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Spotted: possible efficiencies in competitor combos

By Howard Morse and David Burns

In a rare appellate opinion addressing a merger challenge, the 9th U.S. Circuit Court of Appeals last month sided with the Federal Trade Commission, finding that a merger of two health care providers was likely to substantially lessen competition in violation of the antitrust laws. *St. Alphonsus v. St. Lukes*, 2015 DJDAR 1699 (Feb. 10, 2015).

Even though it found for the government, the court broke with long-standing 9th Circuit precedent and held that merger efficiencies may create a more efficient combined entity and enhance competition.

The FTC and Department of Justice review hundreds of proposed mergers under the Hart-Scott-Rodino Act every year. The agencies typically litigate only a handful of challenges each year, and appellate decisions are rarer still.

There have been only a few substantive 9th Circuit merger decisions in the last 20-plus years, and the Supreme Court has not issued a substantive merger decision since the mid-1970s. St. *Alphonsus* thus provides valuable insight into the state of merger review in federal courts and will likely also guide agency investigations.

Continued Reliance on Market Definition and Market Share Analysis

Merger review in federal court typically follows a "burden shifting framework," under which the government bears the initial burden of establishing a prima facie case of likely anticompetitive effect — typically based on high market shares in some "market" — at which point the burden shifts to the defendant to rebut this evidence. If successful, the burden shifts back to the government, which bears the "ultimate burden of persuasion."

The starting point of this analysis is traditionally to define the relevant product and geographic markets. The 9th Circuit deemed this step — quoting 1970s Supreme Court case law — a "necessary predicate to deciding whether a merger contravenes the Clayton Act."

To define the product market, the 9th Circuit endorsed the DOJ/FTC 2010 Horizontal Merger Guidelines' reliance on the "SSNIP" test, which examines whether a hypothetical monopolist in a candidate product market could impose a "small but significant and nontransitory increase in price," considering the anticipated behavior of buyers and sellers. If so, the proposed market may constitute a relevant market.

Once the relevant market is established, the government must show the likelihood of anticompetitive effects within that market. In *St. Alphonsus*, that was fairly straightforward, given the merger was between two of the three adult primary care physician providers in the Nampa, Idaho market.

One metric commonly used to to predict competitive effects is the Herfindahl-Hirschman Index, or the sum of the squares of each firm's market share. In this case, the level and change in HHI "blew through" the thresholds established in the guidelines, at which a merger may be "presumed to be likely to enhance market power." Reasoning that a "*prima facie* case can be established simply by showing high market share," the court found the government's initial burden satisfied.

The FTC's prima facie case — and the 9th Circuit's analysis of this showing — followed the traditional framework, relying on market shares in the relevant market. That approach, however, may not be consistent with current thinking at the antitrust agencies, which have in recent years shifted away from a structural antitrust analysis, centered on market definition and concentration, towards a "more flexible" framework, which considers factors such as post-merger price increases and historical events (or "natural experiments"), which the agencies consider to be direct evidence of competitive effects.

This "more flexible" framework, reflected in the guidelines, may be used by the agencies. But in federal court it remains the case that the "determination of the relevant product and geographic markets is a necessary predicate." The *St. Alphonsus* court's analysis was nothing if not orthodox, beginning with the relevant market definition, and effectively ending with the high market share.

In so reasoning, the 9th Circuit followed the district courts that have decided merger cases since the 2010 revisions to the guidelines in continuing to insist on structural merger review. These cases require the government to prove its prima facie case using a structural framework, evincing the enduring significance of market definition and market share.

The "Efficiencies Defense" in *St. Alphonsus*

The decision in *St. Alphonsus*, which requires a divestiture to unwind a consummated acquisition, effectively reversed decades-old 9th Circuit law, and accepted, in principle, a role for efficiencies in analyzing mergers. While the court found the parties' "efficiencies defense" insufficient to overcome the FTC's prima facie showing, the court addressed the parties' contention that the transaction was both genuinely intended and likely to improve patient care, and hence procompetitive.

Treatment of efficiencies in merger review before the federal courts has long been equivocal. The 9th Circuit was quick to cite 1960s Supreme Court cases suggesting that "possible economies cannot be used as a defense to illegality," reasoning that "Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition." The 9th Circuit also noted that no reported appellate decision has ever found a merger defendant successfully rebutted the prima facie case with an efficiencies defense.

Yet while expressing some lingering "skeptic[ism]" about the efficiencies defense "in general and about its scope in particular," the 9th Circuit nonetheless indulged the parties' efficiencies-based arguments.

Citing to the underlying text of the Clayton Act, which condemns only those mergers whose effect "may be substantially to lessen competition," the court recognized that a defendant may rebut a prima facie case with evidence that the merger will "create a more efficient combined entity and thus increase competition."

The court offered an example: A merger of two small firms may lower production costs to compete with a large competitor. The guidelines recognize efficiencies may enhance competition in other ways: For instance, incremental cost reductions may reduce or reverse any increases in the merged firm's incentive to elevate price, and may make coordination less likely or effective by enhancing the incentive of a maverick to lower price, or by creating a new maverick firm. Efficiencies may also lead to new or improved products, even if they do not immediately and directly affect price.

In accepting that efficiencies may be relevant, the 9th Circuit was careful to emphasize the "linchpin" of the Clayton Act analysis remains whether the merger is likely to increase — not harm — competition. This position follows the guidelines' directive not to challenge mergers in which "efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market."

This is where the parties' efficiencies arguments foundered. The parties had contended the merged entity would be able to move towards integrated patient care and risk-based reimbursement, a procompetitive, patient-friendly outcome. The court agreed with this factual predicate — but squarely rejected that it was sufficient to overcome the FTC's prima facie showing.

The 9th Circuit concluded, "the Clayton Act does not excuse mergers that lessen competition … simply because the merged entity can improve its operations." Absent an efficiencies argument sufficient to show a "positive effect on competition," the defendant had not overcome the prima facie case, dooming the merger.

The FTC has lauded the decision for adhering to the "language and intention of the Clayton Act." But arguably, the decision departs from the statute by requiring the defendant prove the "merger is not, despite the existence of a prima facie case, anticompetitive." This arguably reverses the Clayton Act's burden of proof, under which the ultimate burden to prove a likely anticompetitive effect rests with the plaintiff.

Future merger defendants will no doubt emphasize that while the three-part merger review framework shifts to the defendant the burden of demonstrating efficiencies, that burden ought not require the defendant prove the merger is ultimately procompetitive.

The Future of the Efficiencies Defense

It is at least now clear that merger efficiencies may undermine the government's prima facie case. The *St. Alphonsus* decision assures that efficiencies arguments will see the light of day — but also underscores the skepticism to which such arguments will likely be subject.

Prudent companies exploring a potential merger with a competitor should evaluate, analyze and document proposed efficiencies early, paying special attention to whether and how the efficiencies benefit competition, and not merely the merging competitors. Future merger litigants in the 9th Circuit may face an uphill battle justifying a facially anticompetitive merger with evidence of efficiencies, but well-founded documentation of such procompetitive benefits can ease the burden.

Howard Morse *is a partner and* **David Burns** *is an associate in the Antitrust & Competition practice in the Washington D.C. office of Cooley LLP.*

HOWARD MORSE
Cooley LLP

DAVID BURNS
Cooley LLP

Cooley

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