took hold, and the 1968 Merger Guidelines simply defined horizontal mergers as those between "direct competitors." Department of Justice Merger Guidelines (May 30, 1968), *reprinted in* 1 TRADE REG. REP. (CCH) § 4510, at 6883 (1968) [hereinafter cited as Merger Guidelines].

166. The definition of horizontal merger appears in the following passage from the House Report:

Mergers and acquisitions have traditionally been designated as horizontal, vertical, and conglomerate. *Horizontal acquisitions are those in which the firms involved are engaged in roughly similar lines of endeavor*; vertical acquisitions are those in which the purchase represents a movement either backward from or forward toward the ultimate consumer; and conglomerate acquisitions are those in which there is no discernible relationship in the nature of business between the acquiring and acquired firms.

House Report, *supra* note 157, at 11 (emphasis added). Although not a precise definition, the language on its face suggests a broader meaning for horizontal mergers than that used by the courts. But we need not speculate. The above language is easily traced to its source, the 1948 FTC Report from which it was taken almost verbatim. FTC REPORT, *supra* note 163, at 29. The FTC Report contains additional amplification in a passage shortly following the language quoted above:

Within these broad categories of horizontal, vertical, and conglomerate there are a number of recognizable subgroups. Thus, horizontal mergers may be broken down into three such groups—direct, substitute products, and chain. The first takes place when the companies involved make essentially the same type of products; the second occurs when the acquired company makes a product which can be substituted for that of the acquiring firm; and the third takes place when a company expands geographically through acquisitions in one locality after another, purchasing firms making generally similar products for local market consumption.

Id. at 31-32. The crucial importance of the 1948 FTC Report in the legislative history is emphasized by Derek Bok, who wrote that the heavy congressional reliance on the FTC Report is a fact "no judge can overlook [in] interpreting the statute." Bok, *supra* note 23, at 234.

Further indication of the broad meaning attached to horizontal merger can be seen in the three illustrative charts included in the House Report. *House Report*, *supra* note 157, charts I, II & III (following p. 10). Also taken from the FTC Report (charts 8, 9 and 13, following pp. 40, 42 & 62, respectively), these illustrations show horizontal, vertical and conglomerate mergers. They make clear that not only mergers of firms producing substitutes and market extension mergers were classified as horizontal, but also close product extensions (e.g., acquisition by a pharmaceutical firm of a vitamin company; acquisition by a fluid milk producer of an ice cream company) were so classified. The conglomerate classification was reserved for mergers involving unrelated

The difference in usage reflects a fundamental disagreement as to the time perspective of section 7. Congress wished to forestall concentration and to promote competitive market structures over the long run.¹⁶⁷ Viewed from this longer-term perspective, the distinction between direct and potential competition blurs. Under the logic of the congressional usage, market and close product extension mergers are horizontal because, over time, potential competitors in close market proximity tend to become actual competitors.¹⁶⁸ Not all potential competitors finally meet in the market place, to be sure, but as the time frame extends, the probability of such eventual competition is sufficient, according to Congress, to require a statute that reaches future events of reasonable probability.¹⁶⁹

The narrower judicial definition of horizontal mergers reflects a shorter-term perspective. Given a sufficiently short outlook, only a merger between existing competitors (or involving a firm in the process of entry) is horizontal. Other mergers are then either described as conglomerate,¹⁷⁰ or put into the hybrid but nonhorizontal categories of market or product extension.¹⁷¹ Within this shorter time frame, the attractiveness of the perceived effect doctrine emerges despite its operational difficulties and its impoverished view of the values behind antitrust policy; whatever its drawbacks, the perceived effect is at least a *present* market effect.

By taking a longer range view of competition the judiciary would give clearer recognition to the congressional desire not only to arrest increases in concentration, but also to promote a competitive structure in the future, for clearly Congress thought concentration to be already excessive. This does not mean that the courts must apply a single, undifferentiated rule to all mergers that Congress viewed as

products (e.g., pharmaceutical firm acquires a food specialty firm) or less closely related product extensions (e.g., pharmaceutical firm acquires an insecticide company or dairy acquires a soy bean firm). See W. THORP, *THE STRUCTURE OF INDUSTRY* 163-66 (TNEC Monograph No. 27, 1947) (examining various forms of combination).

167. See notes 157 & 158 *supra*.

168. See *House Report*, *supra* note 157, charts I and III (following p. 10) (showing horizontal classification for market and product extension mergers).

169. The probability that over a period of years a potential competitor will at some point become an actual competitor is directly related to the number of years included in the estimate, the probability increasing with the number of years.

170. See *Merger Guidelines*, *supra* note 165, paras. 18-20, at 6887-89. This seems to conflict with the congressional view that reserved the conglomerate category for mergers into "unrelated lines of manufacture." See 96 CONG. REC. 16449 (Sen. O'Mahoney) (1950) (Congress must act to stop "constant concentration" brought about by "widespread entry of corporations into unrelated lines of manufacture"). See generally FTC REPORT, *supra* note 163, at 32, 59; W. THORP, *supra* note 166, at 146.

171. See *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 577 (1967) (product extension merger "neither horizontal, vertical nor conglomerate").

Potential Competition Mergers

horizontal,¹⁷² nor that courts must wage an all out “campaign against ‘superconcentration’” based on no more than “sonorous phrases in the pages of the Congressional Record.”¹⁷³ Certainly Congress failed to specify how its broad antitrust goals were to be achieved, but it said enough to require judicial attention to nonefficiency as well as to efficiency goals. As a start, particular attention should be focused on those potential competition mergers that Congress would have viewed as horizontal. In so doing, the courts must strike a balance of values. The congressional policy was neither oblivious to protecting economic efficiency nor closed to nonefficiency or equity values. It was, in the historic tradition of American antitrust policy, a compromise designed to achieve a fair measure of both.

D. *Judicial Doubts as to Clayton Act Applicability*

The most striking challenge to the use of potential competition doctrine to achieve long-run structural improvement appears in the Supreme Court’s recent questioning of foreclosure of future entry as a basis for section 7 liability.¹⁷⁴ Having divided the concept of potential competition into two distinct effects, the Court has refused explicitly to recognize section 7 liability for any but the short-term perceived effects of potential competition. Doubt was introduced by dictum in *Falstaff*:

We leave for another day the question of the applicability of § 7 to a merger that will leave competition in the marketplace exactly as it was, neither hurt nor helped, and that is challengeable under § 7 only on the grounds that the company could, but did not, en-

172. In *Marine Bancorporation* the Government urged that an additional line of commerce be defined in terms of a future or emerging statewide banking market. 418 U.S. 602, 620 (1974). The Supreme Court rejected this theory, which would have permitted application of horizontal merger rules to a market extension merger, as “foreclosed by the precedents.” *Id.* at 620-23. For the reasons developed above, such a view is surely not foreclosed by the legislative history, which would have defined the market extension merger in *Marine Bancorporation* as horizontal. The facts presented practically a paradigm case in which a market of local competitors was undergoing a transformation into one dominated by a few multi-market firms. Nor does it seem clear that a holding that the bank merger was a species of horizontal combination was entirely unsupported by the precedents. Cf. *United States v. Continental Can Co.*, 378 U.S. 441 (1964) (metal and glass containers placed within single product market although present competitive overlap is small).

Nevertheless, the congressional intent as to market and product extension mergers can be recognized without collapsing all distinction between direct horizontal mergers and other types of mergers viewed by Congress as horizontal. Such an approach is urged in this article. See pp. 80-83 *infra*.

173. Turner, *supra* note 28, at 1395.

174. *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 639 (1974); *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 537 (1973).

ter *de novo* or through "toe-hold" acquisition and that there is less competition than there would have been had entry been in such a manner.¹⁷⁵

This was a surprising comment, since earlier section 7 cases had simply assumed without much discussion that the statute encompassed future entry as well as perceived effects.¹⁷⁶ But once this doubt has been raised, it is crucial that the issue be resolved if the potential competition doctrine is to become an effective legal instrument. Careful consideration will show a clear line of legal authority, reaching back prior to 1950, recognizing loss of future competitive improvement as a basis for the imposition of section 7 sanctions.

The Supreme Court did not rest its doubt on any cited authority. The point was not briefed in *Falstaff*, and it was explored only tangentially in the *Marine Bancorporation* briefs.¹⁷⁷ In all likelihood the source of the Court's doubt traces to the scholarly journals, especially to a 1958 article by James Rahl.¹⁷⁸ Sharply criticizing the concept of potential competition, Dean Rahl leveled his heaviest salvos at the future entry effect, which he termed a "pseudo-potential competition idea."¹⁷⁹ Rahl contended that it is fallacious to treat "an election not to augment competition" as equivalent to an actual lessening of competition, because such treatment would convert the statutory prohibition against injury to competition into an affirmative program that seeks "to compel competition."¹⁸⁰ A recent note writer, discussing toe-hold mergers, has rephrased the problem:

175. 410 U.S. at 537.

176. See *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 561 (1973) (Marshall, J., concurring). Justice Marshall found the Court's doubt "inexplicable" in the light of past precedents, *id.* at 562 (citing *Ford Motor Co. v. United States*, 405 U.S. 562, 567, 587 (1972); *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 580 (1967); *United States v. Continental Can Co.*, 378 U.S. 441, 462, 464 (1964); *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 173 (1964); *United States v. El Paso Natural Gas Co.*, 376 U.S. 651 (1964)).

177. The *Marine Bancorporation* defendants argued that a finding of a § 7 violation could not be based on foreclosure of future entry because the event was too remote a contingency to constitute a "real probability." Brief for Appellees at 67-71. The Comptroller of the Currency, intervening in support of the merger, gravely cautioned that unless the potential competition doctrine were strictly limited to prospective competition that is "probable and imminent," a dangerous precedent would be set that might pose "a threat to our civil liberties." Brief for Comptroller of the Currency at 86, 90.

The Government's brief contains no more than a short discussion of the issue, citing previous § 7 decisions that recognized "the importance of preserving potential competition in concentrated industries" and the judicially recognized goal of achieving "eventual deconcentration" in such industries. Brief for Appellant at 29-31 (citing *United States v. Aluminum Co. of America (Alcoa-Rome)*, 377 U.S. 271, 279 (1964)).

178. Rahl, *Applicability of the Clayton Act to Potential Competition*, 12 ABA SECTION ON ANTITRUST L. 128 (1958).

179. *Id.* at 142.

180. *Id.* at 142-43.

Potential Competition Mergers

The Clayton act, by its terms, reaches only those actions that decrease competition, not those that fail to increase competition.

. . . [T]here must be some "probability" of anticompetitive consequences, however small, to come within the statutory prohibition. As a comparison of real and hypothetical market states, however, the toehold theory cannot reveal a probability that present competition will be lessened¹⁸¹

Briefly answering Dean Rahl in 1965, Donald Turner began with the comment that the conceptual problem was "not all that serious," but three pages later confessed a "lingering suspicion" that the objection might after all have substance.¹⁸² Turner agreed that neither section 7 nor any other antitrust rule compels competition, but pointed out that section 7 does prohibit a legally defined act, a merger, if the merger reduces the level of competition below what it otherwise would have been. That the standard is in terms of future effects is no barrier to finding an antitrust violation; ample precedent exists for declaring conduct unlawful without proof of actual or present anticompetitive consequences. Examples of rulings based purely on anticipated competitive injury include the attempt to monopolize and price conspiracy cases under the Sherman Act.¹⁸³

Since Turner did not fully convince even himself, it is scarcely surprising that this analysis did not quiet all doubts. In giving expression to these doubts in *Falstaff*, the Court emphasized the time when the

181. Note, *Toehold Acquisitions and the Potential Competition Doctrine*, 40 U. CHI. L. REV. 156, 181-82 (1972) (footnote omitted).

Dean Rahl objected to the potential competition doctrine on at least two other grounds: (1) the inappropriateness of finding a violation of § 7 based on a single measure of competitive effect, i.e., loss of potential competition; and (2) the lack of a determinate minimum threshold probability for finding a § 7 violation. But these objections appear less weighty.

The first claim challenges the use of simplified rules for testing injury to competition, in contrast to full rule of reason analysis. Dean Rahl did not think potential competition could be "an ultimate theory of violation" any more than could evidence "that the number of existing firms has diminished . . . or that concentration has increased." Rahl, *supra* note 178, at 133. But 14 years after *Philadelphia Bank* there can be little doubt as to the permissibility, indeed the preferability wherever possible, of a simplified approach.

Dean Rahl's second claim seems more properly an objection to the weight of evidence in specific cases than a general objection to the potential competition doctrine. In any event, the Supreme Court has rejected Rahl's argument as applied to the perceived effect of potential competition, which it has held to be squarely covered by § 7. There seems no basis for finding the future entry effect less probable as a general rule, since the assumption of limit pricing induced by recognition of entry (perceived entry effect) seems no more likely than that future entry into a highly concentrated market will induce increased competition or deconcentration. If predicting future entry is hazardous, determining when perceived entry actually "tempers" market conduct is equally difficult. See Posner, *supra* note 28, at 313-25.

182. Turner, *supra* note 28, at 1379-82.

183. *Id.*

anticompetitive effects of the merger would be felt. The applicability of section 7 was doubtful, according to the *Falstaff* Court, because the merger would leave competition "exactly as it was, neither hurt nor helped" at the time of acquisition, its only effect being that "there is less competition than there would have been."¹⁸⁴ This constitutes the peculiar issue raised by a future entry case, which the Court said it had not "squarely faced."¹⁸⁵

The Court acknowledged that at least "traces" of support appeared in its earlier decisions for the view that section 7 encompassed the future entry effect.¹⁸⁶ But this is an understatement. The Court has long recognized that the Sherman Act itself is intended to protect and facilitate future competition. As far back as *Standard Oil Co. v. United States*¹⁸⁷ in 1911, the Court declared a holding company to be presumptively unlawful because it destroyed "'the potentiality of competition'" among the constituent companies. As Judge Hand explained in *Alcoa*, "so far as concerns the public interest, it can make no difference whether an existing competition is put an end to, or whether prospective competition is prevented."¹⁸⁸ Judge Hand's words seem especially pertinent since *Alcoa's* offense, the successive expansions of its facilities, left existing competition, to paraphrase *Falstaff*, "exactly as it was, neither helped nor hurt." The only effect was that there would be "less competition [in the future] than there would have been."

United States v. Columbia Steel Co.,¹⁸⁹ a Sherman Act merger case involving the precise issue of whether an acquisition foreclosing future market entry can be a restraint of trade, is even more closely on point. The acquisition by United States Steel of Consolidated, a steel fabricator, was challenged even though Consolidated manufactured primarily steel plate, a product that United States Steel did not make at all. Although the Court found no violation of law on the

184. *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 537 (1973). Time of competitive impact is also the only objective way of distinguishing between Rahl's opposing concepts of a "lessening of competition" (covered by § 7) and "an election not to augment competition" (not covered by § 7), the lessening being in the present and the election having impact only in the future. Rahl, *supra* note 178, at 143. The underlying event in both instances is the same—a merger—and the only legally relevant managerial decision is the decision to merge.

185. 410 U.S. at 537.

186. *Id.*

187. 221 U.S. 1, 74-75 (1911).

188. *United States v. Aluminum Co. of America*, 148 F.2d 416, 429 (2d Cir. 1945). *Accord*, *United States v. Griffith*, 334 U.S. 100, 107 (1948) (§ 2 aimed at acquisition or retention of effective market control); *American Tobacco Co. v. United States*, 328 U.S. 781, 814 (1946) (citing *Alcoa's* language with approval).

189. 334 U.S. 495 (1948).

Potential Competition Mergers

particular facts, it accepted the Government's legal theory that the merger would restrain trade if it demonstrably foreclosed the possibility of future entry by United States Steel into steel plate fabrication.¹⁹⁰ This clear recognition of the future entry effect is all the more striking for its appearance in a decision that, because of its narrow view of the Sherman Act, proved unacceptable to Congress¹⁹¹ as well as to a later Supreme Court.¹⁹²

But these cases were decided under the Sherman Act, and assuredly the reach of the Clayton Act is longer, for its purpose was "to supplement the Sherman Act."¹⁹³ This supplementation must surely include the protection of an economic environment in which the likelihood of future competition is preserved in markets where present competition is deficient. The principle is explicitly recognized in the *Standard Stations* decision, in the joint venture cases, and in the Supreme Court's repeated references to eventual deconcentration as a goal of section 7.

*Standard Oil Co. v. United States (Standard Stations)*¹⁹⁴ further supports the proposition that violation of the Clayton Act can be based on injury to future competition. Exclusive dealing contracts between Standard and its dealers were held unlawful under section 3 of the Clayton Act, although it was not shown that the contracts had actually reduced competition or that competition would have been more vigorous without them. The Court rejected an interpretation of the Clayton Act that would "reestablish the necessity of meeting the same tests of detriment to the public interest" as required by the Sherman Act.¹⁹⁵ The Court added:

[E]vidence that competitive activity has not actually declined is inconclusive. Standard's use of the [requirements] contracts creates just such a potential clog on competition as it was the purpose of § 3 to remove wherever, were it to become actual, it would impede a substantial amount of competitive activity.¹⁹⁶

190. *Id.* at 528. The Court considered that such future entry would make the market more competitive than it then was, but rejected the proffered showing as "highly speculative." *Id.*

191. See *House Report*, *supra* note 157, at 10-11 (citing *Columbia Steel* to counter claim that Sherman Act is sufficient to control anticompetitive mergers); 96 CONG. REC. 16452-53 (1950) (Sen. Kefauver).

192. *United States v. First Nat'l Bank & Trust Co. (Lexington Bank)*, 376 U.S. 665, 672 (1964) (*Columbia Steel* "confined to its special facts").

193. *United States v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 597 (1957). See p. 41 *supra*.

194. 337 U.S. 293 (1949).

195. *Id.* at 312.

196. *Id.* at 314.

Thus *Standard Stations* explicitly recognizes that a requirements contract can be unlawful under section 3, which contains a definition of competitive injury identical to that in section 7, although the threatened injury to competition is entirely in the future.¹⁹⁷

Yet the joint venture cases, particularly *United States v. Penn-Olin Chemical Co.*,¹⁹⁸ present the most decisive authority. A joint venture necessarily involves recognizing the competitive value of future entry under the antitrust laws, because a joint venture, unlike a merger, has the immediate effect of increasing the number of market participants and thus increasing competition. Hence the only theory on which formation of a joint venture can be said to injure competition is the foreclosure of probable future entry by one or both of the parents.

The *Penn-Olin* Court specifically identified two separate bases of competitive injury, each of which involved foreclosure of future entry. The first was the probable future entry into the market by both of the parents. The second was the probable future entry by one of the parents while the other remained at the edge of the market as a perceived entrant.¹⁹⁹ The Supreme Court remanded the case with the direct instruction that the second theory, of which probable future entry is a necessary part, be considered. And the lower court was admonished to include in its consideration "an appraisal of what the competition in the relevant market would have been if one of the joint venturers had entered it alone instead of through Penn-Olin."²⁰⁰

197. The relevance of *Standard Stations* to the interpretation of § 7 was established by the Court's claim in *Philadelphia Bank* that, pursuant to congressional intent, it had "relied upon decisions under . . . other sections [of the Clayton Act] in applying § 7," and specifically on *Standard Stations*. *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 365 (1963) (citing *House Report*, *supra* note 157, at 8). The Court in *Philadelphia Bank* also cited *United States v. E.I. duPont de Nemours & Co.*, 353 U.S. 586, 595 n.15 (1957), which had relied on *Standard Stations* in holding foreclosure of competition to be a § 7 violation. 374 U.S. at 365.

198. 378 U.S. 158 (1964).

199. If both parents were merely perceived entrants, not probable entrants, an anti-competitive effect would seem quite remote, for it would require a finding that perceptions of entry are more potent than actual entry by a joint venture.

200. 378 U.S. at 177. Additional recognition of the essential place of future competition in the scheme of § 7 appears in the Court's construction of the meaning of the statutory language "engaged in commerce." Defendants had argued that § 7 could not apply to the creation of an entirely new joint venture since the acquired firm, *i.e.*, the joint venture, was *not* at the time of the stock acquisition "engaged in commerce" as the statute mandated. In rejecting this argument the Court gave explicit recognition to the need to protect future competition, stating:

Certainly the formation of a joint venture and purchase by the organizers of its stock would substantially lessen competition—indeed foreclose it—as between them, both being engaged in commerce. This would be true whether they were in actual or potential competition with each other and even though the new corporation was formed to create a wholly new enterprise.

Potential Competition Mergers

Penn-Olin necessarily recognized foreclosure of future market entry as a basis for Clayton Act violation.²⁰¹ This was not a radical departure in the joint venture field. Under a well-established line of Sherman Act precedents, joint ventures between major firms in concentrated markets have been held unlawful as foreclosing independent entry by the parents.²⁰²

Further arguments can be added in support of the analysis that section 7 applies to the future entry effect.²⁰³ One can only hope that when the Supreme Court does "squarely face" the question, it will agree with Justice Harlan, no advocate of expansionist views of anti-trust, that the exclusion of probable future market entry by an im-

Id. at 168. The Court defended its reading of "engaged in commerce" as extending to potential or future competition as necessary "in the light of the wording of the section and its legislative background." *Id.*

201. See Note, *United States v. Falstaff Brewing Corporation: Potential Competition Re-examined*, 72 MICH. L. REV. 837, 857 n.132 (1974).

202. *Timken Roller Bearing Co. v. United States*, 341 U.S. 593 (1951); *Consolidated Gas Elec. Light & Power Co. v. Pennsylvania Water & Power Co.*, 194 F.2d 89 (4th Cir. 1952); *United States v. Minnesota Mining & Mfg. Co.*, 92 F. Supp. 947 (D. Mass. 1950); *United States v. National Lead*, 63 F. Supp. 513 (S.D.N.Y. 1945), *modified*, 332 U.S. 319 (1947). See *United States v. Paramount Pictures*, 334 U.S. 131, 150 (1948) (joint ownership of theatres that eliminates putative competition between joint owners is unreasonable restraint of trade).

In *United States v. General Dyestuff Corp.*, 57 F. Supp. 642 (S.D.N.Y. 1944), the court rejected the argument that the joint venture was not unlawful because it eliminated no previous competition between the parents, stating "[n]either the letter of the law nor its purpose 'distinguishes between strangling a commerce which has been born and preventing the birth of a commerce which does not exist.''" *United States v. General Dyestuff Corp.*, 57 F. Supp. at 648 (quoting *United States v. United Shoe Machinery Co.*, 247 U.S. 32, 53 (1918)).

203. These include (1) the Supreme Court's thrice-repeated recognition of a policy goal of eventual deconcentration under § 7, *Ford Motor Co. v. United States*, 405 U.S. 562, 567-71 (1972); *United States v. Aluminum Co. of America (Alcoa-Rome)*, 377 U.S. 271, 279-81 (1964); *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 365 & n.42 (1963), (2) frequent lower court recognition of restrictions on probable future entry as a lessening of competition under § 7, *see, e.g., Ekco Prods. Co. v. FTC*, 347 F.2d 745, 752-53 (7th Cir. 1965); *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1234 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974); *United States v. Wilson Sporting Goods Co.*, 288 F. Supp. 543, 562-63 (N.D. Ill. 1968); *United States v. Standard Oil Co. (New Jersey)*, 253 F. Supp. 196, 227 (D.N.J. 1966). *But see BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977) (declining to rule on doctrinal validity); *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449, at 71,699 n.5 (D.D.C. 1977) (doctrine self-contradictory), and (3) the consistent thrust of the legislative history toward achieving long-run competitive benefit even if no short-run threat to competition appears. In concluding that the Sherman Act was inadequate to meet the economic problem addressed by the Celler-Kefauver Act, the House Report set forth specific passages from the *Alcoa* and *American Tobacco* decisions, which mentioned exclusion of potential competition as an antitrust offense. *House Report*, *supra* note 157, at 9-10. Although the discussion focused on another aspect of the decisions, the passage also demonstrates that when Congress adopted an amendment reaching "far beyond the Sherman Act," *Senate Report*, *supra* note 157, at 5, it was quite aware of the existing coverage of potential competition under the Sherman Act.

portant firm "[c]ertainly . . . may be sufficient, in itself, to support a finding of illegality under § 7 . . . when the market has few competitors."²⁰⁴

204. *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 586 (1967) (Harlan, J., concurring).

An alternative "solution" to the feared excessive reach of the future entry doctrine was suggested in a recent court of appeals decision, *BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977), which sought to narrow the time period in which the future entry effect applies. Under this decision the entry effect would be limited to entry likely to occur "in the near future." *Id.* at 29.

The case involved a market extension merger between the world's second largest producer of industrial gases and the third-ranking producer (with a 16% market share) in the concentrated United States market, making the acquiring British firm the largest producer of industrial gases in the world. The Second Circuit held that in an actual entry case the finding of probable entry must contain "some reasonable temporal estimate related to the near future, with 'near' defined in terms of the entry barriers and lead time necessary for entry in the particular industry." *Id.* Since the FTC had placed no temporal boundary on its finding of probable future entry, the agency's decision was reversed and remanded for further proceedings.

On first reading, the court's decision seems sensible, since, as the petitioner argued to the court, almost anything may happen "eventually." Transcript of Oral Argument at 12, *BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977). Reflection suggests, however, that the new formulation is choked with difficulties and could cripple potential competition merger enforcement.

To begin, the meaning of the crucial time reference "near future" is clouded. "Near" must be defined with respect to the technology and economics of entry into the particular industry, so the term will vary in meaning among industries, and within an industry it may vary over time as technology and economic factors change. Also, the Second Circuit's standard would almost surely give even greater emphasis to subjective evidence. A requirement that entry would occur in the near future, even adjusted for entry lead time, necessarily implies that the *decision* to enter must be made in the very short term. For example, if a court finds the entry lead time in a particular industry to be five years following decision, under the "near future" standard the court might require a showing of probable entry within the next eight years, or perhaps within the next ten. So the court must gauge the likelihood of the firm's deciding to enter within the next three, or at most five, years. Thus the relevant entry decision would in most cases be made by the current management. The inevitable result will be reliance on subjective evidence, which is already too prominent in potential competition cases. *See* pp. 55-56 *infra*.

Third, despite the Second Circuit's careful statement that it was not requiring "any exact, precisely calibrated assessment of time of entry," 557 F.2d at 29, litigation practicalities will probably force a narrow focus on the time factor. Suppose "near future" is defined as eight years and lead time is five years in the industry, so that a decision to enter must then be proved within three years of the merger. The company will no doubt be able to show that such a decision could not be made during the first year or two due to prior commitments, planning lead time, lack of unbudgeted funds, and the like. Proof of a probable decision to enter is then likely to concentrate on a relatively small time period, the third year. Of course, no such precise proof of the future decision of an adverse litigant is possible.

Fourth, by severely reducing the time period during which new entry must take place, the court necessarily reduced the government's ability in future cases to prove entry probability. The probability of entry will always be greater within a longer time span than within a shorter time span, since the entry probability over time is the summation of probabilities in each individual year. *See* G. STIGLER, *supra* note 12, at 8-9 (cost of moving resources to new uses is high in short term, but diminishes over time). The FTC was probably trying to express this condition in its "eventual entry" standard. Literally construed, however, the Commission's language was over-encompassing, since

II. Formulating an Effective Legal Rule

Because antitrust policy toward potential competition mergers has been severely weakened by a complex legal doctrine basically unsympathetic to the broad policy goals of the amended Clayton Act, only very close market extension mergers remain substantially subject to section 7 sanction.²⁰⁵ Indeed, by imposing a performance-conduct standard on the enforcement agencies, which bear the burden of proof of showing injury to competition, the judicial development has thwarted effective protection of potential competition, especially with respect to product extension mergers.²⁰⁶ In light of the purpose of the amended section 7 and the paucity of effective legal tools for reducing economic concentration, the prevailing judicial doctrine should be modified.

There are three distinct policy approaches to potential competition mergers: (1) the present mixed, performance-conduct standard, (2) a conduct standard, and (3) a structural-presumptive standard. Although the standards overlap to some degree, they reflect distinct analytic approaches.

a summation to infinity, or without time limit, would lead to an unfairly high probability. But summation over too short a time period may be equally inequitable, for it will just as surely lead to unfairly low probabilities.

Any temporal standard for estimating entry probability is necessarily somewhat arbitrary, but an estimate should be selected in light of the statute's overall purpose to reduce market concentration in the long run. It might also properly take into account the time it takes courts to administer alternative structural remedies. Since society must now wait approximately 20 years for a structural remedy in monopolization cases, *see* note 2 *supra*, it seems reasonable to preserve potential entrants for a roughly comparable period.

The failure of the court of appeals to consider these issues may be traced to the parties' failure to discuss the time of entry question in any depth. *See* Brief for Petitioner at 82, *BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977) (sole mention of issue in briefs). This may explain the court's unusual reference in its opinion to the oral argument, where there was colorful, but not very informative, discussion of temporal constraints on future entry effect. Transcript of Oral Argument at 12, 37-40, 42-44, *BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977). It seems clear that the court acted without the benefit of careful and detailed briefing by counsel.

A final consideration may ameliorate the impact of the ruling. The British nationality of the acquiring firm may have been a factor in the decision. The British Government filed a brief in the court of appeals urging approval of the merger in the interest of preventing barriers to the free flow of foreign investment "between friendly countries," *Amicus Curiae Brief of the United Kingdom* at 2, and the point was also stressed in oral argument, Transcript of Oral Argument at 2-4, 15-16, 21-22.

205. A district court judge recently noted this development, commenting that the more viable perceived effect branch of the potential competition doctrine "has rarely, if ever, been applied to product extension mergers." *FTC v. Tenneco, Inc.*, 5 TRADE REG. REP. (CCH) (1977-1 Trade Cas.) ¶ 61,449, at 71,699 (D.D.C. 1977).

206. *See* pp. 19-25 *supra*.

A. *Performance and Conduct Approaches*

1. *Mixed Performance-Conduct Standard*

The shortcomings of this approach were explored in Part I of this article, particularly in connection with the several lower court decisions since *Marine Bancorporation*.²⁰⁷ Under this standard both prediction of future business conduct and assessment of market performance are required, and subjective as well as objective facts are relevant. The failure of this approach, which has resulted in complex litigation, is not surprising; effective antitrust policy cannot be based on a standard encompassing economic performance.²⁰⁸

2. *Conduct Standard*

The conduct standard focuses on predicting the probable action or conduct of the specific firms involved in the merger: whether, for example, the acquiring firm will enter or will be perceived to be a likely market entrant by means other than merger. The conduct standard makes no attempt to assess economic performance questions, such as the likely impact of entry on price, product quality, or other economic features. Through detailed assessment of the past record and, to varying degrees, the present and past states of mind of the managers of the acquiring firm, this approach attempts to predict whether competition-improving conduct will occur.

Before *Marine Bancorporation* the conduct standard was the dominant legal approach, so the simplest reform might simply be to return to that standard. A conduct approach might be based on an open-ended factual inquiry, or it might rest on a simplified objective test in which proof of a limited number of facts would lead to a presumption of violation. These alternatives will be considered in turn, but in either event the ultimate legal issue is the prediction of specific behavior by a particular business firm.

Two general problems that beset any conduct-based rule for potential competition must be noted: the inherent unreliability of subjective evidence and the difficulty of predicting the future conduct

207. See pp. 19-25 *supra*.

208. Effective antitrust policy must be suitable for general administration in the courts. A performance standard may be more feasible if administered by an expert agency, as occurred under the Public Utility Holding Company Act of 1935 (PUHCA), ch. 687, 49 Stat. 838 (codified at 15 U.S.C. §§ 79-79z-6) (and as was proposed under the late Senator Hart's Industrial Reorganization Act, *supra* note 2). The experience under the PUHCA, however, offers no clear proof that the performance issue, even when limited, can be effectively administered even by an expert agency. See Brodley, *Efficiencies*, *supra* note 14, at 368-70 (1975).

Potential Competition Mergers

or perception of a bureaucratic institution. To a degree the first problem can be remedied; the second cannot.

Under the conduct standard the issue of subjective versus objective evidence is critical in a potential competition case, because the ultimate questions in the case are intrinsically subjective. Would the acquiring firm have decided to enter the market in the absence of the merger? Do existing firms perceive the acquiring firm as a potential entrant? The most direct evidence on the point would be the testimony of corporate managers as to what they intended or perceived. But such testimony is biased in a way that testimony in an antitrust proceeding seldom is: the ultimate fact is a subjective mental state. As Justice Marshall has noted,²⁰⁹ such testimony could never be the subject of perjury prosecution (absent direct and unexplainable contradiction), and, perhaps even more to the point, the conjunction of litigation interest and the usual fallibility of memory is apt to distort the testimony of even the most scrupulous.²¹⁰

Subjective evidence has additional disadvantages. Rules based on subjective evidence make antitrust consequences unpredictable and hence retard "sound" business planning.²¹¹ Moreover, the managers of firms change, and the intentions or perceptions of new management may differ sharply from those of the old. Indeed, the real locus of decisionmaking may be unclear in a large, bureaucratic organization; it will formally be lodged in the chief executive officers, but as a practical matter key staff members may have the decisive voice.²¹² Finally, the subjective evidence rule confronts managers with an impossible choice between antitrust compliance and corporate loyalty. The rule, in effect, says to a manager who is undertaking a merger: the legality of this acquisition depends in significant part on what you later testify were your subjective intentions if the merger had not occurred, and on what you now choose to say in corporate memoranda about such intentions. Such considerations have led commentators²¹³

209. *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 568 (1972) (concurring opinion).

210. Not only defendants, but also competitors in the target market may have strong litigation interests. Competitors may fear entry of the acquiring firm, and therefore may have an incentive to block the merger by showing that they perceived the acquiring firm as a potential entrant.

211. *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1238 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974).

212. Analyses of corporate and bureaucratic institutions reveal "infinite gradations of corporate decisionmaking," and a variety of incentive systems. Note, *Decisionmaking Models and the Control of Corporate Crime*, 85 YALE L.J. 1091, 1128 (1976). See G. ALLISON, *ESSENCE OF DECISION: EXPLAINING THE CUBAN MISSILE CRISIS* (1971).

213. See Pitofsky, *Joint Ventures Under the Antitrust Laws: Some Reflections on the Significance of Penn-Olin*, 82 HARV. L. REV. 1007, 1029 (1969); Turner, *supra* note 28, at 1370-79; Brodley, *Oligopoly Power*, *supra* note 62, at 357-59.

and some courts²¹⁴ to express varying degrees of preference for "objective" facts in potential competition cases.

But the courts have been unwilling to close the door to subjective testimony,²¹⁵ and many defendants still rely on such evidence.²¹⁶ Continued emphasis on subjective proof would seem inevitable under a conduct standard, for pertinent company documents may always be consulted in predicting whether the firm would have entered the market in the absence of merger. Are the makers and recipients of such communications to be denied the opportunity to explain the context in which the documents were written? If, as seems inevitable, such explanation is permitted, the line becomes fuzzy indeed between disfavored direct testimony of past subjective intention and allowable testimony explaining prior expressions of subjective intention.²¹⁷ But if subjective proof cannot be totally avoided, its use can be minimized.²¹⁸ Building on this analysis, would a conduct rule relying as much as possible on objective evidence offer a viable policy alternative? The options, as discussed below, are a full objective fact inquiry or a simplified test.

a. *Full-Fact Analysis*

United States v. Phillips Petroleum Co.,²¹⁹ a district court decision of painstaking care, provides an excellent example of a full-fact, con-

214. See, e.g., *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 532 (1972); *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 175 (1964); *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1234-38 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974).

215. The strongest suggestion came from Justice Marshall, who proposed that use of subjective evidence be limited to cases where the objective evidence is indecisive. *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 548 (concurring opinion). But such a limitation is not likely to be effective. Given counsel of ability, defendants should be able to create at least a conflict in the objective evidence as to an issue as complex as potential competition. See *FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 298 (4th Cir. 1977) (court reached issue of subjective evidence only after first finding objective evidence unclear).

216. See, e.g., *FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 298 (4th Cir. 1977); *British Oxygen Co.*, 86 F.T.C. 1241, 1351-52, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,911 (1975), *rev'd and remanded sub nom. BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977); *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1255-56 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974).

217. Nor would it be possible under a conduct approach to exclude all evidence of intent, present or past. Such a practice would exclude virtually all internal corporate documents since any discussion or estimate with respect to entry may be evidence of the company's intent.

218. There are some suggestions in this direction in recent Supreme Court decisions. See *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 640 (1974) (ten-year-old memorandum by officer of acquiring bank "does not establish a violation of § 7"); *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 533-35 (1973) (subjective testimony "not necessarily the last word" in identifying potential entrant). There is even support in the legislative history: "[under amended § 7] it would be unnecessary for the Government to speculate as to what is in the 'back of the minds' of those who promote a merger" *House Report*, *supra* note 157, at 8.

219. 367 F. Supp. 1226 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974).

Potential Competition Mergers

duct-based approach.²²⁰ The decision reveals that despite the advantages of focusing on objective facts, a conduct-based rule for potential competition faces unavoidable limitations. The issue was whether Phillips, the eighth largest domestic oil company, was a probable future entrant or perceived entrant into the California market, where it had acquired Tidewater. Recognizing the difficulties of proof, the district court attempted to simplify the legal standard through an objective fact approach:

The court adopts the standard that where credible objective evidence shows the basic economic facts of the acquiring company's overall size, resources, capability, and motivation with respect to entry into an adjacent attractive market involving a line of commerce in which the firm is already heavily engaged, that firm must be considered to be a significant potential entrant unless it is objectively demonstrated that some unique feature of the market precludes such entry.²²¹

The court relied on numerous factors to establish the "basic economic facts" of the company's "overall size, resources, capability and motivation." Capability of entry was inferred from Phillips' size, previous record of market entry, national marketing capacity, dynamic growth and vertical integration, research and development resources, financial strength, and managerial experience. Determining feasibility of entry involved a careful delineation of the necessary conditions for successful entry—gasoline supply, market outlets, crude supply, and ability to construct a refinery—and demonstration that Phillips possessed each. Motivation rested on more shaky data. Phillips' general interest in entering the market was inferred from the number of merger alternatives considered, from the sketchy data on which Phillips made its decision to acquire Tidewater and the speed with which it executed the decision, from the fact that it pondered unilateral entry, and from the profit potential of West Coast entry.²²²

Despite the district court's factual mastery of the case, even this

220. This is also the approach of the Justice Department's Merger Guidelines, *supra* note 165.

221. 367 F. Supp. at 1239. Compare Merger Guidelines, *supra* note 165, para. 18, at 6888: In determining whether a firm is one of the most likely potential entrants into a market, the Department accords primary significance to the firm's capability of entering on a competitively significant scale relative to the capability of other firms (*i.e.*, the technological and financial resources available to it) and to the firm's economic incentive to enter (evidenced by, for example, the general attractiveness of the market in terms of risk and profit; or any special relationship of the firm to the market; or the firm's manifested interest in entry; or the natural expansion pattern of the firm; or the like).

222. 367 F. Supp. at 1239-52.

cursory review reveals serious problems with a conduct-based rule. First, a conscientious inquiry into the facts impelling a future business decision, even limited to "objective facts," is far from simple, and the complexity lies in areas particularly inappropriate for courtroom resolution, that is, cost determination, profit estimation, and risk assessment. Second, the motivation of a large bureaucratic institution, however considered, remains incurably unreliable as a legal concept. Third, if the company's interest and intent are inferred from internal statements and documents, corporate officers have a strong incentive to manage such evidence so as to negate inferences that the company would enter by means other than merger. Finally, the factors are subject to change over time with variations in the economic environment, the business cycle, and the individuals occupying managerial and staff positions in the corporation.

Moreover, the overriding problem remains: the ultimate fact—probability of entry by a particular firm—is obscure and uncertain. Attempting to predict the conduct of even a single human individual can be immensely complicated, in view of the many motivations, conscious and unconscious, that determine human choice. Predicting the future action of an institution composed of numerous officials with varying degrees of influence and widely differing motivations seems hopeless. Any attempts to forecast what the individual firm would have done on the hypothetical assumption that the merger had not occurred can lead only to an uncertain and shifting legal standard, with many of the same drawbacks as a purely subjective test.

b. *Simplified Objective Tests*

The problems and complexities inherent in a full-fact test for potential competition have led legal scholars to search for a simplified conduct test. Is it feasible to focus on a few explanatory facts, from which at least a presumption of injury to potential competition might be drawn? Tests of this nature have been suggested by Professors Turner²²³ and Pitofsky.²²⁴ If neither approach seems fully satisfactory, the basic problem is not the analytic development, but the attempt to adhere to a single conduct-predicting standard.

i. *The Turner Approach*

Turner would prohibit substantial acquisitions in highly concentrated markets by the most likely potential entrants. The difficulty

223. Turner, *supra* note 28, at 1362-86.

224. Pitofsky, *supra* note 213.

Potential Competition Mergers

in Turner's approach arises from the method of proving potential entry, which would differ for market and product extension mergers. For a narrow group of market extension mergers, a clear presumptive rule is set forth. For all other potential competition mergers, the rules pose difficulties of proof that the government will rarely, if ever, be able to overcome. Strikingly, this dichotomy accords neatly with the lower court results in the seven post-*Marine Bancorporation* cases, where the only case the government won at trial was a market extension meeting the Turner criteria.²²⁵

Under Turner's approach, significant market extension mergers by the most likely (or one of the two or three most likely) entrants to a highly concentrated market would be unlawful under the strong presumption enunciated in *Philadelphia Bank*.²²⁶ Other market extensions and all product extensions would be subject to a weaker prima facie presumption under alternative perceived and actual entry effect theories. The evidentiary requirements under each, however, are so severe as to preclude an effective legal rule. For these theories require that it be shown that the acquiring firm is either recognized by target market firms as one of the few potential entrants, or that it was in fact one of a few potential entrants and was virtually certain to enter the market, as established by internal corporate documents or by overwhelming objective evidence.²²⁷ The second of these approaches, actual future entry, poses difficulties of proof so formidable as to be rarely, if ever, satisfied.²²⁸ This is not accidental, since Turner emphasizes the first, or perceived entry approach, which he views as more objective. Under this approach, he stresses, the "significant question" is not the entry intentions of a particular firm, but what the existing producers believe to be the case.²²⁹ Such belief can be proved by economic facts showing that the acquiring firm has the capacity,

225. *British Oxygen Co.*, 86 F.T.C. 1241, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063 (1975), *rev'd and remanded sub nom. BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977) (market extension acquisition of third-ranking firm in concentrated market by most likely entrant).

226. *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 363 (1963) (presumption subject to rebuttal only by evidence "clearly showing" merger not likely to have anti-competitive effects).

227. Turner, *supra* note 28, at 1369, 1377-78, 1383-84. Precise application of the presumption depends on the interrelation of the probability of entry and the market share of the target firm. The most likely entrant would be more limited in its acquisitions than, for example would the second or third most likely entrant.

228. Turner acknowledges that proof of actual future entry by internal evidence is a rare event and is apt to become even more rare if his rule is adopted. *Id.* at 1383. Objective facts proving that entry is certain are likely to be present only when entry is actually in progress. See *United States v. El Paso Natural Gas Co.*, 376 U.S. 651, 660-61 (1964) (target firm had unsuccessfully attempted to enter market).

229. Turner, *supra* note 28, at 1378.

interest, and incentive²³⁰ to enter a market in which demand is expanding.²³¹ The Turner analysis is encapsulated in *Falstaff's* concept of the rational beer merchant in the target market.²³²

Turner's approach contains one striking simplification—the assumption that market extension entry is more probable than other types of entry. This is a highly useful generalization, since it permits judicial inquiry to focus on a relatively small number of primary potential entrants.²³³ But Turner has provided no equally effective stratagem for product extension mergers. Even under the perceived or recognized entry approach, elaborate inquiry will be required into both whether the firm is a probable entrant and whether it is a more probable entrant than other firms. The facts bearing on a firm's capacity, interest, and incentive to enter a market are virtually open-ended. Moreover, the need to prove that the acquiring firm was a more probable entrant than other firms conceivably opens the record to proof of the capacity, interest, and incentive of other would-be entrants, followed by a comparative evaluation. A final disadvantage is that by making the ultimate fact one of perception of entry, Turner's approach cannot bar direct testimony by firms in the market as to what they did in fact perceive.²³⁴ In all, the result is apt to be burdensome proceedings, absence of predictive rules, and ineffective enforcement.²³⁵

ii. *The Pitofsky Approach*

In a refinement and further development of the Turner analysis, Professor Pitofsky's 1969 article moved appreciably closer to a struc-

230. "Capacity" is shown by technological know-how or production of competitive or complementary goods; "incentive" is established by showing that expected profits were within the range the company deems adequate; "interest" is not specified further, but presumably is demonstrated by evidence showing the company explored market entry alternatives. *See id.* at 1384.

231. *Id.* at 1385-86. A firm is deemed more likely to enter the market if demand is expanding. *But see* pp. 78-79 *infra*.

232. *See* pp. 14-16 *supra*.

233. The generalization seems justifiable based on the close market proximity of market extensions. *See* p. 69 *infra*. Within the defined product market it will still be necessary under Turner's approach to identify the most probable potential entrants. These will, however, frequently be the largest out-of-the-market firms, as the trial courts found in the *British Oxygen* and *Phillips* cases. *See* pp. 56-57 & note 204 *supra*.

234. *See, e.g.,* *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,596-97 (D. Md. 1976) (extensive survey of market executives' perceptions of entry probability); *The Budd Co.*, 86 F.T.C. 518, 579-80, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,998, at 20,855-56 (1975) (testimony on perceived effect by "large number of industry witnesses").

235. Three years following Turner's article, the Department of Justice issued its Merger Guidelines, *supra* note 165, which included potential competition mergers. Although similar in approach to Turner's criteria, these were somewhat less inclusive and were formulated in terms of actual potential entrants rather than recognized entrants.

Potential Competition Mergers

tural-presumptive rule.²³⁶ Turner rested his objective proof of potential competition on three basic elements—capacity, interest, and incentive—but did not confine the scope of the factual inquiry into these elements. Pitofsky carefully specified and narrowed the proof of each, but in so doing he retained at least one complex and prediction-defeating factual issue.

For Pitofsky, capacity to enter the market is rebuttably presumed where the acquiring and target firms (1) are engaged in collateral or complementary product lines, (2) sell to the same general class of customers or through the same distribution channels, or (3) use the same advertising techniques.²³⁷ Interest in market entry, at least in a joint venture setting, would be inferred from the fact of entry.²³⁸ Incentive to enter the market is the crucial factor in determining the scope of the rule and is defined as the probability of earning acceptable profits. This depends on a showing that the profit rate likely to result from unilateral entry is equal to or greater than the profit level necessary to induce such entry.²³⁹

Pitofsky would introduce “a strong presumption” of probable entry by internal expansion when these three factors are present.²⁴⁰ This is a useful simplification, which leaves proof of incentive as the only conduct issue to be resolved. But therein lies the problem, for proof of incentive turns on ascertaining an estimated future profit sufficient to induce entry, an uncertain statistic fraught with possibilities for manipulation and understatement by the acquiring firm. Pitofsky seeks to meet the problem by recommending the use of outside consultants to estimate the anticipated return against which the company’s own target rate of return would be compared.²⁴¹

But this approach understates the difficulties of an incentive standard. A rule resting merger legality on the company’s internal estimates of profitability would create strong incentives to distort or suppress such estimates where merger is contemplated.²⁴² Indeed, the

236. Pitofsky, *supra* note 213. Pitofsky’s analysis focuses on joint ventures, but the problem of identifying potential competition is common to both mergers and joint ventures. In both transactions there is a desire to enter the market and to manage, as distinct from merely investing in, productive assets; and the relative attraction of the alternative methods of entry is chiefly a question of comparative costs.

237. *Id.* at 1025.

238. *Id.*

239. *Id.* at 1028-29.

240. *Id.* at 1028.

241. *Id.* at 1029. If target rate-of-return data is not available for the acquiring firm, then the benchmark of comparison could be the return acceptable to similar companies in situations of similar risk.

242. At the very least there would be an incentive to keep profit estimates sufficiently vague when merger is anticipated, so that supplementary testimony and explanation will be necessary. Another evasion short of actual distortion would be the establishment

identification by Pitofsky and others of the relevance of such projections may have already affected managerial practices of merger-bound firms.²⁴³ Further, by opening the inquiry to testimony by outside experts as to anticipated profit in the target market as compared with other markets, public utility-type issues of market comparability, investment risk, cost allocation, and expected return will be introduced. The result can only be evidentiary conflict and unmanageable complexity in litigation.²⁴⁴

In addition, by reopening the possibility, even if only in part, of subjective testimony by interested managers, Pitofsky moves a step farther away from a workable rule. Despite his searing critique of subjective evidence,²⁴⁵ Pitofsky would permit its use *against* a company when it amounts to an admission against interest, and *on behalf* of a company when there is external corroboration of the firm's unwillingness to enter unilaterally.²⁴⁶ Although the first situation is apt to be rare, the latter condition (objective corroboration) almost always will be arguably present in the complex and ambiguous facts of a potential competition case.

of a benchmark return for unilateral entry far above the firm's existing rate of return. This might be very effective, as past acceptance of lower return either in the firm's daily business or in previous investments cannot be dispositive as to the company's view of the acceptability of return from new projects. See note 244 *infra*.

243. If this has occurred it is probably because the hard data of internal profit projections tends to drive out softer data as to managerial intent, and firms are cautious not to create such hard evidence. In any event, there seems to be less recourse to such estimates in recent cases. In the seven lower court post-*Marine Bancorporation* cases, the only reference to concrete profit estimates involved a foreign firm. See *British Oxygen Co.*, 86 F.T.C. 1241, 1253-55, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,913 (1975), *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977).

244. The lower court opinion and record in *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158 (1964), illustrate some of the difficulty. Both Olin Mathieson and Pennsalt had estimated the return from independent entry. Although Olin's highest estimate was 18.9% on investment, Pennsalt's ran as high as 26.2%. *United States v. Penn-Olin Chem. Co.*, 246 F. Supp. 917, 922, 933 (D. Del. 1965), *aff'd by an equally divided court*, 389 U.S. 308 (1967). Yet this was insufficient to meet the target return of 30% set by Pennsalt's president, though sufficient to meet the company's general target return of 25%. Record in *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158 (1964), at 329-31, 916 [hereinafter cited as Record]. These figures were, of course, well above either Olin's or Pennsalt's average return, which in 1960 were 8.7% and 8.0%, respectively. Record at 917. It was also comfortably above the estimated return for the joint venture, which was 17%. Record at 733. (The figures are not entirely comparable since they are not adjusted for risk, and arguably the joint venture was less risky than independent entry.) The source of Pennsalt's president's 30% target return for independent entry is also of interest; it was the profit needed to raise the company's overall return by one percent on an investment of \$30,000,000, Record at 331-33, a wholly self-imposed standard. This data (of which no more than a flavor has been suggested) is subject to no easy or ready reconciliation. (I am indebted for this example to a seminar paper prepared by D. Edward Morgan, a third-year student at Indiana University School of Law).

245. Pitofsky, *supra* note 213, at 1024.

246. *Id.* at 1029.

Potential Competition Mergers

However difficult the incentive standard may be under the Pitofsky approach, it cannot simply be eliminated, for it plays a vital role in narrowing the otherwise broad scope of the potential competition rule. Standing alone, the first two tests of potential competition, capacity and interest, would sweep in a vast number of mergers. Many firms are adjacent to numerous markets and product lines, and presumptively and in fact would have the capacity to enter such markets. With interest presumed from the fact of merger, incentive furnishes the necessary tool for selecting those markets in which entry is most probable.²⁴⁷ Thus, despite notable simplification, an effective and predictive rule for potential competition mergers is not fully achieved by Pitofsky's proposal. A structural rule, if it is not to follow Pitofsky, must find an alternative means to accomplish a similar result.

B. *A Proposed Structural-Presumptive Approach*

The third approach to potential competition is structural and focuses on the more permanent organizational characteristics of the market. Particularly suited to the legal process, it does not attempt to assess economic performance or to predict the future conduct of an individual firm. Instead, a structural legal rule identifies, as specifically as possible, the market structures most likely to lead to anti-competitive behavior and permits a presumption of illegality to be drawn from the structure so identified. To be effective, such a rule must utilize structural dimensions that can easily be observed and measured, such as seller concentration and firm market share and size.²⁴⁸ Inevitably, a structural rule is presumptive, for a transaction is subject to the rule not because of its highly particularized facts, but due to general characteristics identifying it as one of a class of transactions carrying high risk of anticompetitive impact.

Although the decisions and commentary on potential competition make some use of structural factors,²⁴⁹ they do not attempt a thoroughgoing structural approach. No doubt this reflects a healthy caution in an area in which, as Turner observed, the risk to competition is less compelling than that posed by horizontal mergers.²⁵⁰ But other ap-

247. Without the narrowing effect of an incentive standard, for example, Procter & Gamble, having the capacity to enter many dry goods markets, could be defined as a potential entrant to hundreds of markets, a patently "unfair" result. *Id.* at 1026. See note 283 *infra*.

248. Not every structural parameter is suitable for legal use. See pp. 28-29 *supra* (Bain's "condition of entry" not appropriate for judicial use).

249. See, e.g., *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 631 (1974) (presumption that concentrated market is "candidate for the potential-competition doctrine").

250. Turner, *supra* note 28, at 1320-21.

proaches have not produced a rational, consistent policy, and potential competition merger doctrine must either utilize structural-presumptive rules or cease to exist as a viable legal policy.²⁵¹ A structural approach to potential competition mergers of utmost simplicity and generality was recommended in the 1968 White House Task Force Report on Antitrust Policy (the Neal Report). The policy put forward by the Neal Report would have barred acquisitions of leading firms in concentrated markets by any "large firm."²⁵² But that proposal, applicable to all conglomerate mergers, failed to consider whether mergers not strictly horizontal could be broken down into more discrete categories, such as product and market extension mergers, on the basis of probability of entry. As a result, the Neal Report proposal posed a higher risk to economic efficiency and welfare than would the more confined rule urged here.²⁵³

251. The claim here is not that there is any simple causal nexus between market structure and conduct or performance, *see* Phillips, *Commentary*, in *INDUSTRIAL CONCENTRATION*, *supra* note 2, at 409-13 (complex relationships among structure, conduct, and performance), but rather that among those variables causally related to conduct, performance, and the noneconomic goals of antitrust, structure represents the only variable on which effective legal policy can be based. *Cf.* G. STIGLER, *supra* note 12, at 301-03 (outlining structural approach for horizontal mergers).

The extent to which a viable potential competition merger doctrine would significantly reduce concentration is an empirical question, which cannot be definitively answered before such a policy is implemented. There are, however, at least suggestive indications that firms barred from market extension mergers will tend to enter the market *de novo*. *See* E. KOHN & C. CARLO, *POTENTIAL COMPETITION: UNFOUNDED FAITH OR PRAGMATIC FORESIGHT* 3-5 (N.Y. State Banking Dep't 1970) (10 banks that were denied right to merge into particular market between 1961 and 1963 eventually entered market *de novo*); Horvitz, *Book Review*, 20 *ANTITRUST BULL.* 411, 412-13 (1975) (follow-up study showing similar result in six out of eight post-1963 bank merger disapprovals in New York); Rhoades & Yeats, *An Analysis of Entry and Expansion Predictions in Bank Acquisition and Merger Cases*, 10 *W. ECON. J.* 337 (1972) (review of all federal regulatory decisions involving probable future competition showing that within two years of decision 32% of banks had entered market *de novo*, and within 9 to 10 years 50% had entered). *See also* *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1247 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974) (major petroleum company entered California market *de novo* after merger was barred, despite prior statement to contrary); Baker, *Potential Competition in Banking: After Greeley, What?* 90 *BANKING L.J.* 362, 372-75 (1973) (noting that disavowal of intention to enter by bank holding company was followed by entry after prohibition of merger).

252. *White House Task Force Report on Antitrust Policy*, reprinted in 2 *ANTITRUST L. & ECON. REV.*, Winter 1968-69, at 11, 30 [hereinafter cited as *Neal Report*]. The Task Force proposal would have prohibited acquisitions by "large firms" (sales exceeding \$500 million or assets exceeding \$250 million) of leading firms (one of four largest firms with market share of at least 10%) in concentrated markets (four-firm concentration ratio of 50%). *Id.* at 736-37. Defending its proposal, the Neal Report urged that the legal system is unable to ascertain the probability of market entry by a particular firm, and that efforts to do so lead either to "extended and contrived interpretations of Section 7" or "ineffective enforcement." *Id.* at 681. The report recommended a rule prohibiting leading firm acquisitions by large firms in order to channel expansion activity of such firms into more competitive alternatives, *i.e.*, acquisitions of smaller firms, or entry by internal expansion. *Neal Report, supra* at 681-82.

253. The Neal Report proposal may also have exceeded the scope of § 7. Some authorities view the injury to competition standard of § 7 as requiring that defendants

Potential Competition Mergers

In broadest outline, the strategy proposed here would identify the class of most likely entrants into the most ill-structured markets, and then bar large acquisitions in those markets by such firms. The novelty, if any, in this approach is that it accepts the impossibility of basing an effective legal rule on a prediction of whether a specific firm will in the future enter a specific market, or whether it is or will be perceived as an entrant. The strategy recognizes, as did the Neal Report, that the most feasible approach is to define clearly a class, or general category, of most probable and most significant entrants.²⁵⁴ But it aims for greater specificity than the 1968 proposal. To achieve these goals an effective legal rule must find workable surrogates for the key elements of potential competition analysis, most particularly probable future entry. In so doing, the severed halves of the potential competition doctrine—the future entry and perceived effects—can be reunited as two aspects of a single concept: the rivalry offered by a firm not currently in the market.²⁵⁵

1. *Probable Future Entry and the Concept of Market Proximity*

By far the greatest barrier to an effective potential competition policy is the difficulty of identifying the acquiring firm (1) as a probable market entrant or potential competitor and (2) as one of the few most likely such entrants. The most appropriate legal indicator, or surrogate, for probable entry is the concept of “market proximity,” or distance between the acquiring firm and the target market. Market proximity refers to the closeness between markets in terms of technology and equipment, marketing techniques, and customer and supplier overlap. Firms in close proximity to the target market would be presumed to be the most likely entrants.

Viewed in economic terms, proximity is a concept of information distance: the availability of information about the market with minimum search cost. Two markets are proximate to the extent that they share similar information in production, marketing, technology, and

have an opportunity to prove the benign competitive effects of a particular merger. Such a requirement would not bar a presumptive test, *see* *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 362-63 (1963), but might preclude a *per se* rule. *See generally* Pitofsky, *supra* note 213, at 1039 (citing *Brown Shoe Co. v. United States*, 370 U.S. 294, 319-23 (1962)). The Neal Report avoided the problem of § 7 coverage by making its proposal as a statutory amendment. *See Neal Report, supra* note 252, at 682.

254. *Cf.* Turner, *supra* note 28, at 1319 (general antitrust rules which do not specify the probability of harm in particular case should “at least indicate those probabilities for the class of such cases”).

255. *See* pp. 10-11 *supra*.

transactional relations (that is, common customers and suppliers).²⁵⁶ The relation between proximity and probable market entry is based on the plausible assumption that in a world where information is costly and time scarce, firms do not continually scan the economic universe in search of new investment, but focus on those markets and processes with which they already have some familiarity.²⁵⁷ Put differently, the barriers to entry are apt to be lowest into proximate markets.²⁵⁸ This assumption is supported by both managerial theory and empirical evidence. Analysis of managerial behavior indicates that managerial decisions are at all times constrained by human limitations in dealing with complexity and by imperfect information.²⁵⁹ It is rational to concentrate management activities in familiar areas. Moreover, the observed expansion activities of firms indicate the greater likelihood of entry into related product lines.²⁶⁰ Thus, on both theoretical and empirical grounds, the conclusion seems well supported that there is a strong correlation between proximity and probable market entry.²⁶¹

256. See J. NARVER, CONGLOMERATE MERGERS AND MARKET COMPETITION 67-76 (1967); Joskow, *supra* note 120, at 276-77; Lydall, *Conditions of New Entry and the Theory of Price*, 7 OXFORD ECON. PAPERS 300, 305-06 (1955).

257. See K. ARROW, THE LIMITS OF ORGANIZATION 40-43 (1974). Professor Arrow points out that an individual or organization is a bundle of special abilities and knowledge. Information costs are not uniform since learning generalizes naturally and cheaply in particular directions. In very simple illustrations, an explorer does best in territories near those he has covered before, a chemical analyst in studying compounds similar to those already studied. For an individual or firm it is easier and cheaper to move in known directions.

258. See Turner, *supra* note 28, at 1377-78.

259. See H. SIMON, *supra* note 63, at 198-99; Williamson, *Transaction Cost*, *supra* note 142, at 1442-47. Professor Williamson summarizes the constraints in terms of (1) uncertainty as to the future, (2) bounded rationality (the complexity of problems exceeds human problem-solving capacity), (3) information impactedness (the distribution of information among firms is uneven), and (4) opportunism in interfirm behavior (firms seek their self-interest with stealth and guile).

260. A recent study of nonmerger entry in 48 industries over a 16-year period indicated that 49% of large firm entrants were previously producing in related markets. M. Harris, *Entry, Barriers to Entry, and Limit Pricing* 146 (unpublished Ph.D. thesis, Columbia University, 1973). The criterion of related markets was production in the same two-digit census market. *Id.* As high as this figure is, it probably understates proximity since it measures only productive similarity and neglects shared marketing and distributional traits.

261. See Turner, *supra* note 28, at 1315: "Companies looking for new lines of business tend to buy into those fields with which they have at least some degree of familiarity, and where economies and efficiencies from assimilation are at least possible." See O. WILLIAMSON, MARKETS AND HIERARCHIES 169 (1975) (entry barriers apt to be less severe "for those few firms which have closely complementary production processes and sales organizations").

An illustration of this principle in operation is seen in the new products policy of Olin Mathieson, as revealed in *Penn-Olin*. The entry objective of the company's Industrial Chemicals Division was to develop new products, provided they (1) were related

Potential Competition Mergers

Proximity as a measure of probable entry is less of a departure from current legal practice than may at first appear. The notion of proximity is built into the legal classification of product and market extension mergers, for proximity, in terms of similarity of products and markets, is the defining characteristic of such mergers. Also, proximity has been explicitly identified as a significant factor in several cases. An important measure of potential competition in *El Paso* was "the nature or extent of [the target] market and . . . the nearness of the absorbed company to it" ²⁶² In finding that a market extension acquisition threatened potential competition, the court in *Northern Natural Gas Co. v. FPC* ²⁶³ relied on "the nearness of the absorbed company to the market;" ²⁶⁴ and in *Kennecott Copper Corp. v. FTC*, ²⁶⁵ "close proximity to the coal industry," in addition to adequate financial resources and entry capability, made Kennecott "not only a likely entrant but also the most likely entrant into the coal business." ²⁶⁶ Whether or not explicitly discussed, findings of injury to potential competition have consistently involved proximate markets. ²⁶⁷

There has also been considerable development of the concept of proximity in legal writing. Turner accepts a more stringent rule for

to existing products, (2) could be produced by an extension of existing technology, and (3) could be sold in markets where the company was already active. *United States v. Penn-Olin Chem. Co.*, 246 F. Supp. 917, 920-28 (D. Del. 1965), *aff'd per curiam by an equally divided court*, 389 U.S. 308 (1967).

262. *United States v. El Paso Natural Gas Co.*, 376 U.S. 651, 660 (1964).

263. 399 F.2d 953 (D.C. Cir. 1968).

264. *Id.* at 964.

265. 467 F.2d 67 (10th Cir. 1972), *cert. denied*, 416 U.S. 909 (1974).

266. *Id.* at 77.

267. Thus, in cases finding an injury to potential competition, or with facts showing sufficient injury to justify remand for reconsideration by lower courts or the FTC, there was significant proximity between the markets. The proximity at times has been very close, as in the case of a market extension or close product extension. *See Northern Natural Gas Co. v. FPC*, 399 F.2d 953 (D.C. Cir. 1968) (market extension); *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974) (market extension); *United States v. Wilson Sporting Goods Co.*, 288 F. Supp. 543 (N.D. Ill. 1968) (close product extension; sporting goods firm acquired gymnastics equipment manufacturer). At other times it has only been moderately close, as in less clearly connected product extensions. *See FTC v. Procter & Gamble Co.*, 386 U.S. 568 (1967) (soap manufacturer and bleach firm); *General Foods Corp. v. FTC*, 386 F.2d 936 (3d Cir. 1967), *cert. denied*, 391 U.S. 919 (1968) (packaged food firm and steel wool pad manufacturer); *United States v. Standard Oil Co. (New Jersey)*, 253 F. Supp. 196 (D.N.J. 1966) (oil company and potash firm); *Beatrice Foods Co.*, 86 F.T.C. 1, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,944 (1973), *aff'd sub nom. Beatrice Foods Co. v. FTC*, 540 F.2d 303 (7th Cir. 1976) (food and household goods firm acquired paint brush maker). Of course, proximity in itself has not led inevitably to findings of injury to potential competition, for other criteria must be satisfied. But where proximity between markets has been absent, the courts have found a corresponding absence of potential competition. *See, e.g., Missouri Portland Cement Co. v. Cargill, Inc.*, 498 F.2d 851, 853, 866 (2d Cir.), *cert. denied*, 419 U.S. 883 (1974) (refusing to enjoin tender offer by commodities trading firm for cement manufacturing company).

market extension than for product extension mergers,²⁶⁸ an assumption that can rest only on the closer proximity of the target and acquiring firms in a market extension merger. Carrying the analysis a step further, Pitofsky defines capacity to enter the market essentially in terms of proximity factors.²⁶⁹ And Professor Steiner uses market proximity in proposing a rebuttable presumption of illegality for market extension and some product extension mergers.²⁷⁰

Proximity as an indicator of probable entry has advantages over measures like capacity, motivation, and incentive. It requires no proof of managerial intent; as a relatively long-run condition, it has greater stability, for it varies only as the firm expands and contracts its markets; and proximity will frequently be clearly visible and thus easy to establish. In fact, defining proximity is an undertaking akin to defining the market, a familiar, if challenging, antitrust task. The complexity of market definition is manageable because it describes an objective economic state and has proved to be a workable tool for antitrust policy.²⁷¹

2. *Defining the Proximate Market*

Definition of the proximate market would require a showing that the acquiring firm is in close proximity to the target market. As a necessary corollary, the acquiring firm's market must also be one of relatively few markets in such close proximity. Generally, there is little difficulty in applying this standard to market extension mergers, but improved analytical tools are needed for gauging the impact of product extension mergers on potential competition, for this area has suffered the most severe enforcement breakdown.

268. Turner, *supra* note 28, at 1377-78 (adopting "reasonable" supposition that existing producers generally view other manufacturers of same product as most likely potential entrants).

269. Pitofsky, *supra* note 213, at 1025 (similarity of product, customers, distribution, and advertising methods). See p. 61 *supra*.

270. P. STEINER, *MERGERS* 284-87, 334 (1975). Under Steiner's proposal, "nearby" market extension mergers into concentrated markets would be presumed unlawful, while "distant" market extension and most product extension mergers would be unlawful where the target was a leading firm. *Id.* Somewhat similar proposals have also been advanced in Note, *supra* note 201.

271. See Brodley, *Oligopoly Power*, *supra* note 62, at 350-53. Although market definition in merger cases has not always been of high quality, the very reason one can be critical of the cases is that there exists a standard of judgment. See generally Brodley, *id.* at 303-06 (evaluating market definitions in *United States v. Aluminum Co. of America* (Alcoa-Rome), 377 U.S. 271 (1964) and *United States v. Continental Can Co.*, 378 U.S. 441 (1964)).

Potential Competition Mergers

a. *Market Extensions*

A market extension normally involves a market of closest proximity. Since the sole barrier is geographic, it is reasonable to assume that firms in the proximate market are uniquely close to the target market.²⁷² The greater willingness of courts to find injury to potential competition in market extensions is consistent with this principle.²⁷³

When firm activity is so intensely local or regional that there are numerous geographic markets, it is more difficult to determine the particular market or markets of closest proximity. If the major entry barrier is transportation cost, the most proximate markets will generally be those physically closest.²⁷⁴ In other cases a more elaborate inquiry may be needed along the lines to be suggested below for product extension mergers.²⁷⁵

b. *Product Extensions*

Product extension mergers pose the crucial test for the proximity concept, because the post-*Marine Bancorporation* standards preclude effective antitrust enforcement policy against such mergers.²⁷⁶ Concentrated markets of national scope, where no significant market extension entry remains possible, are thus cut off from the benefits of the potential competition doctrine.

A rule for product extension mergers must select the one or few markets in closest proximity by administratively feasible methods. Two tests are suggested to meet these criteria: the market similarity test and the observed entry test. The market similarity test registers the

272. See Turner, *supra* note 28, at 1377-78. See also U.S. Dep't of Justice, Guide for International Operations (Jan. 26, 1977), reprinted in ANTITRUST AND TRADE REG. REP. (BNA) § E, at 1, 9 (Feb. 1, 1977) (recognizing higher entry probability for market extensions).

273. In no recent product extension case has there been a finding of § 7 liability. By contrast, two recent market extension decisions have found liability, though one was reversed on appeal. *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226 (D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974); *British Oxygen Co.*, 86 F.T.C. 1241, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063 (1975), *rev'd and remanded sub nom.* *BOC Int'l Ltd. v. FTC*, 537 F.2d 24 (2d Cir. 1977).

274. See, e.g., *Northern Natural Gas Co. v. FPC*, 399 F.2d 953, 964 (D.C. Cir. 1968) (natural gas transmission company supplying gas to geographically adjacent market considered "true potential competitor" because of proximity to market plus ability and desire to enter). Cf. *United States v. El Paso Natural Gas Co.*, 376 U.S. 651, 653-54 (1964) (acquired firm held potential competitor geographically proximate).

275. In bank merger cases, for example, adjacent small communities may be the physically closest markets, but the most proximate market in an entry sense may be a distant metropolitan market. See, e.g., *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 606-12, 618-23 (1974).

276. See pp. 22-25 *supra*.

degree of information overlap between the markets based on shared production and marketing characteristics.²⁷⁷ The observed entry test registers whether in fact there has been entry from one market to the other.²⁷⁸ The first test identifies markets between which the information gap is comparatively small; the second test confirms the inference from the first test by showing that cross-market entry has occurred. Used together, the two tests provide an objective basis for identifying the most proximate markets.

Market similarity must be measured in both production and marketing terms. Production similarity would be shown by (1) similar production methods and technology, (2) similar or convertible equipment, (3) product complementarity, or joint use of a single productive process, (4) common inputs and suppliers, and (5) availability in the market of essential inputs not currently within the firm's possession. Marketing similarity would be established by (1) similar advertising and promotion methods, (2) overlapping distribution outlets, (3) common customers, and (4) product substitutability.²⁷⁹ A finding of similarity would require a substantial showing of common production and marketing traits. In fact, these conditions have generally been met in the product extension cases in which the government has prevailed.²⁸⁰ For example, in *United States v. Wilson Sporting Goods Co.*,²⁸¹ Wilson, the largest sporting goods manufacturer in the nation, acquired the leading producer of gymnastic equipment. The markets were highly proximate, with both marketing similarity (common customers, a number of shared dealers, and some overlap in sales methods) and production similarity (existing facilities for metal working and chrome plating, absence of technological barriers, and availability of any other necessary production inputs).²⁸² More-

277. This is similar to Professor Pitofsky's test of entry capability, see Pitofsky, *supra* note 213, at 1025, but includes production as well as marketing capability.

278. This test was recommended in the 1969 Stigler Task Force Report. See President's Task Force Report on Productivity and Competition (1969), reprinted in 5 TRADE REG. REP. (CCH) ¶ 50,108, at 55,136 [hereinafter cited as Stigler Report]. See also G. STIGLER, *supra* note 12, at 22 (likelihood of entry determined by previous entry record and market similarities).

279. These criteria are derived from a reading of the potential competition decisions.

280. See, e.g., *Ford Motor Co. v. United States*, 405 U.S. 562, 565-66 (1972) (similar distribution, customers, production methods and equipment, and product complementarity); *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 577 (1967) (similar distribution, advertising, production equipment, and product complementarity); *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 175 (1964) (similar distribution, customers, production methods, raw material inputs, suppliers, and product complementarity); *United States v. Wilson Sporting Goods Co.*, 288 F. Supp. 543, 545-48 (N.D. Ill. 1968) (comparable similarities, as discussed in text).

281. 288 F. Supp. 543 (N.D. Ill. 1968).

282. *Id.* at 545-48, 554-56, 560-61.

Potential Competition Mergers

over, the sporting goods product line was not so broad that the analysis would define Wilson as adjacent to numerous markets.²⁸³

An example of how the test would distinguish highly proximate from less proximate markets appeared in *United States v. Crowell, Collier & Macmillan, Inc.*²⁸⁴ The acquiring firm manufactured educational goods, including instructional course materials, sheet music, choir robes, and lodge regalia.²⁸⁵ There were two separate target markets involved in the acquisition, since the target firm produced brasswind instruments and band uniforms.²⁸⁶ In the case of brasswind instruments, there was limited marketing overlap, and there was some degree of complementarity in product use between sheet music and brasswind instruments. Marketing similarity was otherwise minimal, and there was no productive similarity at all.²⁸⁷ In the case of band uniforms, however, the proximity was much greater, extending both to marketing (identical customers, similar selling, and distribution methods) and production (machinery and facilities for sewing uniforms).²⁸⁸ Thus an inference of close proximity was *not* appropriate for the brasswind instrument market, but was for the band uniform market. On the same reasoning, other school uniform markets might also have been classified as proximate, but this would involve few, if any, additional markets.²⁸⁹

Systematic guidance on production similarity can be gained from the industrial census classification categories.²⁹⁰ The census categories provide a useful and readily available benchmark for cross-industry and cross-product comparison; both industries and products are classified in terms of physical similarity and homogeneity.²⁹¹ Classifi-

283. Proximity to numerous markets was seemingly present in *FTC v. Procter & Gamble Co.*, 386 U.S. 568 (1967), where there was also a close marketing and production overlap. It has been suggested that a rule based simply on marketing similarity would preclude Procter from merger into hundreds of markets. See Pitofsky, *supra* note 213, at 1026-27. The scope of the preclusion can be narrowed considerably, however, by examining the close complementarity in use between liquid bleach (the target market) and Procter's existing soaps and detergents product line. In addition, use of the second (observed entry) test would help to narrow the zone of proximity. See note 299 *infra*.

284. 361 F. Supp. 983 (S.D.N.Y. 1973).

285. *Id.* at 985-86.

286. *Id.* at 986, 990, 998-1001.

287. *Id.* at 1002-05.

288. *Id.* at 991-96.

289. The court, in ruling that neither aspect of the acquisition would injure potential competition, found that the acquiring firm was not a potential entrant into the brasswinds market, *id.* at 1004-05, and that the band uniform market was workably competitive, not oligopolistic, *id.* at 995-96.

290. U.S. OFFICE OF MANAGEMENT AND BUDGET, STANDARD INDUSTRIAL CLASSIFICATION MANUAL (1972); U.S. BUREAU OF THE CENSUS, 1972 CENSUS OF MANUFACTURERS.

291. Industries and products are classified into numerical and progressively narrower groupings, ranging from broad "two-digit" industry groupings (*e.g.*, food and kindred

cation within related categories, although not decisive, would indicate market similarity; the absence of shared classification categories would tend to show a lack of market similarity.²⁹² Use of census categories for such purposes would hardly be novel, for they have been utilized to assist market definition in many cases,²⁹³ in economic research,²⁹⁴ and most recently in the FTC's proposed Premerger Notification Rules.²⁹⁵

The second test for proximity is the observed entry test, which is satisfied if there has been actual entry from the proximate market into either the target market or into one closely resembling the target market.²⁹⁶ The observed entry test reflects the pragmatic assumption that if there is a reasonable potential of entry between two markets, there will have been some manifestation of that potential.²⁹⁷ The test is analogous to the survivor test for minimum scale efficien-

products) to narrow "seven-digit" product categories (e.g., whole carcass beef from animals slaughtered at the same plant). For a general description, see E. SINGER, *ANTI-TRUST ECONOMICS* 156-63 (1968).

292. The census categories, however, measure only production (supply) similarity, not demand (marketing and distribution) similarity. See *id.* at 162-63.

293. See *United States v. Aluminum Co. of America (Alcoa-Rome)*, 377 U.S. 271, 285 (1964) (Stewart, J., dissenting) (lack of census classification urged to show absence of separate market); *Brown Shoe Co. v. United States*, 370 U.S. 294, 300-01 nn.4-6, 341-43 nn.69-70 (1962) (market definition); *Beatrice Foods Co.*, 86 F.T.C. 1, 70-71 [1973-1976 Transfer Binder] *TRADE REG. REP. (CCH)* ¶ 20,944, at 20,794-95 (1975), *aff'd sub nom. Beatrice Foods Co. v. FTC*, 540 F.2d 303 (7th Cir. 1976) (market definition in potential competition case).

294. See M. Harris, *supra* note 260, at 134 (for survey purposes, firm presumed potential entrant into four-digit industries if currently within same three- or two-digit classification).

295. 42 Fed. Reg. 39,040, 39,048, 39,061 (1977) (sample report form) (to be codified at 16 C.F.R. § 801.1(j)) (defining "engaged in manufacturing"). The proposed rules require a merging firm to report both its four-digit industry classifications and seven-digit product categories. The requirement was adopted by the government in fulfillment of its mandate under the Antitrust Improvements Act of 1976, Pub. L. No. 94-435, § 201, 90 Stat. 1383, 1390, to screen corporate mergers.

296. The Stigler Report confined the second alternative under the observed entry test to entry by the acquiring firm into a closely similar market. Stigler Report, *supra* note 278, at 55, 136. This is a somewhat stronger indicator of potential entry than proposed here since it is specific to the acquiring firm. But see G. STIGLER, *supra* note 12, at 22 (using broader test). This article uses the more expansive test since, in contrast to the Stigler Report formulation, it is used only as a supplementary measure for potential entry.

297. In the words of the Stigler Report:

If the producer of X is truly a likely entrant into the manufacture of Y, the likelihood will have been revealed and confirmed by entrance into Y of other producers of X (here or abroad), or by the entrance of the firm into markets very similar to Y in enumerable respects.

Stigler Report, *supra* note 278, at 55, 136.

This analysis can be extended also to toehold entries. Thus prior entry from market X to market Y by means of toehold acquisition strongly evidences the feasibility of this mode of entry into Y, the target market, particularly as to firms in market X. This assumes, of course, the continued presence of smaller firms in the target market.

Potential Competition Mergers

cies, which establishes the minimum efficient size for a firm in an industry by observing the smallest firm in the market that has survived and grown.²⁹⁸ Like the survivor test, the observed entry test can be clearly applied and administered.²⁹⁹ Its first branch, previous entry from the proximate market into the target market, is entirely straightforward. The second branch of the test, entry from the proximate market into a market similar to the target market, is more intricate, but should be manageable.³⁰⁰

The observed entry test was used recently in *United States v. Black & Decker Manufacturing Co.*,³⁰¹ which involved the acquisition of a manufacturer of gasoline-powered chain saws by a producer of portable electric tools. In finding de novo entry precluded by technological barriers between the two markets, the court relied on both branches of the observed entry test. The court noted that no electric tool company had ever entered the gasoline-powered chain saw market and that the acquiring firm had never entered a similar market (gasoline engines).³⁰²

Together, the market similarity and observed entry tests would define the proximate market or markets, to determine whether the acquiring firm must be presumed a probable entrant. Both tests were satisfied in *Ford Motor Co. v. United States*,³⁰³ in which (1) close market similarity existed between the automobile manufacturing and spark plug markets and production processes, and (2) another auto manufac-

298. See G. STIGLER, *supra* note 12, at 71; Saving, *Estimation of Optimum Size of Plant by the Survivor Technique*, 75 Q.J. ECON. 569 (1961). See generally E. WEBB, D. CAMPBELL, R. SCHWARTZ & L. SECHREST, *UNOBTRUSIVE MEASURES* (1970) (arguing that social science research based on observation, rather than on surveys and interviews, may well be more reliable).

299. Moreover, the observed entry test provides a means of narrowing the number of markets to which any one firm is viewed as proximate (the Procter & Gamble problem, see note 283 *supra*). By observing the actual pattern of entry by soap companies into the bleach and other household industries, for example, particular markets of highest proximity can be designated. G. STIGLER, *supra* note 12, at 22.

300. The method of ascertaining market similarity in the observed entry test would be exactly the same as for the market similarity test for proximity. See pp. 70-71 *supra*. The perceptive reader may object that the observed entry test is not structural, but is a measure of conduct. In a sense this is true, but such an objection misunderstands the distinction between structure and conduct. A structural parameter measures patterns of conduct that are relatively fixed over time. Seller concentration, for example, simply reflects the sustained conduct of firms in capturing industry sales. Although entry may occur infrequently, the fact of previous entry serves as an indicator that entry barriers are surmountable and that the return is sufficiently high to make cross-market entry a reasonable probability. The test is therefore structural, measuring not a condition obtaining at a single moment, but one sustained over time.

301. 1976-2 Trade Cas. ¶ 61,033 (D. Md. 1976).

302. *Id.* at 69,586-92.

303. 405 U.S. 562 (1972).

turer had previously entered the spark plug market.³⁰⁴ Frequently, however, both tests cannot be satisfied, either because there has been no entry at all into the target market or because entry has come from markets other than those of greatest similarity. In such cases the inquiry will be more difficult, just as some market definition problems are more challenging than others.

*FTC v. Atlantic Richfield Co.*³⁰⁵ provides a more difficult example for analyzing the two tests. Atlantic Richfield, a petroleum company, had acquired Anaconda, a large copper mining and refining firm.³⁰⁶ In arguing that Atlantic Richfield was not a potential entrant, defendants urged that entry was more likely from other hard rock mining markets, such as zinc or lead, because of their greater technological similarity.³⁰⁷ The Government urged that there was a broad similarity between the petroleum and copper markets, since both were natural resource extraction businesses with high capital intensity and high risks, and that there had in fact been several entries from petroleum into copper mining.³⁰⁸ Without judging the facts, which were in sharp dispute, the case can be used to illustrate the proximity measure. Suppose market similarity is greatest between copper and other hard rock mining industries, and suppose further that significant entry has occurred in recent years from hard rock industries into copper, thus satisfying both proximity tests. Under such circumstances, Atlantic Richfield would then *not* be presumed a potential entrant. Suppose, however, there had been no significant entry from hard rock mining industries into copper, but that (1) there had been such entry from the petroleum industry into copper, (2) there was significant similarity between petroleum and copper in both marketing and production processes, and (3) there had been no substantial recent entry into copper from a market of closer similarity than petroleum. Petroleum would then clearly be a highly proximate market, and Atlantic Richfield would be presumed a potential entrant.³⁰⁹

304. *United States v. Ford Motor Co.*, 286 F. Supp. 407, 433-34 (E.D. Mich. 1968), *aff'd*, 405 U.S. 562 (1972).

305. 549 F.2d 289 (4th Cir. 1977).

306. *Id.* at 291. A separate issue, not discussed here, concerned uranium oxide production. *Id.*

307. *Id.* at 294 n.8; Reply Brief of Atlantic Richfield at 20-22.

308. Brief for Appellant at 24, 29.

309. There is no avoiding the fact that the identification of the proximate market in a product extension case may in some instances introduce an issue of complexity—though one that has the advantage of being accessible to objective evaluation. Should, however, the burden of resolving the issue become too great, a further simplification is possible through introduction of additional presumptions. But it seems premature to suggest such further simplification in the absence of direct experience under a market proximity standard.

Establishing that an acquiring firm is within a proximate market would still not make the firm a reasonably probable potential competitor under section 7. The firm must be shown to be one of the most significant entrants from the proximate market.

3. *One of Few Most Significant Entrants*

The loss of a potential competitor is apt to injure competition only if the firm is one of the few most likely entrants.³¹⁰ But the cases have floundered in attempting to ascertain whether a specific firm is more likely than other firms to enter the market.³¹¹ To some degree the issue is misfocused, since it is the probability of entry *plus* the impact of entry that is crucial. Entry by a small firm may be highly probable, but it is unlikely to have the competitive impact of large firm entry.³¹² Antitrust policy should emphasize the identification of the most significant potential entrants. Although the market proximity approach will identify the acquiring firm as a probable entrant, additional criteria are needed to narrow the application of the presumptive rule to those potential entrants of greatest significance.

Surprising in its simplicity, the most suitable presumption is that the largest firms in the proximate market are the most significant entrants. "Most significant potential entrant" in the proximate market can be defined as a firm meeting either of the following criteria: (1) one of the two leading proximate market firms not yet in the target market, with both (a) a share of the proximate market of at least ten percent, and (b) annual sales or assets of at least \$100 million; *or* (2) one of the 200 largest industrial corporations (or a comparably sized firm of another type), with significant sales in the proximate market. An acquiring firm meeting either criteria would be presumed to be one of the few most significant potential entrants.³¹³

310. Turner, *supra* note 28, at 1363 ("most likely entrant or one of a very few most likely entrants"). See *Kennecott Copper Corp. v. FTC*, 467 F.2d 67, 76-77 (10th Cir. 1972), *cert. denied*, 416 U.S. 909 (1974) (acquiring firm a "substantial potential entrant"); Merger Guidelines, *supra* note 165, para. 18(a), at 6887-88 (challenges to mergers by "one of the most likely entrants into the market").

311. This is hardly surprising, since if there is no reliable way to predict individual firm entry, a comparative assessment of entry probability is a fortiori unattainable. See Posner, *supra* note 28, at 323-24 (arguing that impossibility of measuring likelihood of entry creates insuperable proof barriers for government); pp. 22-25 *supra*.

312. See W. SHEPHERD, *supra* note 150, at 174-76 (input-price advantages of absolute and relative size); O. WILLIAMSON, *supra* note 261, at 167 (comparative financial and other advantages of large enterprise). See generally C. KAYSER & D. TURNER, *supra* note 33, at 77-79 (market power and relative size); M. HARRIS, *supra* note 260, at 11 (that small firms gain a niche does not prove that significant, competition-enhancing entry is possible).

313. The West German antitrust law follows a comparable approach by subjecting a "market dominating" enterprise to special rules. A firm is presumed to be market

The basis for the proposed presumption is strong. Large firms are most likely to have the financial resources to enter at significant scale and are the predominant source of new entry, since the frequency of entry into new markets varies directly with firm size.³¹⁴ The cases finding section 7 liability have almost invariably involved acquiring firms meeting one of these criteria and frequently meeting both.³¹⁵

dominating if it holds more than one-third of the market and its annual sales are at least 250 million DM in the preceding business year (just over \$100 million), or if the three leading firms hold at least one-half of the market and the firm's sales are at least 100 million DM (just over \$40 million), or if the five leading firms control two-thirds of the market, and, again, the individual firm has sales of at least 100 million DM. § 22(3) Gesetz gegen Wettbewerbsbeschränkungen [Law Against Restraints of Trade] BG Bl, I, p. 869 (1974). Both the definition proposed in text and the German definition clearly exclude small firms from the presumption.

314. An empirical study conducted by the FTC Bureau of Economics in 1968 showed that the 200 largest manufacturing and mining firms in the country acquired approximately 66% of the total dollar-value of all manufacturing and mining assets acquired during the period 1948-1968. (The study was confined to an investigation of mergers in which the acquired firm had at least \$10 million in assets.) STAFF OF SUBCOMM. ON ANTITRUST & MONOPOLY OF THE SENATE JUDICIARY COMM., 92d Cong., 1st Sess., INVESTIGATION OF CONGLOMERATE MERGERS, 39-40 (Comm. Print 1971). It may be noted that these figures reflect the peak of the merger boom, see BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, STATISTICAL REPORT ON MERGERS AND ACQUISITIONS 113 (Oct. 1975). For the longer period 1948-1974, the figures show the 200 largest manufacturing and mining firms to have accounted for the acquisition of 56% of the total dollar-value of acquired assets. *Id.* at 120. See also M. Harris, *supra* note 260, at 143 (250 largest firms especially capable of new entry). Harris's empirical investigation revealed that other significant characteristics of entrants were product diversification, high gross advertising expenses, and large size relative to the target market. Such factors should not be included in the presumptive definition of a most significant entrant, however, unless they can be clearly and accurately measured; and to a considerable extent the large firm category overlaps these additional factors. See F. SCHERER, *supra* note 15, at 67-69 (size and diversification); Brozen, *Entry Barriers: Advertising and Product Differentiation*, in INDUSTRIAL CONCENTRATION, *supra* note 2, at 115, 128-30 (firm size tied to gross advertising expenditures); Mann, *Advertising, Concentration, and Profitability: The State of Knowledge and Directions for Public Policy*, in *id.* at 137, 142-48 (size related to gross advertising spending and intensity).

315. In the following cases the acquiring firm ranked first or second in its market and was among the 200 largest industrial firms (or of comparable size): *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 572-73 (1967); *Kennecott Copper Corp. v. FTC*, 467 F.2d 67, 71 (10th Cir. 1972); *U.S. v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1239, 1255 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974); *U.S. v. Ford Motor Co.*, 286 F. Supp. 407, 408 (E.D. Mich. 1968), *aff'd*, 405 U.S. 562 (1972); *British Oxygen Co.*, 86 F.T.C. 1241, 1342, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,033, at 20,906 (1975), *rev'd and remanded sub nom.* *BOC Int'l Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977). See FORTUNE, May 1977, at 366; *id.*, May 1974, at 232; *id.*, May 1973, at 226.

The first or second rank criterion was satisfied in *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 528 (1973); *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 163-64 (1964) (Pennsalt Chemicals Corp.); *Ekco Prods. Co. v. FTC*, 347 F.2d 745, 746 (7th Cir. 1965); *United States v. Crowell, Collier & MacMillan, Inc.*, 361 F. Supp. 983, 986 (S.D.N.Y. 1973); *United States v. Wilson Sporting Goods Co.*, 288 F. Supp. 543, 546 (N.D. Ill. 1968). The 200 largest firms criterion was met in *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 162-63 (1964) (Olin Mathieson's total revenues in 1960 were \$690 million); *Beatrice Foods Co. v. FTC*, 540 F.2d 303, 305 (7th Cir. 1976); *Bendix Corp. v. FTC*, 450 F.2d 534, 538 (6th Cir. 1971).

Potential Competition Mergers

Further, the presumption recognizes the congressional desire to limit additional economic concentration via merger growth by large firms. Although it is conceivable that a large firm will in some instances lack the financial or other resources to enter the market *de novo*, that showing should be left as an affirmative defense, since such facts are peculiarly within the firm's knowledge.³¹⁶ Also, the large firm in a proximate market would more likely be perceived as a significant entrant than would a smaller firm.³¹⁷ Finally, large firms would not be totally barred from mergers in the target market, since toehold acquisitions would still be permitted.³¹⁸

4. *Elements Excluded from the Presumptive Rule*

Other elements of proof would be excluded from the presumptive rule as either too complex or of uncertain significance.³¹⁹ Excluded

316. It is frequently urged that the capital market is so imperfect that purchase of a firm is apt to be much cheaper than entry by expansion or toehold acquisition followed by expansion. *See, e.g.,* Turner, *supra* note 28, at 1318. Yet it is not clear why sellers of firms should consistently and over the long run receive less than the value (alternative cost) of what they sell. It is, of course, not a fair comparison to contrast the price of a new plant with the cost of a half-worn-out plant, which will require new investment if it is to produce as long and as efficiently as the new plant.

317. It bears emphasis that this is a general inference and is not meant to become an issue of fact in specific cases.

318. Two additional elements of proof—concentration and market share of target firms—would present no novelty. The potential competition doctrine would continue to be limited to highly concentrated target markets. High concentration would be defined as a four-firm concentration ratio of 60% or an eight-firm ratio of 75%. The Justice Department's Guidelines use the latter figure as an indicator of unacceptably high concentration. Merger Guidelines, *supra* note 165, at para. 18(a)(iii), (a)(iv), at 6888. The figures have also found support in the case law. *See, e.g.,* FTC v. Procter & Gamble Co., 386 U.S. 568 (1967) (two firms held 65% of target market and four firms held 80%); United States v. Phillips Petroleum Co., 367 F. Supp. 1226, 1251-52 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974) (four firms held 61% of refining capacity and 58% of gasoline sales; seven firms held 83% and 81%, respectively); United States v. Wilson Sporting Goods Co., 288 F. Supp. 543, 546 & n.5 (N.D. Ill. 1968) (four firms held 60% of market and nine firms held 97% of market); British Oxygen Co., 86 F.T.C. 1241, 1348, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,909-10 (1975), *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977) (four firms held 70% of market and eight firms held 86% of market). Within such concentrated markets, only acquisitions of target firms having substantial market share—five or ten percent, depending on the particular rule, *see* p. 82 *infra*—would be covered.

The definition of a highly concentrated market could be expanded in borderline cases to take concentration trends into account. Thus a market with a four-firm ratio in the 50 to 60% range might be classified as concentrated if there were a trend toward concentration, with a market somewhat above the 60% range defined as unconcentrated if the reverse trend were evident. If the trend factor were included, however, it would have to be established with mathematical specificity and is best treated as an affirmative defense. *See, e.g.,* Merger Guidelines, *supra* note 165, para. 7, at 6884 (trend to concentration defined as increase of seven percent or more over five to ten years). *See also* pp. 85-88 *infra*.

319. Limited additional proof would be admissible as rebuttal evidence, however. *See* pp. 87-88 *infra*.

factors would include height of entry barriers, rate of new entry, level of profits, growth of demand, number of competitors, asymmetry in market shares, and special significance of the target firm as a growing or innovative firm. Each could be defined as a relevant variable,³²⁰ and most have been at least mentioned in recent lower court decisions.³²¹ Nevertheless, the presumptive rule should exclude these criteria because their significance is typically unclear. Consider what is perhaps the most plausible excluded factor, demand growth.³²² Increasing market demand tends to bolster price, creating greater incentive for entry, while still permitting entrants to gain market share without diminishing the sales of existing sellers.³²³ A number of cases have relied on growing market demand as a factor indicating probability of entry by the acquiring firm.³²⁴ In addition, proof that the market is expanding poses no special evidentiary barrier to a predictive rule, since the facts to be proved are objective and relatively straightforward.

Nevertheless, the interpretation of market demand is ambiguous, because its effect is felt across the whole set of potential entrants. The potential competition issue concerns whether the acquiring firm is one of the few most probable and most significant entrants. It is a concept of relative advantage. A growing demand raises the probability of entry for all potential entrants; it does not illuminate whether the defendant is one of the narrow group of most likely and most significant entrants. Further, in the presence of growing demand the loss of a particular potential entrant may be less significant; conversely, when demand is not growing the supply of potential entrants is limited and the loss of an individual entrant may be more acute. Thus the Stigler Report concluded that it is precisely when entry is difficult and only "a select few firms" are likely entrants or capable of entering that it is vital to preserve them as potential entrants.³²⁵

320. See note 329 *infra*.

321. See, e.g., *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1251-54 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974) (barriers to entry, number of entrants, growth of market demand, and asymmetry in market share held by independents). See also pp. 19-25 *supra* (reviewing post-*Marine Bancorporation* cases).

322. See Turner, *supra* note 28, at 1367-68.

323. See Kamien & Schwartz, *supra* note 123, at 452-53 (in order to deter entry, limit pricing strategy in expanding market requires that price be set lower than in stationary market); Orr, *supra* note 123, at 63 (empirical study shows growth rate had positive but weak relation to entry); Osborne, *supra* note 123, at 399 (high demand growth undermines limit pricing).

324. See, e.g., *FTC v. Atlantic Richfield Co.*, 549 F.2d 289, 294 n.8 (4th Cir. 1977) (lack of growth "lessen[s] the case for prohibition"); *United States v. Wilson Sporting Goods Co.*, 288 F. Supp. 543, 561 (N.D. Ill. 1968) ("market is rapidly expanding and offers attractive opportunities for profitable operations").

325. Stigler Report, *supra* note 278, at 55,136.

Potential Competition Mergers

Finally, whatever the proper inference from stagnant demand conditions, the long-term objectives of section 7 must be considered. What appears today to be a stagnant market may become dynamic on short notice, as the coal industry recently demonstrated.³²⁶ The case for inclusion of other factors within the presumptive rule, such as ease of entry³²⁷ and profit level,³²⁸ is even weaker.³²⁹

326. Compare *United States v. General Dynamics Corp.*, 341 F. Supp. 534, 545 (N.D. Ill. 1972), *aff'd on other grounds*, 415 U.S. 486 (1974) (pre-energy crisis merger of coal companies not significant because industry's future growth limited by intense interfuel competition "as more and more industrial consumers convert from coal to gas or oil") with *N.Y. Times*, May 17, 1977, § 2, at 44, col. 6 (Consolidation Coal Co. announces 90% increase in production).

327. Ease of entry might be measured either by height of entry barriers or rate of new entry. The former, presumably referring to the price-cost margin (*i.e.*, the extent to which price can be elevated above cost without inducing new entry), is wholly unsuited for judicial use since it requires a comparative assessment of costs between firms within and without the market. See G. STIGLER, *supra* note 12, at 22. Rate of new entry is easily ascertained, but its significance is usually unclear. In the *Phillips* case, for example, there were five new entries in the seven years following the merger. *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1252 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974). But how is that fact to be evaluated? Is it to be discounted because concentration remained high? Does it reduce the significance to be drawn from the concentration ratios, or perhaps increase them because the pool of most favorably situated entrants is now exhausted? And what is the significance of five entrants, as distinct from three or seven? See Bok, *supra* note 23, at 260-66 (discussing ambiguities in evidence in *Brillo* case). Moreover, if new entry is having the maximum desired effect, it will be reflected in decreasing concentration, and thus be indirectly measured by the concentration ratio or at least the trend in the concentration ratio over time; and this will be most apparent in just those instances where the rate of entry is most significant, *i.e.*, where it is very low or very high.

328. Level of profits provides an alternative approach to measuring entry barriers. Under this approach above normal profit would be equated with high entry barriers. But this also raises difficult problems, particularly in a litigation setting. Accounting and economic profit are not the same thing; and even accounting profit may involve excruciating issues of allocations as between expense and capital investment, present value versus historic cost, tangible versus intangible capital, all of which is compounded when the relevant profit is that of one division of a multiproduct firm. K. ELZINGA & W. BREIT, *THE ANTITRUST PENALTIES* 108-09 (1976). See Bok, *supra* note 23, at 263 (lack of standards for what is "fair" profit level); Scherer, *supra* note 75, at 984 (variability over time of "reasonable" price level standard due to changing business conditions). Profit can be excessive only after adjusting for investment risk, tax factors, capitalization of prior profits, and unrecorded intangible capital, all of which create intractable factual issues. Still, net of all adjustments some industries appear obviously more profitable than others. See W. SHEPHERD, *supra* note 150, at 190-91. This suggests that profitability is a better guide for enforcement agency attention than for judicial assessment. In addition, the policy implications of "above normal" profits, even if ascertainable, are less than clear. Presence of sustained high profits suggests both a greater need for new entry and a lesser likelihood, due to the probable existence of entry barriers, that the acquiring firm will enter; absence of high profits might suggest the exact converse (*i.e.*, a lesser need for new entry and a greater probability that entry by the acquiring firm will be relatively unobstructed). Finally, a profit-based rule, unlike a market concentration rule, fails to give full recognition to non-economic reasons for containing high concentration.

329. Weaker still is the rationale for including in the presumptive rule other plausible factors. For example, reduction in the number of firms in the market simplifies the problem of oligopolistic coordination, see *Phillips*, *supra* note 142, at 607-10; Shubik,

5. *Proposed Presumptive Rules*

Building on the essential elements described, feasible rules for potential competition mergers can be developed. The rules would be presumptive in nature, and given the practical problems of litigating complex issues of fact, they would be rebuttable only by clear and convincing proof.³³⁰ Drawing legal boundaries is always somewhat arbitrary, but the experience of almost a score of decided cases provides a basis for most of what is suggested. There is, moreover, no other way to achieve a predictive and effective rule and so to reach a "satisfactory compromise among the competing needs of our legal system."³³¹

a. *Market Extensions*

Market extension acquisitions would be subject to the most stringent rule. This can be justified by the closer proximity between target and acquiring firm when both produce the same output in adjacent geographic markets, by the decisions which have at least recently taken a more critical view of such mergers,³³² by academic commen-

supra note 142, at 282, but seems a redundant measure because when the number of competitors is sufficiently small, concentration will itself already be high; pronounced asymmetry in firm size, particularly single firm dominance, may also aid oligopoly coordination by providing a single focal point for market decision, *see* Phillips, *supra* note 142, at 607-10; Stigler Report, *supra* note 278, at 55,134, but it is subject to no accepted theory or clear definition; and the special significance of unusual market vitality of the target firm, *see* Turner, *supra* note 28, at 1367-68, remains a relevant but highly speculative surmise.

330. *See* pp. 24-25 *supra*. Some types of evidence excluded by the presumptive rule would be admissible in rebuttal. *See* pp. 87-88 *infra*.

331. Bok, *supra* note 23, at 270.

It may be objected that general presumptions for potential competition mergers, however narrowly constructed, violate the oft-repeated judicial admonition that § 7 "deals in 'probabilities' not 'ephemeral possibilities.'" *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 622-23 (1974) (quoting *Brown Shoe Co. v. United States*, 370 U.S. 294, 323 (1962)). Despite the emptiness of the literal statement, it correctly suggests a minimum probability threshold below which a theory of competitive injury cannot be pushed without doing violence to the notion of law. But above that minimum the interpretation of "reasonable probability" must be found in the purpose of the statute itself. Congress sought to arrest and modify what it saw as excessive concentration by enacting a statute that would apply to more than just direct horizontal mergers. Indeed, Congress specifically defined the merger problem as encompassing market and close product extensions. *See* pp. 40-45 *supra*. Although it does not follow that the courts are bound to recognize potential competition theories that lack any substance, it is the duty of the judiciary to construe the statute to develop an effective rule for this type of merger if it can possibly be done. This superior principle should govern the construction of "reasonable probability" for potential competition merger policy. The proposed presumptive rules should satisfy this criterion.

332. *See* *Northern Natural Gas Co. v. FPC*, 399 F.2d 953, 961-74 (D.C. Cir. 1968) (applying § 7 standards in review of FPC order authorizing joint venture); *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1254-57 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974); *British Oxygen Co.*, 86 F.T.C. 1241, 1351-60, [1973-1976 Transfer Binder]

Potential Competition Mergers

tary,³³³ and by the legislative history, which viewed a market extension as akin to a direct horizontal merger.³³⁴ The proposed rule for market extensions would define as presumptively unlawful any acquisitions by firms in the most proximate geographic market or in markets when (1) the acquiring firm is a "most significant potential entrant" as previously defined,³³⁵ (2) the target market is highly concentrated, and (3) the target firm has a market share of at least five percent.³³⁶

The proposed rule follows closely from the previous analysis, the only addition being the specification of target firm market share at five percent. Suggested guidelines have tended to use a ten percent minimum,³³⁷ but these formulations have not focused specifically on market extensions. The greater probability of entry in market extensions and the limited number of mergers that would be covered by a market extension rule militate in favor of a lower cut-off point. The five percent figure, although necessarily arbitrary, would seem sufficiently low to encompass all or most of the significant firms in the market; designedly it would include an acquisition like that in the *Phillips* case, when the target firm had a market share of just under seven percent, yet ranked seventh in sales and fourth in refining capacity.³³⁸

TRADE REG. REP. (CCH) ¶ 21,063, at 20,911-16 (1975), *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 537 F.2d 24 (2d Cir. 1977). *But see* United States v. Falstaff Brewing Corp., 383 F. Supp. 1020, 1027-28 (D.R.I. 1974) (on remand from 410 U.S. 526 (1973)) (finding of fact) (Falstaff not perceived in target market as potential competitor).

333. See P. STEINER, *supra* note 270, at 285-86; Turner, *supra* note 28, at 1377-78.

334. See pp. 43-44 *supra*.

335. See p. 75 *supra*.

336. See United States v. Falstaff Brewing Corp., 410 U.S. 526, 544-45 (1973) (Douglas, J., concurring), where Justice Douglas identifies as persuasive factors for determining § 7 liability several of the elements of the proposed presumptive rule, including large size of the acquiring firm, the market-leading position of the target firm, and the proximity of the markets. The Douglas approach was essentially objective since interest in market entry was to be presumed from the fact of merger. *Id.*

337. Brodley, *Oligopoly Power*, *supra* note 62, at 356; Campbell & Shepherd, *Leading Firm Conglomerate Mergers*, 13 ANTITRUST BULL. 1361, 1363 (1968); Merger Guidelines, *supra* note 165, para. 18(a)(iii), at 6888; *cf.* The Budd Co., 86 F.T.C. 518, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 20,998, at 20,857-58 (1975) (acquisitions of target firms having less than 10% market share presumptively lawful).

338. Alternatively stated, acquisitions of firms below five percent could be described as permissible "toehold acquisitions." See Note, *supra* note 181, at 180 (defining toehold in terms of five percent unless target firm is dwarfed by much larger competitors). See generally Fox, *Toehold Acquisitions, Potential Toehold Acquisitions and Section 7 of the Clayton Act*, 42 ANTITRUST L.J. 573 (1973).

The toehold exception can be justified only as a concession to the value of assuring minimal risk of injuring economic efficiency since, viewed with the goal of improving competition in mind, new entry is preferable to toehold acquisition. *Cf.* Rhoades, *The Impact of Foothold Acquisitions on Bank Market Structure*, 22 ANTITRUST BULL. 119, 126-27 (1977) (study of bank holding company acquisitions over period 1966-1972 showed no decreases in concentration following toehold acquisition).

b. *Product Extensions*

Product extension mergers would be subject to a less stringent rule, recognizing both the lesser market proximity, and hence lower entry probability, involved in such mergers, and the more serious merger-inhibiting effect of an overly broad rule in this area. Thus only target firms having a market share of at least ten percent would be covered by the presumptive rule. This follows previously suggested guidelines for potential competition mergers.³³⁹ This standard would not normally bar acquisition of more than the leading three or four firms in a concentrated market.³⁴⁰

339. See note 337 *supra* (citing sources).

340. A supplementary rationale for prohibiting product extension acquisitions by very large firms is the somewhat nebulous doctrine of market entrenchment. Under this doctrine an acquisition of the first-ranking firm in a highly concentrated market by a much larger firm, itself ranking first in its own market, has been condemned on the theory that it would further entrench the market power of the target firm. See, e.g., *Ford Motor Co. v. United States*, 405 U.S. 562, 570 (1972) (acquisition "aggravated an already oligopolistic market"); *Kennecott Copper Corp. v. FTC*, 467 F.2d 67, 78-79 (10th Cir. 1972), *cert. denied*, 416 U.S. 909 (1974); *Ekco Prods. Co. v. FTC*, 347 F.2d 745, 752 (7th Cir. 1965). See also *United States v. Wilson Sporting Goods Co.*, 288 F. Supp. 542, 544-56 (N.D. Ill. 1968) (psychological advantage based on Wilson's respected name and large dealer network). The doctrine is loosely connected with potential competition analysis because it has been applied only in cases where potential competition was also an issue. Thus the entrenchment issue might be viewed simply as an aggravating factor in potential competition cases; but the judicial articulation has been in terms of independent significance. See, e.g., *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 623 n.23 (1974) (dictum) (noting entrenchment doctrine). The Merger Guidelines define an entrenchment effect as a leading firm acquisition in a concentrated market which "may serve to entrench or increase the . . . market power . . . of [the leading] firm or raise barriers to entry in that market." Merger Guidelines, *supra* note 165, para. 20, at 6889. As a distinct and independent doctrine, the entrenchment effect is questionable, since the judicial articulation has been in terms of a dubious cross-market transfer of economic power. See, e.g., *United States v. Black & Decker Mfg. Co.*, 1976-2 Trade Cas. ¶ 61,033, at 69,599 (D. Md. 1976); *United States v. Crowell, Collier & MacMillan, Inc.*, 361 F. Supp. 983, 991 (S.D.N.Y. 1973). But see Goldberg, *Conglomerate Mergers and Concentration Ratios*, 56 REV. ECON. & STATISTICS 303 (1975) (target market concentration did not increase following acquisition by larger firms). The decisions reflect carefully limited attempts to give expression to the congressional intent that the Clayton Act be used to restrain the growth of concentration in the economy. In almost all of the entrenchment decisions, the acquiring firm was among the 200 largest industrials and was the leading firm in its own market.

The minimum statement, therefore, of the unarticulated rationale of the entrenchment effect cases is simply this: a firm holding market leadership in a highly concentrated market, and being already one of the largest firms in the country, has sufficient discretionary authority that it ought not be permitted to augment it further by achieving a ranking position in a related market through merger. So formulated, it is narrower than previous proposals to limit conglomerate size. See, e.g., Blake, *Conglomerate Mergers and the Antitrust Laws*, 73 COLUM. L. REV. 555, 560, 590-91 (1973) (substantial acquisitions by large firms should be presumed unlawful); cf. Davidow, *Conglomerate Concentration and Section Seven: The Limitations of the Anti-Merger Act*, 68 COLUM. L. REV. 1231, 1260 (1968) (*Procter & Gamble* crystallized "a modest legal principle" constraining "giant firm in a closely related industry" from acquiring "a dominant and near-monopolistic company in an industry populated by relative pygmies").

An entrenchment effect rule, as formulated above, would add to the previous potential

Potential Competition Mergers

To summarize the proposed presumptive rules:

I. A market extension acquisition would be presumptively unlawful where (A) the acquiring firm is either (1) one of the two largest out-of-the market firms with market share of at least ten percent and annual sales or assets of at least \$100 million in a closely proximate geographic market, or (2) one of the 200 largest industrial corporations (or comparably sized other firm) with significant sales in the proximate market, (B) the target market is highly concentrated, and (C) the target firm has a market share of at least five percent.

II. A product extension acquisition would be presumptively unlawful where (A) the acquiring firm is either (1) one of the two largest out-of-the market firms with market share of at least ten percent and annual sales or assets of at least \$100 million in a closely proximate product market, or (2) one of the 200 largest industrial corporations (or comparably sized other firm) with significant sales in the proximate market, (B) the target market is highly concentrated, and (C) the target firm has a market share of at least ten percent.

6. *Possible Efficiency Loss*

The proposed rules pose minimal risks to efficiency or economic welfare. Two types of efficiency loss are possible from an overly harsh merger rule: the loss of specific efficiencies that would have resulted from the fusion of the particular firms involved in the merger, and the general reduction in managerial incentives to achieve efficiencies by impeding the marketability of controlling interests. Neither effect seems likely from a rule that would affect only mergers with larger target market firms by a narrowly defined group of leading firms within a closely proximate market.

Loss of specific efficiencies is more likely to occur in a horizontal than a potential competition case.³⁴¹ Unlike horizontal merger doc-

competition rules in two ways. As to acquisition by firms in highly proximate markets, the existence also of an entrenchment effect would make the defendants' task of rebutting the presumption even more formidable. In addition, such an entrenchment effect rule would apply to more distant markets, *i.e.*, markets satisfying any one of the tests for proximity, even though another market would be ranked more closely proximate. Such a rule seems premature, however, and in any event lies beyond the scope of this article.

The entrenchment doctrine, nevertheless, provides some support for the proposed product extension rule, and arguably for an extension of that rule, since at bottom the rationale of the entrenchment decisions is primarily social-political.

341. See Elzinga, *The Goals of Antitrust—Other than Competition and Efficiency, What Else Counts?*, 125 U. PA. L. REV. 1191, 1197-99 (1977). But cf. Williamson, *Economies as an Antitrust Defense Revisited*, 125 U. PA. L. REV. 699, 724 (1977) ("vertical or conglomerate mergers are even more apt to be the source of transactional economies [as opposed to scale economies] than are horizontal mergers") [hereinafter cited as Williamson, *Revisited*].

trine, which bars all but de minimis acquisitions,³⁴² the potential competition rule permits sizable mergers, particularly in product extension cases, even for those firms subject to the rule. The only efficiencies lost would be those uniquely resulting from the union of the acquiring firm and a larger target market firm, and thus not attainable by either (1) independent entry, (2) smaller firm acquisition, or (3) acquisition by a nonleading proximate market firm. These seem sufficient alternative routes to permit achievement of any appreciable efficiencies.³⁴³ Assuming continued enforcement of section 7 against potential competition mergers, the existence of the presumptive rules might even increase efficiency by reducing uncertainty about the legality of most mergers. Because the presumption would necessarily become a focal point for enforcement and litigation, managers could be less concerned over the legality of mergers not within the presumption.

The other efficiency loss is the economy-wide reduction in incentives caused by a narrowing of the market for controlling interests. A rational entrepreneur will, it is widely thought, receive part of his incentive to perform from the prospect of selling the successful firm and thereby capitalizing the value he has created. Additionally, the possibility of unfriendly take-over serves as a negative stimulus for laggard management, as well as a vehicle for moving assets into more dynamic hands.³⁴⁴ If merger rules seriously diminish the supply of

342. See Merger Guidelines, *supra* note 165, paras. 4-7, at 6883-84.

343. These alternatives seem broad enough to meet Professor Baxter's concern that the efficiency-promoting aspects of conglomerate mergers have been underassessed, based on the higher stock market assessment of the value of shares of companies after as compared with before merger. See Baxter, Corporate Performance and Corporate Mergers, in THIRTEENTH CORPORATE COUNSEL'S INSTITUTE 6-9 (Northwestern Law School and Illinois Institute of Continuing Legal Education, 1974). Moreover, a subsequent review of empirical studies of pre-merger and post-merger company welfare revealed no clear pattern or even dominant hypothesis. P. STEINER, MERGERS 188-95 (1975). See Scherer, *supra* note 75, at 987-88 (1977) ("most mergers at a scale large enough to attract antitrust attention yield inappreciable efficiency benefits"); Singh, *Take-Overs, Economic Natural Selection, and the Theory of the Firm: Evidence from the Postwar United Kingdom Experience*, 85 ECON. J. 497, 503-14 (1975) (empirical studies showed constant or declining profit following merger in United Kingdom).

Even a leading proponent of greater reliance on efficiency considerations in antitrust cases has recognized the lesser nature of the efficiency risks in mergers, as contrasted with § 2 Sherman Act proceedings. Williamson, *Revisited*, *supra* note 341, at 733. Reviewing the literature, Elzinga and Breit found the belief that mergers make significant contribution to scale economies to be unfounded. K. ELZINGA & W. BREIT, *supra* note 328, at 102 & n.7.

344. See *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 588 (Harlan, J., concurring): The ability to merge brings large firms into the market for capital assets and encourages economic development by holding out the incentive of easy and profitable liquidation to others. . . . Also merger allows an active management to move rapidly into new markets bringing . . . competitive stimulation and innovation. It permits a large corporation to protect its shareholders from business fluctuation

buyers for controlling interests, both incentives would be reduced.

It seems most unlikely, however, that the proposed rules would reduce these incentives. Pure conglomerate mergers and market and product extension acquisitions not involving highly proximate markets would be unaffected, so most large firms will remain as eligible purchasers. If the target firm can be significantly more profitable in more capable hands, the leading proximate market firms will not be the only enterprises to recognize that fact.³⁴⁵ The possible diminution of entrepreneurial incentive also seems minimal, for there would be no inhibition at all on the sale of a small firm. Thus moderately successful firms could be sold freely. The only inhibition would be on the sale of firms controlling significant market share. It is implausible that the elimination of a few potential buyers when and if a new firm becomes a major success would deter much original investment. Certainly no such showing has been made with respect to horizontal merger rules, which have a much larger buyer-reducing effect.³⁴⁶ For these reasons the risk seems small that the proposed rules would impair economic efficiency or welfare.³⁴⁷

7. *Rebuttal Evidence*

The proposed rules are only presumptive. Does this permit the defendants to reintroduce all of the complexity the presumption so carefully eliminated? Assaying the same question in horizontal mergers, Derek Bok concluded that a per se rule was necessary to avoid a "complex statistical and theoretical jungle."³⁴⁸ Although the Supreme Court did not follow his lead in this regard when it adopted a presumptive rule in *Philadelphia Bank* for horizontal mergers that left some room for rebuttal evidence, the rule has been virtually per se in operation.³⁴⁹ But a per se rule is neither feasible nor desirable

through diversification, and may facilitate the introduction of capital resources, allowing significant economies of scale, into a stagnating market.

See also Manne, *Mergers and the Market for Corporate Control*, 73 J. POLITICAL ECON. 110, 119 (1965) (mergers "in many instances" are "the most efficient" device for transferring control of firm).

345. In the *British Oxygen* case, for example, the acquiring firm, which would have been within the proposed presumptive rule, succeeded in making the acquisition only by beating the tender offer of another large firm not within the presumption. See *British Oxygen Co.*, 86 F.T.C. 1241, 1343, [1973-1976 Transfer Binder] TRADE REG. REP. (CCH) ¶ 21,063, at 20,907 (1975), *rev'd and remanded sub nom.* BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977).

346. Indeed, as in the case of efficiency-promotion, the clearer delineations promoted by the rules might increase the number of prospective buyers.

347. See Scherer, *supra* note 75, at 988.

348. Bok, *supra* note 23, at 291. See generally *id.* at 271-73, 307.

349. See generally Brodley, *Oligopoly Power*, *supra* note 62, at 299-313.

for potential competition mergers. Indeed, in two recent horizontal merger cases the Supreme Court has accepted rebuttal evidence,³⁵⁰ and the weaker policy behind potential competition doctrine would scarcely support a stronger rule. The surrogate measures for probable entry and significance of entry rest on generalizations of insufficient strength to support a per se rule.

Admission of rebuttal evidence need not, however, defeat an effective rule, since a rebuttable presumption by itself can be an effective deterrent to corporate action. Also, the admission of rebuttal evidence does not mean there can be no limits on its use. This article has argued that a simple prima facie presumption, with no other evidentiary limitation, is highly effective in antitrust cases. The intricacy of the litigation makes it difficult for the party bearing the burden of proof to overcome even a prima facie presumption; efforts to do so are likely at most to create a serious conflict in the evidence and thus to induce the trier to fall back on the presumption.³⁵¹ Managerial preference for risk minimization, and often business or financial necessity, dictate that transactions be free of substantial legal risk.³⁵² Even a prima facie presumption creates significant risk and thus should deter mergers that are subject to the presumption.³⁵³ But the presumption can be more than merely rebuttable, for there is precedent for a stronger presumption in merger cases. As we have seen, the presumption in *Philadelphia Bank* was subject to rebuttal only by evidence "clearly showing that the merger is not likely to have . . . anticompetitive effects."³⁵⁴ Both Turner and Pitofsky have proposed *Philadelphia Bank*-type presumptions for certain potential competition mergers.³⁵⁵ A strong presumption, while adding more

350. *United States v. Citizens & S. Nat'l Bank*, 422 U.S. 86, 120 (1975); *United States v. General Dynamics Corp.*, 415 U.S. 486, 497-98 (1974).

351. This seems evident in the post-*Marine Bancorporation* decisions reviewed above, see pp. 19-25 *supra*. But see *United States v. General Dynamics Corp.*, 415 U.S. 486, 497-504 (1974) (presumption overcome in horizontal merger case).

352. See Breit & Elzinga, *Antitrust Penalties and Attitudes Toward Risk: An Economic Analysis*, 86 HARV. L. REV. 693, 704 (1972). See also W. SHARPE, *PORTFOLIO THEORY AND CAPITAL MARKETS* 27 (1970) ("large body of evidence indicates that almost everyone is a risk averter when making important decisions").

353. The imminence of the litigation in the *Penn-Olin* case, for example, blocked outside financing for the joint venture. Record, *supra* note 244, at 149. I am indebted for this point to a seminar paper prepared by Stephen Trattner, Esq., of the Washington D.C. Bar while a student at Indiana University School of Law.

354. *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 363 (1963) (citation omitted).

355. Pitofsky, *supra* note 213, at 1028-29 ("strong presumption" where specified conditions met); Turner, *supra* note 28, at 1377-78 ("speculative suppositions," that only "substantial domestic producer" will influence behavior of oligopolists in another geographic market, "plausible enough to" support "strong presumptions").

Potential Competition Mergers

certainty to the proposed rules, seems unnecessary in view of the considerations advanced above, and in any event is probably not a feasible policy alternative unless a *prima facie* presumption turns out to be unworkable.

Even though rebuttal evidence would be allowed, its use can still be limited.³⁵⁶ Testimony and evidence as to market performance or conduct—for example, target market competitiveness, economic efficiency, or oligopolistic behavior—would be inadmissible.³⁵⁷ In addition, evidence of subjective intent would be excluded, not only in view of the many disadvantages in its use, but because under the long-run perspective of the proximity approach managerial change is necessarily assumed. Under that assumption, the subjective intent of a present management is not very useful, even if it could be accurately ascertained.

Objective facts would be admissible where they show lack of entry capability or beneficial changes in market structure resulting from the merger. Thus in rebuttal of the inference of probable entry drawn

356. Clearly the broad authority given courts under antitrust statutes, and specifically under § 7, would permit evidentiary restrictions.

357. Possible use of an efficiencies defense in merger enforcement is explored in Williamson, *Revisited*, *supra* note 341. Expanding on his original formulation of the tradeoff between welfare loss due to monopoly output restrictions and welfare gain due to cost saving, Williamson proposes a limited use of this analysis in merger enforcement. *Id.* at 733-35. Justice Harlan made a similar suggestion in *Procter & Gamble*, 386 U.S. at 598-600 (concurring opinion).

The Williamson model demonstrates that if a merger produces both monopoly output restriction and cost saving economies, then under very plausible assumptions as to magnitudes, the welfare gain from economies can easily swamp the welfare loss from monopoly. Given the restrictive assumptions of partial equilibrium microeconomics, the result is both deductively valid and striking. But it does not follow that economies should be a defense in merger cases.

The model is subject to numerous qualifications, including imbalance in dispersion of consumer welfare benefits and losses across the industry and cost-increasing product substitution by firms subject to higher input prices. Williamson, *Revisited*, *supra* note 341, at 710-13. For an additional critique, see K. ELZINGA & W. BREIT, *supra* note 328, at 99-106. Beyond the limitations of the model, Williamson recognizes that handling the issue of efficiency gain/monopoly loss tradeoff in a judicial proceeding would raise "severe operational problems," Williamson, *Revisited*, *supra* note 341, at 734, due not only to the complexity of the considerations, but also to the built-in information advantage of the defendants on such an issue. *Id.* at 703. He suggests that tradeoff analysis may be useful chiefly at the enforcement rather than the trial level. *Id.* at 729-31, 734-35. Removing the question of efficiencies versus output loss from trial to enforcement level is not a satisfactory resolution, however, for as has been argued elsewhere, an enforcement standard that seriously departs from the judicial standard is untenable. See Brodley, *The Possibilities and Limits of Decision Theory in Antitrust: A Response to Professor Horowitz*, 52 IND. L.J. 735 (1977).

Williamson's purpose is to create "an enforcement atmosphere in which economies are socially valued." Williamson, *Revisited*, *supra* note 341, at 735. He has succeeded in articulating the argument, but the proper route for realization of that goal is in formulation of rules having minimal efficiency impact, not in specific case adjudication.

from market proximity, the acquiring firm could show lack of entry capability—financial, technological, or otherwise.³⁵⁸ Beneficial changes in market structure would include decreasing concentration (offsetting the adverse inference drawn from the presumptive rule), easy and frequent entry, existence of many firms, and elimination of gross inequality in firm size; but as a practical matter, it would take strong facts to overcome the presumption.³⁵⁹ In addition to the difficulty of sustaining the burden of proof, the use of rebuttal evidence would be offset by the government's right to introduce further evidence of adverse structural impact. Such evidence might include increasing concentration, small number of competitors, asymmetry in size, and prevalence of joint ventures,³⁶⁰ which would indicate an even less competitive structure than the concentration ratios suggest. More than a theoretical possibility, government evidence on aggravating factors could become a potent factor in offsetting the effectiveness of rebuttal evidence.³⁶¹

Conclusion

The proposed rules of presumptive illegality preserve significant forces of new market entry that would otherwise be lost through merger, and thus serve the primary objective of promoting deconcentrated markets. To some extent the firms covered by the rules, the largest firms in the most proximate markets, are likely to be perceived as entrants, and to that extent the procompetitive benefits of perceived entry will be retained without having to measure them. The rules will be operational and clearly predictive in that the potential antitrust liability of a merger should be readily ascertainable, and they are efficient in that no further simplification seems feasible.

358. To a limited extent this could include lack of incentive. Thus, a firm could submit evidence that it is only capable of entry at significantly higher cost than other firms, *e.g.*, due to unavailability of patent or trade secret rights. But evidence should not be admitted on lack of incentive based on policies internal to the corporation and subject to its own control, such as a showing of discrepancy between projected return and target return, since such facts are both easily manipulated and necessarily rooted in the policies of a particular management.

359. The weight to be given such facts would also vary with the power of the underlying economic theory, as well as the particular facts of the case. In general, this type of proof would have to be quite strong to be persuasive (*e.g.*, existing high concentration rapidly diminishing).

360. For the use of this last factor, and also vertical integration, in assessing competitiveness of market structure, see M. ADELMAN, *THE WORLD PETROLEUM MARKET* 100 (1972).

361. See, *e.g.*, *United States v. Amax*, 402 F. Supp. 956, 965-67 (D. Conn. 1975) (government evidence concerning entry barriers, joint ventures, and preferential customer supply system).

Potential Competition Mergers

To the extent that the rules encourage structural improvement of the most concentrated markets, most economists would agree that the probability of competitive behavior is enhanced. The rules also implement the political goal of antitrust by working toward a lesser concentration of discretionary economic authority. But the pursuit of the political goal is constrained, for the rules simply preserve a potential for deconcentration and do so only by barring acquisitions by a limited class of firms. Thus it is unlikely to cause any significant efficiency loss or unduly impinge on the marketability of capital assets. Such an approach is within the coverage of section 7; surely Congress intended to go this far.

The proposed rules are not the best that could be devised for a costless judicial process that operates with precision and in a fully predictable way. But in a world of scarce judicial resources, and in a judicial system with limited capacity to absorb the escalating complexity of merger litigation, there is much in them to commend.