

16.7: Acquisitions and Mergers under Section 7 of the Clayton Act

Learning Objectives

By the end of this section, you will be able to:

- Distinguish the three kinds of mergers.
- Describe how the courts will define the relevant market in gauging the potential anticompetitive effects of mergers and acquisitions.

Neither Section 1 nor Section 2 of the Sherman Act proved particularly useful in barring mergers between companies or acquisition by one company of another. As originally written, neither did the Clayton Act, which prohibited only mergers accomplished through the sale of stock, not mergers or acquisitions carried out through acquisition of assets. In 1950, Congress amended the Clayton Act to cover the loophole concerning acquisition of assets. It also narrowed the search for relevant market; henceforth, if competition might be lessened *in any line of commerce in any section of the country*, the merger is unlawful.

As amended, the pertinent part of Section 7 of the Clayton Act reads as follows:

[N]o corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.

No corporation shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of one or more corporations engaged in commerce, where in any line of commerce in any section of the country, the effect of such acquisition, of such stock or assets, or of the use of such stock by the voting or granting of proxies or otherwise, may be substantially to lessen competition, or to tend to create a monopoly.

Definitions

Mergers and Acquisitions

For the sake of brevity, we will refer to both mergers and acquisitions as mergers. Mergers are usually classified into three types: horizontal, vertical, and conglomerate.

Horizontal

A horizontal merger is one between competitors—for example, between two bread manufacturers or two grocery chains competing in the same locale.

Vertical

A vertical merger is that of a supplier and a customer. If the customer acquires the supplier, it is known as backward vertical integration; if the supplier acquires the customer, it is forward vertical integration. For example, a book publisher that buys a paper manufacturer has engaged in backward vertical integration. Its purchase of a bookstore chain would be forward vertical integration.

Conglomerate Mergers

Conglomerate mergers do not have a standard definition but generally are taken to be mergers between companies whose businesses are not directly related. Many commentators have subdivided this category into three types. In a “pure” conglomerate merger, the businesses are not related, as when a steel manufacturer acquires a movie distributor. In a product-extension merger, the manufacturer of one product acquires the manufacturer of a related product—for instance, a producer of household cleansers, but not of liquid bleach, acquires a producer of liquid bleach. In a market-extension merger, a company in one geographic market acquires a company in the same business in a different location. For example, suppose a bakery operating only in San Francisco buys a bakery operating only in Palo Alto. Since they had not competed before the merger, this would not be a horizontal merger.

General Principles

As in monopolization cases, a relevant product market and geographic market must first be marked out to test the effect of the merger. But Section 7 of the Clayton Act has a market definition different from that of Section 2. Section 7 speaks of “*any line of commerce in any section of the country*” (emphasis added). And its test for the effect of the merger is the same as that which we have already seen for exclusive dealing cases governed by Section 3: Taken together, this language makes it easier to condemn an unlawful merger than an unlawful monopoly. The relevant product market is any *line of commerce*, and the courts have taken this language to permit the plaintiff to prove the existence of “submarkets” in which the relative effect of the merger is greater. The relevant geographic market is any *section of the country*, which means that the plaintiff can show the appropriate effect in a city or a particular region and not worry about having to show the effect in a national market. Moreover, as we have seen, the effect is one of probability, not actuality. Thus the question is, *Might* competition be substantially lessened? rather than, *Was* competition in fact substantially lessened? Likewise, the question is, Did the merger *tend* to create a monopoly? rather than, Did the merger in fact create a monopoly?

In *United States v. du Pont*, the government charged that du Pont’s “commanding position as General Motors’ supplier of automotive finishes and fabrics” was not achieved on competitive merit alone but because du Pont had acquired a sizable block of GM stock, and the “consequent close intercompany relationship led to the insulation of most of the General Motors’ market from free competition,” in violation of Section 7. *United States v. du Pont*, 353 U.S. 586 (1957). Between 1917 and 1919, du Pont took a 23 percent stock interest in GM. The district court dismissed the complaint, partly on the grounds that at least before the 1950 amendment to Section 7, the Clayton Act did not condemn vertical mergers and partly on the grounds that du Pont had not dominated GM’s decision to purchase millions of dollars’ worth of automotive finishes and fabrics. The Supreme Court disagreed with this analysis and sent the case back to trial. The Court specifically held that even though the stock acquisition had occurred some thirty-five years earlier, the government can resort to Section 7 whenever it appears that the result of the acquisition will violate the competitive tests set forth in the section.

Defining the Market

In the seminal *Brown Shoe* case, the Supreme Court said that the outer boundaries of broad markets “are determined by the reasonable interchangeability of use or the cross elasticity of demand between the product itself and substitutes for it” but that narrower “well defined submarkets” might also be appropriate lines of commerce. *Brown Shoe Co., Inc. v. United States*, 370 U.S. 294 (1962). In drawing market boundaries, the Court said, courts should realistically reflect “[c]ompetition where, in fact, it exists.” Among the factors to consider are “industry or public recognition of the submarket as a separate economic entity, the product’s peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes and specialized vendors.” To select the geographic market, courts must consider both “the commercial realities” of the industry and the economic significance of the market.

The Failing Company Doctrine

One defense to a Section 7 case is that one of the merging companies is a failing company. In *Citizen Publishing Company v. United States*, the Supreme Court said that the defense is applicable if two conditions are satisfied. *Citizen Publishing Company v. United States*, 394 U.S. 131 (1969). First, a company must be staring bankruptcy in the face; it must have virtually no chance of being resuscitated without the merger. Second, the acquiring company must be the only available purchaser, and the failing company must have made bona fide efforts to search for another purchaser.

Beneficial Effects

That a merger might produce beneficial effects is not a defense to a Section 7 case. As the Supreme Court said in *United States v. Philadelphia National Bank*, “[A] merger, the effect of which ‘may be substantially to lessen competition’ is not saved because, on some ultimate reckoning of social or economic debits or credits, it may be deemed beneficial.” *United States v. Philadelphia National Bank*, 374 U.S. 321, 371 (1963). And in *FTC v. Procter & Gamble Co.*, the Court said, “Possible economies cannot be used as a defense to illegality.” *FTC v. Procter & Gamble Co.*, 386 U.S. 568, 580 (1967). Congress was also aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition.

Tests of Competitive Effect

Horizontal Mergers

Three factors are critical in assessing whether a horizontal merger may substantially lessen competition: (1) the market shares of the merging companies, (2) the concentration ratios, and (3) the trends in the industry toward concentration.

The first factor is self-evident. A company with 10 percent or even 5 percent of the market is in a different position from one with less than 1 percent. A concentration ratio indicates the number of firms that constitute an industry. An industry with only four firms is obviously much more concentrated than one with ten or seventy firms. Concentration trends indicate the frequency with which firms in the relevant market have been merging. The first merger in an industry with a low concentration ratio might be predicted to have no likely effect on competition, but a merger of two firms in a four-firm industry would obviously have a pronounced effect.

In the *Philadelphia National Bank* case, the court announced this test in assessing the legality of a horizontal merger: “[A] merger which produces a firm controlling an undue percentage share of the relevant market, and results in a significant increase in the concentration of firms in that market is so inherently likely to lessen competition substantially that it must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anticompetitive effects.” In this case, the merger led to a 30 percent share of the commercial banking market in a four-county region around Philadelphia and an increase in concentration by more than one-third, and the court held that those numbers amounted to a violation of Section 7. The court also said that “if concentration is already great, the importance of preventing even slight increases in concentration and so preserving the possibility of eventual de-concentration is correspondingly great.”

The Hart-Scott-Rodino Antitrust Improvements Act of 1976 requires certain companies to notify the Justice Department before actually completing mergers or acquisitions, whether by private negotiation or by public tender offer. When one of the companies has sales or assets of \$100 million or more and the other company \$10 million or more, premerger notification must be provided at least thirty days prior to completion of the deal—or fifteen days in the case of a tender offer of cash for publicly traded shares if the resulting merger would give the acquiring company \$50 million worth or 15 percent of assets or voting securities in the acquired company. The rules are complex, but they are designed to give the department time to react to a merger before it has been secretly accomplished and then announced. The 1976 act gives the department the authority to seek an injunction against the completion of any such merger, which of course greatly simplifies the remedial phase of the case should the courts ultimately hold that the merger would be unlawful. (Note: Section 7 is one of the “tools” in the kit of the lawyer who defends companies against unwelcomed takeover attempts: if the target company can point to lines of its business in which it competes with the acquiring company, it can threaten antitrust action in order to block the merger.)

Vertical Mergers

To prove a Section 7 case involving a vertical merger, the plaintiff must show that the merger forecloses competition “in a substantial share of” a substantial market. But statistical factors alone do not govern in a vertical merger. To illustrate, we see that in *Ford Motor Co. v. United States*, the merger between Ford and Autolite (a manufacturer of spark plugs) was held unlawful because it eliminated Ford’s potential entry into the market as an independent manufacturer of spark plugs and because it foreclosed Ford “as a purchaser of about ten percent of total industry output” of spark plugs. *Ford Motor Co. v. United States*, 405 U.S. 562 (1972). This decision underscores the principle that a company may serve to enhance competition simply by waiting in the wings as a potential entrant to a market. If other companies feel threatened by a company the size of Ford undertaking to compete where it had not done so before, the existing manufacturers will likely keep their prices low so as not to tempt the giant in. Of course, had Ford entered the market on its own by independently manufacturing spark plugs, it might ultimately have caused weak competitors to fold. As the Court said, “Had Ford taken the internal-expansion route, there would have been no illegality; not, however, because the result necessarily would have been commendable, but simply because that course has not been proscribed.”

Conglomerate Mergers

Recall the definition of a conglomerate merger given in Section 26.7.1 “Definitions”. None of the three types listed has a direct impact on competition, so the test for illegality is more difficult to state and apply than for horizontal or vertical mergers. But they are nonetheless within the reach of Section 7. In the late 1960s and early 1970s, the government filed a number of divestiture suits against conglomerate mergers. It did not win them all, and none reached the Supreme Court; most were settled by consent decree, leading in several instances to divestiture either of the acquired company or of another division of the acquiring company. Thus International Telephone & Telegraph Company agreed to divest itself of Canteen Corporation and either of the following two groups: (1) Avis, Levin & Sons, and Hamilton Life Insurance Company; or (2) Hartford Fire Insurance Company. Ling-Temco-Vought agreed to divest itself of either Jones & Laughlin Steel or Braniff Airways and Okonite Corporation. In these and other cases, the courts have looked to specific potential effects, such as raising the barriers to entry into a market and eliminating

potential competition, but they have rejected the more general claim of “the rising tide of economic concentration in American industry.”

Entrenching Oligopoly

One way to attack conglomerate mergers is to demonstrate that by taking over a dominant company in an oligopolistic industry, a large and strong acquiring company will further entrench the oligopoly. In an oligopolistic industry, just a few major competitors so dominate the industry that competition is quelled. In *FTC v. Procter & Gamble Co.*, the government challenged Procter & Gamble’s (P&G’s) acquisition of Clorox. P&G was the leading seller of household cleansers, with annual sales of more than \$1 billion. *FTC v. Procter & Gamble Co.*, 386 U.S. 568 (1967). In addition, it was the “nation’s largest advertiser,” promoting its products so heavily that it was able to take advantage of substantial advertising discounts from the media. Clorox had more than 48 percent of national sales for liquid bleach in a heavily concentrated industry. Since all liquid bleach is chemically identical, advertising and promotion plays the dominant role in selling the product. Prior to the merger, P&G did not make or sell liquid bleach; hence it was a product-extension merger rather than a horizontal one.

The Supreme Court concluded that smaller firms would fear retaliation from P&G if they tried to compete in the liquid bleach market and that “a new entrant would be much more reluctant to face the giant Procter than it would have been to face the smaller Clorox.” Hence “the substitution of the powerful acquiring firm for the smaller, but already dominant firm may substantially reduce the competitive structure of the industry by raising entry barriers and by dissuading the smaller firms from aggressively competing.” The entrenchment theory probably applies only to highly concentrated industries and dominant firms, however. Many subsequent cases have come out in favor of the defendants on a variety of grounds—that the merger led simply to a more efficient acquired firm, that the existing competitors were strong and able to compete, or even that the acquiring firm merely gives the acquired company a deep pocket to better finance its operations.

Eliminating Potential Competition

This theory holds that but for the merger, the acquiring company might have competed in the acquired company’s market. In *Procter & Gamble*, for example, P&G might have entered the liquid bleach market itself and thus given Clorox a run for its money. An additional strong company would then have been in the market. When P&G bought Clorox, however, it foreclosed that possibility. This theory depends on proof of some probability that the acquiring company would have entered the market. When the acquired company is small, however, a Section 7 violation is unlikely; these so-called toehold mergers permit the acquiring company to become a competitive force in an industry without necessarily sacrificing any preexisting competition.

Reciprocity

Many companies are both heavy buyers and heavy sellers of products. A company may buy from its customers as well as sell to them. This practice is known in antitrust jargon as reciprocity. Reciprocity is the practice of a seller who uses his volume of purchases from the buyer to induce the buyer to purchase from him. The clearest example arose in *FTC v. Consolidated Foods Corp.* *FTC v. Consolidated Foods Corp.*, 380 U.S. 592 (1965). Consolidated owned wholesale grocery outlets and retail food stores. It wanted to merge with Gentry, which made dehydrated onions and garlic. The Supreme Court agreed that the merger violated Section 7 because of the possibility of reciprocity: Consolidated made bulk purchases from several food processors, which were purchasers of dehydrated onions and garlic from Gentry and others. Processors who did not buy from Gentry might feel pressured to do so in order to keep Consolidated as a customer for their food supplies. If so, other onion and garlic processors would be foreclosed from competing for sales. A merger that raises the mere possibility of reciprocity is not per se unlawful, however. The plaintiff must demonstrate that it was probable the acquiring company would adopt the practice—for example, by conditioning future orders for supplies on the receipt of orders for onions and garlic—and that doing so would have an anticompetitive effect given the size of the reciprocating companies and their positions in the market.

Joint Ventures

Section 7 can also apply to joint ventures, a rule first announced in 1964. Two companies, Hooker and American Potash, dominated sales of sodium chlorate in the Southeast, with 90 percent of the market. Pennsalt Chemicals Corporation produced the rest in the West and sold it in the Southeast through Olin Mathieson Chemical Corporation. The latter two decided to team up, the better to compete with the giants, and so they formed Penn-Olin, which they jointly owned. The district court dismissed the government’s suit, but the Supreme Court reinstated it, saying that a joint venture can serve to blunt competition, or at least potential competition, between the parent companies. The Court said that the lower court must look to a number of factors to determine whether the joint venture was likely to lessen competition substantially:

The number and power of the competitors in the relevant market; the background of their growth; the power of the joint venturers; the relationship of their lines of commerce; competition existing between them and the power of each in dealing with the competitors of the other; the setting in which the joint venture was created; the reasons and necessities for its existence; the joint venture's line of commerce and the relationship thereof to that of its parents; the adaptability of its line of commerce to non-competitive practices; the potential power of the joint venture in the relevant market; and 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; the effect, in the event of this occurrence, of the other joint venturer's potential competition; and such other factors as might indicate potential risk to competition in the relevant market. *United States v. Penn-Olin Chemical Co.*, 378 U.S. 158 (1964).

These numerous factors illustrate how the entire economic environment surrounding the joint venture and mergers in general must be assessed to determine the legalities.

Remedies

The Clayton Act provides that the government may seek divestiture when an acquisition or a merger violates the act. Until relatively recently, however, it was unresolved whether a private plaintiff could seek divestiture after proving a Clayton Act violation. In 1990, the Supreme Court unanimously agreed that divestiture is an available remedy in private suits, even in suits filed by a state's attorney general on behalf of consumers. *California v. American Stores*, 58 U.S.L.W. 4529 (1990). This ruling makes it more likely that antimerger litigation will increase in the future.

During the years of the Reagan administration in the 1980s, the federal government became far less active in prosecuting antitrust cases, especially merger cases, than it had been in previous decades. Many giant mergers went unchallenged, like the merger between two oil behemoths, Texaco and Getty, resulting in a company with nearly \$50 billion in assets in 1984. With the arrival of the first Bush administration in 1989, the talk in Washington antitrust circles was of a renewed interest in antitrust enforcement. The arrival of the second Bush administration in 2000 brought about an era of less antitrust enforcement than had been undertaken during the Clinton administration. Whether the Obama administration reinvigorates antitrust enforcement remains to be seen.

Key Takeaway

Section 7 prohibits mergers or acquisitions that might tend to lessen competition in any line of commerce in any section of the country. Mergers and acquisitions are usually classified in one of three ways: horizontal (between competitors), vertical (between different levels of the distribution chain), or conglomerate (between businesses that are not directly related). The latter may be divided into product-extension and market-expansion mergers. The relevant market test is different than in monopolization cases; in a Section 7 action, relevance of market may be proved.

In assessing horizontal mergers, the courts will look to the market shares of emerging companies, industry concentration ratios, and trends toward concentration in the industry. To prove a Section 7 case, the plaintiff must show that the merger forecloses competition "in a substantial share of" a substantial market. Conglomerate merger cases are harder to prove and require a showing of specific potential effects, such as raising barriers to entry into an industry and thus entrenching monopoly, or eliminating potential competition. Joint ventures may also be condemned by Section 7. The Hart-Scott-Rodino Antitrust Improvements Act of 1976 requires certain companies to get premerger notice to the Justice Department.

Exercises

1. Sirius Satellite radio and XM satellite radio proposed to merge. Was this a horizontal merger, a vertical merger, or a conglomerate merger? How is the market defined, in terms of both product or service and geographic area?
2. In 2010, Live Nation and Ticketmaster proposed to merge. Was this a horizontal merger, a vertical merger, or a conglomerate merger? How should the market be defined, in terms of both product or service and geographic area? Should the US government approve the merger?

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