Department of Justice

MERGER POLICY TODAY

Remarks by

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Not long ago, government antitrust authorities regarded mergers as a kind of creeping virus that had to be contained with little regard to the economic consequences. In the past several years, however, our approach has changed dramatically, and I regard that change as a great success story of the Reagan Administration.

Government merger policy strongly affects the economy. The free movement of business assets is critical to economic growth. For that reason business managers must be free from irrational antitrust constraints in deciding whether to acquire or divest businesses. Antitrust enforcers should only block mergers when they conclude, based on sound economic analysis, that a particular transaction will adversely affect competition.

Only recently did antitrust practitioners and economists reach a general consensus that merger policy should be based on sound economics. During the prior eight decades, the government frequently brought cases based less on considerations of economic development than on a fear that mergers, particularly large mergers, pose some ill-defined threat to our nation.

During the 1960s, for example, the Supreme Court routinely sustained government attacks even on small mergers between competitors. Those rulings put an artificial constraint on the flow of assets between companies in related businesses, and they also probably contributed to the conglomerate merger mania of the time. Even conglomerate mergers, which combine companies that do not directly compete, were sometimes attacked under vague concepts like "entrenchment," "reciprocal buying," and "leverage," -- concepts that became part of antitrust parlance and gave the policy of that era a facade of intellectual sophistication.

This enforcement policy was rarely based on rigorous economic analysis. In part it was based on simple fear of change. For example, in one opinion Justice Douglas expressed his anxieties about out-of-towners buying up local companies and his longing to make time stand still, when he said:

> A case in point is Goldendale in my State of Washington. It was a thriving community--an ideal place to raise a family--until the company that owned the sawmill was bought by an out-of-state giant. In a year or so auditors in faraway New York City, who never knew the glories of Goldendale, decided to close the local mill and truck all the logs to Yakima. Goldendale became greatly crippled. . . . 1/

Today we are faced with the reality that we can no longer afford to base antitrust policy on a parochial dislike for "auditors in faraway New York City". Today we must focus on companies based in Osaka and Seoul and Cologne.

In past years the antitrust authorities and the courts were

1/ United States v. Falstaff Brewing Corp., 410 U.S. 526, 543 (1973) (Douglas, J., concurring).

also concerned that a few large corporations would assume too much economic -- and thus political -- power in this country. Humorist Art Buchwald may have expressed this fear best in a column Justice Douglas appended to his concurring opinion in United States v. Pabst Brewing. 2/ In Buchwald's column, the head of the Antitrust Division had to decide whether the last two remaining U.S. corporations, "Samson" and "Delilah", could merge. After months of study, the merger was approved, whereupon the merged Samson-Delilah Inc. sought a White House meeting to discuss a buy-out of the United States itself. The public laughed uneasily and seemed to support ever more restrictive antitrust treatment of mergers.

But slowly over the next decade and a half -- roughly from 1965 to 1980 -- faced with increasing competition from abroad, the same public and bar, joined by antitrust enforcers, started to ask hard questions. What, if any, were the real threats of large mergers? What should be the appropriate role of antitrust? The answers have put us on our current course that should provide considerable benefit to the economy, the consumer, and the competitiveness of our industries in the world market.

For example, we know today that if there ever were legitimate concerns over "aggregate concentration" -- the percentage of manufacturing assets owned by the largest firms --

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2/ 384 U.S. 546 (1965).

it does not appear to be an increasing problem. Economy-wide concentration has been relatively stable in recent years and may even have declined.

But more fundamentally, we seem to have answered once and for all -- in the negative -- the question whether antitrust is the proper means of dealing with the social and political -- real or imaginary -- problems created by mergers. It is now clear that antitrust law cannot, for example, provide a reasonable standard for weighing the social dislocation caused by the closing of an inefficient plant in one community, as compared with the probable increase in social welfare caused by a more efficient plant in another community. Nor is antitrust an appropriate vehicle for balancing increases in political power against gains in consumer welfare. These and other non-economic factors may be legitimate political concerns, but they are much better dealt with by other laws, including the securities, tax, and election campaign laws, that are designed to check the abuse of corporate power.

Recent analysis of merger policy also indicates that most acquisitions are procompetitive, or at least not anticompetitive. For example, many mergers permit firms to realize scale economies in production, distribution, and marketing. Where there are technological similarities, mergers may allow for the consolidation of operations, longer production runs, and the elimination of duplication that lower fixed costs and reduce overhead. Mergers may also allow firms to develop complementary product lines, reduce transaction costs, and lower the costs of transporting and obtaining needed raw materials.

Mergers also facilitate the movement of assets to those who can best utilize them. Without an unencumbered merger market, companies would have difficulty divesting businesses they should leave. This is no small concern. Witness the fact that as much as 40 percent of last year's merger activity consisted essentially of corporate divestitures. Similarly, the competitive spur that potential entrants pose to an industry is aided by merger rules that permit firms to enter by acquisition, particularly where entry otherwise would be difficult or costly. An active merger market thus benefits the diversity of American business by allowing easier entry and exit of firms.

In addition, an active merger market is a healthy threat to incompetent management. If a firm is poorly managed, the price of its stock will likely fall below the level that it could be expected to reach with competent management. This makes the firm an attractive takeover candidate. A takeover in these circumstances is good for the economy because it shifts corporate assets from poor managers to more efficient ones. Often takeover threats have spurred management to restructure their firms. Thus the protection of incumbent management --

which is the motivating force behind several "hostile takeover" legislative proposals and state laws -- is hardly a legitimate antitrust concern, and may, in fact, be harmful to the economy.

It is sometimes argued, however, that large mergers deplete capital that might otherwise be used to finance new plants and factories. This concern is exaggerated. The amount of capital available for new investment over any period of time is equal to national savings in that time period, and mergers do not appreciably lessen aggregate savings. Mergers do alter the location of these savings somewhat and may generate some transaction costs, but there is insufficient evidence to conclude these costs are particularly troublesome in the aggregate.

While recognizing the substantial benefits of a free merger market, I am not here to issue a blanket endorsement of individual transactions. Some acquisitions make no economic sense. I am sure that we all have our own candidate for the dumb merger of the decade. But bad merger decisions are simply business mistakes, and the normal discipline of profit and loss provides adequate deterrence to these kinds of acquisitions. The market is the best mechanism for deterring dumb mergers -- not the Paul McGraths of this world.

Given all that I have said, one might reasonably ask: why should the antitrust laws ever proscribe mergers? The reason is that in certain markets excessively increased concentration heightens the risk that prices will rise above competitive levels either through explicit or tacit collusion or through an individual firm's market power. It has long been recognized that the power of firms to raise price unrestrained by competitive forces does not arise only when one firm has 100 percent of market sales. Where only a few firms account for most of the sales in a market, those firms under certain circumstances may coordinate -- explicitly or tacitly -- their decisions on price and output.

Those are the concerns underlying our current merger policy and the 1982 Department of Justice Merger Guidelines that set out that policy. When the Division rewrote the guidelines in 1982, the first revision since they were issued in 1968, it relied on the best economic studies of recent years. As a result, the unifying theme of the guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise. At the same time, the guidelines require the Antitrust Division to desist when the economic evidence indicates that a merger creates no competitive problems.

We do not gauge market power simply by applying the mathematical formula set forth in the guidelines -- the Herfindahl-Hirschman index of market concentration. The index is meaningless without an accurate assessment of which firms should be included in the calculation. The process of making this determination is called market definition, and it requires a good deal of sophisticated economic analysis and an equally strong dose of good common sense if it is to be done properly. To those who would claim that the antitrust laws are hidebound and out of step with present day realities, I can think of no better response than to note the great strides we have made over the last few years in the market definition process and to note how new economic learning has been incorporated into the market definition provisions of our 1982 merger guidelines.

These new provisions recognize that the threat of entry by outside firms -- including imports -- may be a significant force checking price increases. Where significant entry is possible, firms are not able to maintain prices above a competitive level without attracting other firms willing to offer the same product or a close substitute at a lower price. The new guidelines take into account the dynamics of this process under a standard that has become known as the five percent rule -- which holds that outside firms should be included in the market when a factual analysis shows they would enter the market in response to a five percent price increase in sufficient force to make such an increase unprofitable. It is significant that the five percent rule recognizes that foreign competition may play a role in analyzing a merger.

That runs counter to the popular perception that the antitrust laws and government merger policy ignore the realities of foreign competition. The fact is that the five percent rule and the antitrust laws from which it derives clearly take account of foreign competition in defining markets. Where imports check the ability of domestic firms to restrain competition, foreign competitors are included in the market. On the other hand, it would be irresponsible to include foreign competition in the market where technical factors, such as transportation costs or quality differences, or legal factors, such as import quotas or voluntary restraints, prevent imports from effectively blocking anticompetitive abuses by domestic firms. In short, the antitrust laws recognize real -- not imaginary -- world markets.

For example, imports figured prominently in our consideration of the proposed merger between the LTV Corporation and Republic Steel. Our analysis showed that foreign imports had a sufficient market impact on several lines of steel products -- pipes, for example -- to make an antitrust attack on those aspects of the merger inappropriate. The facts were different with respect to carbon and alloy sheet and stainless sheet. The imports of those kinds of steel did not constitute a sufficient check on potential anticompetitive conduct to save the merger. First, customer purchasing preferences have sharply limited imports of carbon and alloy sheet because some customers felt steel from less developed countries was not appropriate for certain uses. Second, because of existing import quotas and voluntary restraints, imports from certain major producers of steel sheet -- Japan and the European Economic Community -- could not be expected to increase substantially in response to a domestic price rise.

The 1982 guidelines also address the treatment of efficiencies in merger analysis. Because efficiencies are difficult to prove, let alone quantify, we are cautious about accepting a claim that specific efficiencies would save a merger which would not otherwise pass muster. We do not ignore efficiency claims, but we do require a factual showing that an otherwise problematic merger proposal is likely to generate substantial cost savings that cannot be achieved otherwise.

In the LTV-Republic context, for example, we were prepared to give considerable weight to possible efficiencies, and we devoted substantial resources to analyzing the companies' claims. Our staff spent several weeks on site investigating the companies' operations; we hired the highly respected British firm of steel experts--Atkins Planning--as an outside consultant; and I personally visited several of the companies' steel mills to gain a first-hand understanding. We concluded, however, that only a fraction of the claimed cost savings were attributable solely to the proposed merger. The majority of the realizable savings could be achieved without the complete consolidation sought by the companies.

Market definition and efficiencies are representative of the general economic approach taken by the 1982 Merger Guidelines. Although I believe that the guidelines reflect a sensible enforcement policy and work well, it is important that we keep them up to date and not allow them to become obsolete as the 1968 guidelines did. Those guidelines were issued with the idea that they would be regularly updated, but in fact no changes were made at all until the 1982 revision. As a result, the 1968 guidelines became a serious impediment to private antitrust counsellors and businessmen attempting to determine the enforcement policy of the Department of Justice.

We are already reviewing the 1982 guidelines to reflect the experience of the past two years. Our goal is to identify and address those portions where experience indicates a need for change. Among other topics, particular attention will be paid to the treatment of foreign capacity and imports and to the relevance of efficiency claims. In addition, it appears that the five percent rule is an inappropriate test in some markets and for some products and services, and we are studying that problem. We will also be considering whether the "failing company defense" has in practice been applied too strictly.

One other aspect of our merger policy worth comment is our so-called "fix it first" practice. Under this policy the Antitrust Division informs parties to a proposed merger of any competitive problems we have uncovered during our investigation. If these problems are eliminated prior to consummation of the transaction, we will not file suit to block it. In working with companies, our practice is to insist that the parties enter into binding agreements to divest or otherwise eliminate troublesome aspects of the proposed transactions. We will also take steps to ensure, through contempt actions if necessary, that the parties fully abide by these agreements.

Before I conclude, there is one more related issue I would like to address. It is ironic how the "pendulum" of opinion swings. Less than two decades ago there was a popular belief that antitrust policy should be very restrictive. Today, one finds well-publicized proposals by some commentators that even the more enlightened approach that characterizes current policy is too restrictive. As a prominent advocate of this position, Professor Lester Thurow, put it:

> America should abolish its antitrust laws. The time has come to recognize that the techniques of the nineteenth century are not applicable to getting ready for the twenty-first. An economy where growth is stopped and living standards are falling behind those of its competitors cannot afford a legal system that cripples its industrial future. [Thurow, "Let's Abolish the Antitrust Laws," The New York Times, October 19, 1980]

This kind of comment reflects the one-sided blindness that in the past characterized antitrust enforcement. While the earlier policy of excessive antitrust intervention threatened to reduce the economy's vigor and the well-being of consumers by seriously impeding the flow of assets through the economy, this more modern -- though equally ill-conceived -- policy of no action would also sap our economy and harm consumers by allowing the aggregation of market power that would seriously impair the efficient allocation of society's scarce resources. The fact is, so long as antitrust enforcement is limited to deterring restrictions on competition, then antitrust enforcement will help make our economy more healthy and competitive.

It is distressing, but not surprising, that some of the most sharp-tongued foes of antitrust at home are the most eloquent salesmen for protection from import competition. Quotas and voluntary restraints are much the fashion today, but such proposals are seriously misplaced, particularly when they come from those who claim deep concern about American industry as a whole. We must remember that not all imported products are finished goods. Many imports are used by U.S. firms as inputs in manufacturing operations. Often these firms rely on low-priced imports to remain competitive with other U.S. firms as well as with their foreign competitors. Import restrictions make such firms less able to compete. More fundamentally, we are all consumers, and if the trend to restrictions on imports should grow stronger, it poses a threat to our ability to obtain goods and services at the lowest possible price, whatever the short term benefit to any particular industry.

The best way to meet foreign competition is to assure that our own industries are competitive, which is precisely the purpose of the antitrust laws. If we continue to apply them in a sensible, realistic fashion and rely on competition instead of protectionism, American industry will remain vigorous, innovative, and capable of competing with any nation in the world.

In conclusion, we plan to pursue an active, vigorous and fair-minded merger enforcement policy -- one that recognizes the contribution that mergers make to the free market system but that also recognizes the economic threat posed by some mergers. We must avoid the habits of thought that cast merger policy as the enemy of business strength and prosperity. Merger policy exists to foster competition -- not to stifle it.

Wherever we can remove ambiguity or unfounded fears that inhibit sound business decisions we have an affirmative obligation to do so, and we will. But we also have an equally strong obligation to enforce the law vigorously when firms seek to merge their way to market power instead of competing on the basis of the quality and price of the goods and services they provide to the American public.

I have outlined here the policies I will follow in enforcing the antitrust laws affecting mergers. I have tried to be candid, and in that spirit I should say that I will probably make some unpopular decisions. They will not, however, be based on arrogance or ignorance. Antitrust enforcement is a tough, demanding business. Decisions, once made, may bring both high praise and harsh criticism. I expect, in the future as in the past, to ignore both. The path of wisdom is sometimes as simple as applying a little common sense. It's not a bad rule to follow in law enforcement, and I for one, intend to follow it.