2010 Horizontal Merger Guidelines: The View from the Technology Industry

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In 2005, MySpace's position as the leading social networking site appeared assured. It was gaining 70,000 new users every day,[1] and by 2006 it was the most visited Web site in the United States. Its 80 percent market share in social networking far outstripped its closest rival, Facebook, which remained a distant second at 10 percent.[2] In 2008, however, MySpace began to lose users to Facebook and then to Twitter. Its share in social networking dropped to 66 percent in 2008, and to 30 percent in 2009.[3]

According to a NewsCorp executive who had oversight for the MySpace business, the reason for this sharp drop was that MySpace stopped innovating at a time when it led in the market and had strong momentum, leaving the door open to its competitors. This executive stated: "The thing you see in this space more than anything else is that if you don't keep innovating and moving forward, you get in trouble. You can't stop [. . . .] And MySpace stopped."[4]

This lesson from MySpace—"if you don't keep innovating and moving forward, you get in trouble"—is, in my experience, the driving factor behind a majority of the mergers in the technology sector. Production efficiencies are rarely the motivation for high-tech mergers, because high-tech markets typically are characterized by large upfront fixed costs and low marginal costs of production.[5] Some high-tech mergers, of course, also are motivated by anticompetitive reasons. Most, however, are spurred by the need to innovate, as Joseph Schumpeter described long ago:

> [I]t is still competition within a rigid pattern of invariant conditions, methods of production and forms of industrial organization . . . that . . . monopolizes attention. But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization . . . competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives.[6]

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1 Matthew Garrahan, *The Rise and Fall of MySpace*, FIN. TIMES, Dec. 4, 2009, *available at* http://www.ft.com/cms/s/2/fd9ffd9c-dee5-11de-adff-00144feab49a.html.

2 Steve O'Hear, *Social Network Traffic up 11.5%; MySpace Still Dominates* (Mar. 15, 2007), *available at* http://www.zdnet.com/blog/social/social-network-traffic-up-115-percent-myspace-still-dominates/114.

3 Garrahan, *supra* note 1.

4 Juan Carlos Perez, *NewsCorp's Jon Miller: MySpace Stopped Innovating*, PC WORLD (Oct. 22, 2009) (quoting NewsCorp executive Jonathan Miller), *available at* http://www.pcworld.com/businesscenter/article/174181/news_corp_jon_miller_myspace_stopped_innovating.html.

5 *See* Antitrust and the New Economy, Hearing before the Antitrust Modernization Commission (Nov. 17, 2005) (statement of George S. Cary), *available at* http://govinfo.library.unt.edu/amc/commission_hearings/pdf/Statement_Cary_final.pdf.

6 JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 82–85 (Harper & Row 1975).

From the perspective of the technology sector, it is disappointing that the Agencies chose not to amend Section 10 of the 2010 Horizontal Merger Guidelines to reflect the importance of this dynamic innovation. Despite repeated calls to revise the 1992 Guidelines to give greater credence to dynamic efficiencies,[7] the Agencies have chosen to give greater weight to static efficiencies, and to the modest gains that they enable, than to the dynamic efficiencies that are the principal source of sweeping productivity gains.[8]

The reason the Agencies give for this policy preference is that static efficiencies are more certain and easier to verify. Thus, they declare in the 2010 Guidelines that efficiencies "resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the incremental cost of production," are "more likely to be susceptible verification and are less likely to result from anticompetitive reductions in output."[9] Dynamic efficiencies, by comparison, "are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions."[10]

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It is true, of course, that Schumpeterian competition to provide "the new commodity, the new technology, the new source of supply" is inherently uncertain. Such leapfrogging innovation, however, is crucial to long-term gains to consumer welfare. Indeed, it is generally accepted that small increases in productivity from innovation can dwarf the effects of static efficiency over time.[11] A merger policy that ignores potential dynamic efficiencies therefore can harm consumers far more than even significant price increases.

Moreover, from a high-tech perspective, the 2010 Guidelines include errors of commission as well as omission. Most notable in this respect is the new Section 2.2.3, where the Agencies indicate that they will consider the views of competitive rivals "especially in cases where the Agencies are concerned that the merged entity may engage in exclusionary conduct."[12] The Guidelines contain the following example:

> *Example 2:* Merging Firms A and B operate in a market in which network effects are significant, implying that any firm's product is significantly more valuable if it commands a large market share or if it is interconnected with others that in aggregate command such a share. Prior to the merger, they and their rivals voluntarily interconnect with one another. The merger would create an entity with a large enough share that a strategy of ending voluntary interconnection would have a dangerous probability of creating monopoly power in this market. The interests of rivals and consumers would be broadly aligned in preventing such a merger.

The Agencies do not indicate that they would require evidence that the parties themselves contemplated such a strategy post-merger, or previously had engaged in similar conduct in compa-

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[7] *See, e.g.*, Antitrust Modernization Comm'n, Report and Recommendations 40 (2007) ("To improve the application of antitrust in new economy industries, antitrust enforcers should give further consideration to efficiencies that lead to more rapid or enhanced innovation. The potential benefits to consumer welfare from such efficiencies are great, thus warranting careful assessments of the potential for certain business conduct to create more rapid or enhanced innovation"), *available at* http://govinfo.library.unt.edu/amc/report_recommendation/chapter1.pdf.

[8] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines 29–31 (2010) [hereinafter 2010 Guidelines], *available at* http://ftc.gov/os/2010/08/100819hmg.pdf.

[9] *Id.* at 31.

[10] *Id.*

[11] *See, e.g.*, *Antitrust and the New Economy, Hearing before the Antitrust Modernization Commission* 5 (Nov. 8, 2005) (statement of M. Howard Morse), *available at* http://www.ftc.gov/os/comments/horizontalmergerguides/545095-00044.pdf.

[12] 2010 Guidelines, *supra* note 8, at 6.

rable circumstances. In view of the high market shares that characterize many high-tech markets, and structural characteristics (such as network effects) that often are present in these markets, the Agencies appear to be opening the door to potent game-playing by rivals.[13]

The Agencies' approach in Example 2 contrasts strikingly with their expressed skepticism about dynamic efficiencies. On the one hand, the Agencies tell merging parties who base their investment decisions on the prospect of potential dynamic efficiencies that, even though "projected reasonably and in good faith," their expected gains will be heavily discounted because they "may not be realized."[14] On the other hand, the Agencies have expressed no similar caution in Example 2 about their ability to estimate the likelihood of potential anticompetitive effects. In the high-tech sector at least, however, such modesty is particularly warranted. A competitor complaining to the Agencies about MySpace in 2007 or 2008, for example, could have pointed to network effects, user lock-in, first-mover effects, and high persistent market shares to argue that MySpace had market power. Such complaints might have seemed compelling. Only a year later, however, MySpace's position in the market was collapsing.

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The Agencies' failure to amend Section 10 is most important from a high-tech perspective, and the addition of Example 2 perhaps the most alarming, the Agencies did make some advances in the Guidelines' analysis of long-term supply constraints. This change is helpful because, in many procompetitive high-tech mergers, long-term supply considerations are the principal competitive restraint on the parties. Under the 1992 Guidelines, the Agencies considered only demand-side factors in their market definition, and limited market participants to those who could enter within one year (and, in entry analysis, those who could enter within two years). Moreover, as a practical matter, Agency staff often tended to give these supply considerations slight attention, despite their significant real-world effects.

Under the 2010 Guidelines, the Agencies now clearly state that supply-side responses are an integral part of their competitive effects analysis.[15] In addition, the Agencies have replaced the one-year standard for assessing new entry with a more flexible assessment, considering the likelihood of "rapid" entrants who will enter "in the near future." They also have eliminated the two-year window on assessing the timeliness of entry.[16] Work remains to be done, however, because the Agencies continue to focus exclusively on the demand side in market definition, with the result that

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[13] It is instructive to compare Example 2 with the Federal Trade Commission's review a few years ago of the acquisition of Adelphia by Comcast. In that case, the Commission considered whether increased concentration of market shares in several regional cable markets would give Comcast the incentive to engage in exclusionary conduct (the use of exclusive contracts to tie up essential programming). The Commission found that, in other markets where Comcast had similar shares, it did not engage in such anticompetitive conduct:

> But we do need facts that show that it is likely that the transactions would lessen competition in a relevant market. "Natural experiments," i.e., evidence that the posited harm has occurred under circumstances similar to the proposed transactions, are relevant to merger analysis. Consequently, the Bureaus carefully reviewed the evidence of prior conduct by the parties in markets such as Chicago and Sacramento. . . . The evidence concerning the conduct in these other markets did not indicate that the proposed transactions under review here are likely to reduce competition in any relevant geographic market.

Statement of Chairman Majoras, Commissioner Kovacic, and Commissioner Rosch Concerning the Closing of the Investigation into Transactions Involving Comcast, Time Warner Cable, and Adelphia Communications, FTC File No. 051-0151 (Jan. 31, 2006), *available at* http://www.ftc.gov/os/closings/ftc/0510151twadelphiamajoras_kovacic_rosch.pdf.

[14] 2010 Guidelines, *supra* note 8, at 30.

[15] *See id.* at 7 ("The responsive actions of suppliers are also important in competitive analysis. They are considered in these Guidelines in the sections addressing the identification of market participants, the measurement of market shares, the analysis of competitive effects, and entry").

[16] *Id.* at 28–29.

a disproportionately large percentage of high-tech mergers still fit poorly within the Agencies' articulated framework.

Where, then, are we with respect to the evaluation of high-tech mergers under the 2010 Guidelines? High-tech mergers, as noted earlier, are likely to include participants with deceptively high market shares (because the Agencies' view is static, not dynamic). The Agencies remain likely to give insufficient weight to long-term supply constraints. Finally, because the role of innovation continues to be inadequately considered (the mergers achieve "only" dynamic efficiencies), high-tech mergers remain potentially vulnerable to attack as anticompetitive based on structural market characteristics (such as network effects).

We are thus still far away from a merger framework that, in Schumpeter's words, captures "capitalist reality as distinguished from its textbook picture." The Agencies' decision not to amend Section 10, and the addition of new Section 2.2.3, suggest a deliberate policy decision to give undue weight to the benefits of enforcement, and too little weight to the costs of excessive deterrence. This policy preference calls to mind the implicit policy decision of the Federal Circuit during the 1980s and 1990s, that, because patents reward innovation, facilitating the issuance of more patents must also be good for innovation. In truth, antitrust enforcement is good, but more antitrust enforcement is not better. Chilling procompetitive mergers that have the potential for leapfrogging innovation can and will do very great harm to consumer welfare, and I hope that we will see further improvements in future Guidelines to rectify these apparent shortcomings. ●