

JUST THE FACTS: THE ROLE OF CUSTOMER AND
ECONOMIC EVIDENCE IN M&A ANALYSIS

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*Facts are stubborn things; and whatever may be our wishes, our inclinations, or the dictates of our passions, they cannot alter the state of facts and evidence.*¹

INTRODUCTION

The U.S. competition agencies—the U.S. Federal Trade Commission (“FTC”) and U.S. Department of Justice (“DOJ”)—and U.S. courts (and their counterparts in other jurisdictions with mature enforcement regimes) have become increasingly sophisticated in their analysis of potential transactions, having evolved from the pure *structure-conduct-performance* paradigm of the 1950s-1970s, which the U.S. Supreme Court’s decision in *United States v. Philadelphia National Bank* epitomized.² Antitrust enforcers today recognize the importance of “fact-based analyses that properly account for institutions and *all* the relevant theories, not just market structure and market power theories.”³ This has led to more nuanced analyses

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¹ Timothy J. Muris, Former Chairman of the Federal Trade Commission, Address at the American Bar Association Antitrust Section Annual Meeting: Antitrust Enforcement at the Federal Trade Commission: In a Word—Continuity (Aug. 7, 2001), <http://www.ftc.gov/speeches/muris/murisaba.htm> (quoting John Adams).

² See generally *United States v. Philadelphia Nat’l Bank*, 374 U.S. 321 (1963) (establishing a presumption of anticompetitive harm from a merger resulting in a significant increase in concentration and the merged firm having a substantial market share).

³ Timothy J. Muris, Former Chairman of the Federal Trade Commission, Address at the George Mason Law Review’s Winter Antitrust Symposium, Improving the Economic Foundations of Competi-

such as those advocated by the New Institutional Economics school, which places a greater emphasis on dynamic market characteristics beyond merely size and concentration, including the interactions that firms have with suppliers, customers, and each other.⁴

With the increased focus on specific industry facts and performance dynamics, agencies now consider a broad spectrum of “staple” sources of evidence, including documents, written responses to interrogatories, economic/econometric analyses, and testimony from customers, competitors, and industry consultants. Agencies are training staff to collect and evaluate all evidence, as reflected in the DOJ’s framework for coordinated effects analysis⁵ and the International Competition Network (“ICN”) handbook on investigative techniques for merger review.⁶ These guides encourage agency staff to take a holistic approach during the investigation stage of a transaction to obtain a more complete and rounded picture of likely future competitive effects.

Despite this greater emphasis on training, recently, U.S. agencies have not fared well before the courts in their use of customer and economic evidence.⁷ This article provides: (1) a summary of recent agency views towards customer and economic evidence; (2) an overview of their treatment in recent U.S. cases; and (3) suggestions on the use of such evidence before agencies and the courts.

tion Policy (Jan. 15, 2003), <http://www.ftc.gov/speeches/muris/improveconfoundatio.htm>.

⁴ See Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. ECON. LIT. 595 (2000).

⁵ See Andrew R. Dick, *Coordinated Interaction: Pre-Merger Constraints and Post-Merger Effects*, 12 GEO. MASON L. REV. 65 (2003); Charles A. James, Address at the American Bar Association Annual Meeting Section of Antitrust Law: Rediscovering Coordinated Efforts (Aug. 13, 2002), <http://www.usdoj.gov/atr/public/speeches/200124.htm>.

⁶ INTERNATIONAL COMPETITION NETWORK, ICN INVESTIGATIVE TECHNIQUES HANDBOOK FOR MERGER REVIEW (Jun. 2005), http://www.internationalcompetitionnetwork.org/handbook_5-5.pdf [hereinafter ICN HANDBOOK].

⁷ Similarly, the E.U. Court of First Instance criticized the factual record, and particularly lack of economics, in three decisions annulling Commission merger prohibitions: Cases T-5/02, *Tetra Laval BV v. Commission* [2002] E.C.R. II-4381; Case T-310/01, *Schneider Electric v. Commission* [2002] E.C.R. II-4071; Case T-342/99, *Airtours v. Commission* [2002] E.C.R.-II 2585. These losses resulted in major procedural reforms. See Michael Byowitz & Ilene Knable Gotts, *Could Convergence Be in the Cards? U.S. and EU Antitrust Agencies Issue “Best Practices for Coordinating Merger Reviews and EU Commissioner Proposes Review Process Changes*, 6 M&A LAW. 1 (2002), available at <http://www.ftc.gov/opa/2002/10/mergerbestpractices.htm>.

I. CUSTOMER EVIDENCE

A. *Role of Customer Evidence in Agency Investigations*

“Customers benefit from competition. Thus, in general, customers’ interests are very close to the interest in the competitive process that the agency is trying to protect. For this reason, customers can be a very useful source of information.”⁸

U.S. agencies (particularly their lawyers) typically place significant weight on the opinions of the merging parties’ customers regarding the potential effects of a merger on competition.⁹ Customers may be particularly well placed to provide useful information based on first-hand experience, which can have a direct bearing on a variety of competitive considerations, including the degree of competition among firms on such key dimensions as price, quality of products and services offered, and pace of innovation. From such information, the investigating agency may infer the likely competitive impact from the loss of rivalry between the merging firms. Customers can also provide information that is instructive in delineating the relevant market, including the alternatives available to the products or services offered by the merging parties (“product market”), and how far they are willing to go to obtain those products or services (“geographic market”).¹⁰ Customer testimony may also help validate or refute arguments regarding ease of entry into a particular market—at least currently.¹¹

⁸ ICN HANDBOOK, *supra* note 6, at 43.

⁹ For example, in DOJ’s recent investigation of the proposed merger of Whirlpool Corporation and Maytag Corporation, the parties demonstrated substantial support for the merger on the part of many retail customers (although this was not mentioned in the DOJ’s press release announcing its decision to close its investigation). During a government investigation, such testimony is typically obtained through informal telephone discussions or meetings. In some situations, customers will also participate in investigational hearings or depositions. For those matters that end up in court, affidavits are often used, together with in-court testimony.

¹⁰ David Scheffman, Remarks to a session on “The Use of Economics in EC Competition Law,” delivered in Brussels, Belgium: Sources of Information and Evidence in Merger Investigations: An FTC Economist’s View (Jan. 2003), <http://www.ftc.gov/speeches/other/sourcesofinfobrussels03.pdf>.

¹¹ Although the focus here is on customer testimony, competitors and industry consultants can also provide useful information regarding key industry facts, such as identifying important customers, substitute products, entry conditions, and the nature and significance of innovation in the industry. Industry experts can also assess the likelihood of claimed efficiencies being realized and whether those efficiencies are truly merger-specific, and may be in a unique position to identify current industry trends, such as repositioning that is taking place by actual and potential competitors. Caution should be exercised, however, when obtaining and relying on such evidence, especially competitor testimony. Competitors may fear that the merged firm will be a stronger and more effective market participant than either of the merging parties alone, and may therefore oppose a procompetitive transaction, or they may anticipate that the merger will lead to higher prices, and thus favor an anticompetitive transaction.

There are, however, potential problems with customer evidence that can severely limit its utility: First, customer opinions are just that—subjective opinions. Customers typically have their own motives and agendas and may use merger investigations to advance those private agendas. For example, customers may wish to: (1) obtain “sweetheart deals” from suppliers; (2) obtain better deals than their rivals (where customers are not end users but rather compete with each other);¹² or (3) avoid adjustment costs associated with changes in merged firm operations.¹³ In industries where customers are less sophisticated, their opposition to mergers may be based more on fears about change or uncertainty regarding their options rather than true competitive concerns. It may be difficult for agency staff to determine whether customer concerns are based on genuine fear of anticompetitive effects resulting from proposed mergers, or based on other motives and misgivings.

Second, customers may lack sufficient information or expertise to assess complex issues such as market definition and competitive effects.¹⁴ For example, customers may not be privy to the plans of the transaction parties or third parties that could affect future competitiveness; customers may not be fully aware of all the supply alternatives available to them; or they may not be uniquely placed to predict whether prices or quality will be adversely affected by the transaction.¹⁵

Third, there may be too many customers, or too many different categories of customers, to canvass adequately the full range of customer views.¹⁶

Industry consultant testimony, while potentially valuable, should not be viewed as a substitute for other forms of evidence such as documents or economic analysis: for example, an industry expert’s opinion that a particular industry practice is routine does not mean that the practice is not anticompetitive. See ICN HANDBOOK, *supra* note 6, at 43, 46. The court in the *Oracle* case, discussed *infra*, considered in detail testimony of competitor and industry witnesses offered by both sides. See *infra* Part I.B.3 and note 34.

¹² See Joseph Farrell, *Listening to Interested Parties in Antitrust Investigations: Competitors, Customers, Complementors, and Relativity*, ANTITRUST, Spring 2004, at 64.

¹³ Robert H. Lande & James A. Langenfeld, *Recent Trends in Merger Enforcement in the United States: The Increasing Impact of Economic Analysis*, 15 NIHON U. COMP. L.J. 73, 94 (1998).

¹⁴ Scheffman, *supra* note 10, at 4. With regard to the hypothetical monopolist test for market definition contained in the DOJ/FTC 1992 Horizontal Merger Guidelines, see *infra* note 27, it has been observed: “In the 1980s and into the early 1990s, (the early years for the implementation of the Guidelines at the FTC), legal staff investigations placed considerable emphasis on the answers of customers to the hypothetical price increase question. In retrospect, it is clear that customers had difficulty understanding the hypothetical question . . .” David Scheffman, Malcolm Coate, & Louis Silvia, *20 Years of Merger Guidelines Enforcement at the FTC: An Economic Perspective*, 71 ANTITRUST L.J. 13 (2002), available at <http://www.usdoj.gov/atr/hmerger/12881.pdf>.

¹⁵ For further discussion of customers lacking relevant information, see Lande & Langenfeld, *supra* note 13, at 91-93.

¹⁶ Scheffman, *supra* note 10, at 3.

One way, potentially, to address this empirical concern is by conducting a statistical survey of clearly defined subsets of customers, although this poses its own challenges, for example, selecting a truly representative sample from the total customer base.¹⁷

B. *Attitude of the Courts to Customer Evidence*

Federal courts explicitly expressed concerns with customer evidence in three recent agency challenges:

1. *SunGard*

*United States v. SunGard Data Systems, Inc.*¹⁸ involved the proposed acquisition of Comdisco Inc.'s disaster recovery solutions assets by SunGard Data Systems. The case substantially turned on the issue of market definition. The DOJ argued that the provision of shared hotsite services for customers with mainframe and midrange computer processing centers constituted the appropriate relevant market: under this definition, the proposed transaction would have created a virtual duopoly, with the merged firm having a 71% share of the market, and IBM controlling almost all of the remainder.¹⁹ In contrast, the defendants proposed a much broader market definition encompassing various other disaster recovery systems, including high availability solutions, internal hotsites (self-provisioning), and quick-ship services.²⁰ The defendants contended that numerous firms competed in this broader market and the merged firm would have, at most, a 35% share.²¹ The DOJ based its case on approximately fifty statements from customers indicating that they would not switch to a substitute product or self-provisioning in response to a small but significant and nontransitory increase in price ("SSNIP") of the merging parties' product (shared hotsite services for customers with mainframe and midrange computer processing centers).²²

¹⁷ On the other hand, in certain types of mergers, such as those involving differentiated products or services, the real issue may not be identifying a subset of customers that is representative of all customers, but rather determining whether there is a narrower market consisting of a group of customers that could be harmed because of the merger. This is discussed further below. *See infra* Part I.C.

¹⁸ *United States v. SunGard Data Sys., Inc.*, 172 F. Supp. 2d 172 (D.D.C. 2001).

¹⁹ *Id.* at 181.

²⁰ *Id.* In support of such a broader market definition, the defendants offered 68 letters from former SunGard clients who had switched from a shared hotsite service to an internal solution. *Id.* at 188.

²¹ *See id.* at 187.

²² *Id.* at 192.

The court rejected the sufficiency of the DOJ's evidence, noting that defendants had about 7,500 customers and the DOJ failed to show that the fifty complaining customers constituted a representative sampling of the entire client base for the relevant product.²³ The court noted that the DOJ's sampling failed to account for significant differences among customers in terms of their size, the equipment they used, and their business needs. Thus, the government's fifty customer statements did not provide a sufficient foundation for the court to determine that the merged firm could profitably raise price post acquisition under a hypothetical monopolist test.²⁴ Accordingly, the court found in the defendants' favor.²⁵

2. *Arch Coal*

In *FTC v. Arch Coal, Inc.*, the FTC sought to block the acquisition by Arch Coal Inc., an owner and operator of coal mines in Wyoming, of two mines held by Triton Coal Company LLC, a subsidiary of New Vulcan Coal Holdings LLC.²⁶ Before the FTC voted to challenge the proposed acquisition, Arch Coal entered into an asset purchase agreement for the sale of one of those mines to Kiewit, another mining company. The FTC challenged both the acquisition by Arch Coal and the transfer to Kiewit, on the ground that the transactions would lead to a substantial lessening of competition in the supply of coal from the Southern Powder River Basin ("SPRB") region of Wyoming.²⁷ After a two-week trial, the U.S. District Court for the District of Columbia dismissed the FTC's motion for a preliminary injunction.²⁸

²³ *Id.*

²⁴ From this evidence, one can only surmise that there are some customers that cannot switch to an internal solution in response to a SSNIP of shared hotsites, nor can they make a credible threat to switch in order to keep the merged company from raising prices. The government has failed, however, to show whether this captive group is substantial enough that a hypothetical monopolist would find it profitable to impose such an increase in price. *Id.* at 191-92.

²⁵ *Id.* at 193. Most merger challenges involve a motion for preliminary injunction, in which the standard of proof is "likelihood of success on the merits." In contrast, *SunGard* involved a full trial on the merits before the U.S. District Court for the District of Columbia, which imposed a higher standard of proof on the DOJ. *SunGard*, 172 F. Supp. 2d 172, 180.

²⁶ *FTC v. Arch Coal, Inc.*, 329 F. Supp. 2d 109 (D.D.C. 2004), *appeal dismissed per curiam*, No. 04-5291, 2004 U.S. App. LEXIS 18620 (D.C. Cir., Aug. 20, 2004).

²⁷ *Id.* at 114-15. The FTC relied on a coordinated effects theory of anticompetitive harm. Under a coordinated effects theory, "a merger may diminish competition by enabling the firms selling in the relevant market more likely, more successfully, or more completely to engage in coordinated interaction that harms consumers," for example, through tacit or express collusion on price or output. U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 2.1 (1992), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104 (Apr. 8, 1997) [hereinafter HORIZONTAL MERGER GUIDELINES].

²⁸ A motion by the FTC to the U.S. Court of Appeals for the District of Columbia Circuit for an

The FTC relied heavily on testimony from utility customers expressing concern that the consolidation would result in higher prices for coal in the SPRB. However, the court (Judge John D. Bates) gave little weight to this customer testimony:

[W]hile the Court does not doubt the sincerity of the anxiety expressed by SPRB customers, the substance of the concern articulated by the customers is little more than a truism of economics: a decrease in the number of suppliers *may* lead to a decrease in the level of competition in the market. Customers do not, of course, have the expertise to state what *will* happen in the SPRB market, and none have attempted to do so. The Court therefore concludes that the concern of some customers in the SPRB market that the transactions will lessen competition is not a persuasive indication that coordination among SPRB producers is more likely to occur.²⁹

The court predicated its comments regarding customer complaints on the legal standard that the FTC must meet to obtain a preliminary injunction in a Clayton Act Section 7 case,³⁰ requiring anticompetitive effects to be “likely” or “reasonably probable,” and not just “possible” or “feasible.”³¹ The court indicated that customers do not have the necessary expertise and are not qualified to opine on this question in any meaningful way.³² Instead, the court considered factors such as whether there was a history of coordinated interaction, the SPRB market structure and dynamics, and the role of maverick producers.³³

injunction pending appeal was denied, and the case was subsequently dismissed voluntarily. Subsequent to the court’s decision, the FTC continued its investigation into Arch Coal’s acquisition, eventually announcing that it would not proceed with an administrative trial and that it had closed its investigation. See Press Release, Fed. Trade Comm’n, FTC Closes Its Investigation of Arch Coal’s Acquisition of Triton Coal Company’s North Rochelle Mine (Jun. 13, 2005), available at <http://www.ftc.gov/opa/2005/06/archcoal.htm>.

²⁹ *Arch Coal*, 329 F. Supp. 2d at 145-46.

³⁰ 15 U.S.C. § 18 (2006).

³¹ *Arch Coal*, 329 F. Supp. 2d at 115-116, 138. Note that the court found that the FTC only barely succeeded in establishing a prima facie case of anticompetitive harm, since the market concentration figures were only slightly above the safe harbor thresholds set out in the Horizontal Merger Guidelines. *Id.* at 129.

³² At least one senior government economist agrees with this aspect of the court’s opinion in *Arch Coal*: “I do not see how the Federal Rules of Evidence permit testimony from witnesses with experience as buyers but no specialized knowledge of economics or any other discipline that would qualify them to opine about increased risk of coordination. That is not something they have any basis for knowing about.” *Coordinated Effects Analysis: The Arch Coal Decision*, THE ANTITRUST SOURCE, March 2005, at 10-11 (comments of Gregory J. Werden). On the other hand, Werden criticizes the court in *Arch Coal* for allegedly accepting customer testimony as supporting the view that the market was currently performing competitively.

³³ *Arch Coal*, 329 F. Supp. 2d at 138.

3. *Oracle*

The much-publicized *United States v. Oracle Corp.* decision involved a hostile cash tender offer for PeopleSoft by Oracle, a competing provider of enterprise accounting and human resources software.³⁴ In February 2004, the DOJ, along with seven state attorneys general, filed suit in the U.S. District Court for the Northern District of California seeking to enjoin the transaction. The DOJ alleged that the acquisition would substantially lessen competition in the market for high function Human Resources Management (“HRM”) software and high function Financial Management Services (“FMS”) software.³⁵

Both Oracle and the DOJ used customer testimony at trial, although the DOJ relied much more heavily on customer testimony than the defendant, presenting ten customer witnesses. The court (Judge Vaughn R. Walker) viewed DOJ’s customer evidence as follows:

In the main, and contrary to the characterization of plaintiffs’ counsel before trial, the court found the testimony of the customer witnesses largely unhelpful The test of market definition turns on reasonable substitutability Customer preferences towards one product over another do not negate interchangeability [T]he issue is not what solutions the customers would *like* or *prefer* for their data processing needs; the issue is what they *could* do in the event of an anticompetitive price increase by a post-merger Oracle. Although these witnesses speculated on that subject, their speculation was not backed up by serious analysis that they had themselves performed or evidence they presented [U]nsubstantiated customer apprehensions do not substitute for hard evidence [T]he most persuasive testimony from customers is not what they say in court, but what they do in the market.³⁶

By contrast, the court found that the smaller number of Oracle witnesses “testified about concrete and specific actions that they had taken and been able to complete in order to meet their firms’ information processing needs, apart from relying on the three ERP vendors that plaintiffs contend

³⁴ *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

³⁵ The DOJ focused primarily on a unilateral effects theory of competitive harm. Unilateral competitive effects can occur because “merging firms may find it profitable to alter their behavior unilaterally following the acquisition by elevating price and suppressing output,” even though other firms in the market continue to compete independently. HORIZONTAL MERGER GUIDELINES, *supra* note 27, at § 2.2.

³⁶ *Oracle*, 331 F. Supp. 2d at 1130-31, 1167 (emphasis added). In a similar vein, former FTC Chairman Robert Pitofsky has observed that “a determination that there is a class of ‘captive’ customers with strong preferences for a particular product could be the beginning but cannot be the end of the Court’s analysis. There will almost always be classes of customers with strong preferences for physically distinguishable products, but to reason from the existence of such classes to a conclusion that each is entitled to the ‘protection’ of a separate narrow market definition grossly overstates the market power of the sellers.” Robert Pitofsky, *New Definitions of Relevant Market and the Assault on Antitrust*, 90 COLUM. L. REV. 1805, 1816 (1990).

are a market unto themselves”³⁷ (i.e., Oracle, PeopleSoft and SAP). The court thus found Oracle’s witnesses to be more believable.³⁸

Judge Walker’s comments in *Oracle* regarding customer evidence are somewhat narrower than Judge Bates’ broad criticisms in *Arch Coal*. According to Judge Walker, for subjective customer views to have any weight, they must be backed up with “real” evidence that substantiates customer fears; for example, empirical evidence regarding customers’ actual prior purchasing decisions, or information regarding the cost of potential supply alternatives.³⁹

C. *Lessons Learned Regarding Customer Evidence in Recent Merger Cases*

It remains to be seen whether the decisions in *SunGard*, *Arch Coal* and *Oracle* are “aberrations on the subject of customer testimony.”⁴⁰ In the meantime, there are some lessons and practical tips that can be gleaned from the cases:

* Recent judicial pronouncements should *not* be interpreted to mean that customer testimony is unimportant in a Clayton Act Section 7 case. In fact, as Acting Assistant Attorney General Thomas Barnett noted, appropriate customer testimony can still win the day.⁴¹ Customer evidence that has a solid foundation (as described below) will likely continue to be given serious consideration by courts, and will be used to support (or perhaps, in some cases, contradict) documentary and economic evidence.

* More attention should be given to the proper scope of customer evidence. Customer opinions can be useful in aiding the court’s understanding of the history, nature and structure of the industry and its vendor/buyer relationships. More difficult questions arise in evaluating the potential utility of customer opinions concerning the key “legal” questions of market definition and competitive effects.⁴² In particular, lay purchasers of goods and services may lack the legal or economic expertise to comment credibly on whether a merger is likely to reduce competition, whether through coordi-

³⁷ *Oracle*, 331 F. Supp. 2d at 1133.

³⁸ *Id.*

³⁹ *Id.* at 1131.

⁴⁰ James A. Keyte, *Arch Coal and Oracle Put the Agencies on the Ropes in Proving Anticompetitive Effects*, 19 ANTITRUST 79, 85 (Fall 2004).

⁴¹ See *Interview with Thomas Barnett*, THE ANTITRUST SOURCE, May 2005, at 3. Effective June 25, 2005, Mr. Barnett became Acting Assistant Attorney General for the DOJ’s Antitrust Division.

⁴² There is also the issue of whether the Federal Rules of Evidence permit such testimony. That question is beyond the scope of this article.

nated interaction or the unilateral exercise of market power. Customer evidence will be more useful when a key economic issue is the likely magnitude of buyer substitution in response to higher post-merger prices. Examples include defining the relevant market and where unilateral effects from the loss of localized competition among sellers of differentiated products is the theory of anticompetitive harm (as in *Oracle*). In *Arch Coal*, the FTC relied on customer testimony to establish anticompetitive coordinated effects, while in *Oracle* the DOJ sought to delineate the relevant market through customer evidence. The greater skepticism expressed in *Arch Coal* supports the notion that customer opinions are more likely to be helpful determining the scope and structure of the relevant market rather than proving likely effects on future competition (especially in a coordinated effects case),⁴³ since customers may simply be unaware of future technological and market developments. Customers may particularly lack such knowledge in high-tech, nascent or evolving industries.

* To be most effective, customer testimony should be supported by other “tangible” evidence, such as concrete examples of actual prior purchasing decisions, or verifiable information regarding the costs of switching to alternative sources of supply. “Bare” customer claims that the removal of a competitor is likely to influence adversely prices, quality, etc., are generally unhelpful. Similarly, a customer’s testimony that it would (or would not) switch to a competing product in response to a hypothetical five or ten percent price increase may not, without further explanation, be given much weight.⁴⁴ Such assertions, however, can be useful when supported by evidence of, such as specific prior instances when one of the merging parties raised prices, and the customer turned (or did not turn) to other supply options. Once the relative proportions of marginal and inframarginal customers are determined, this information can be used, together with a critical loss analysis, to define a relevant market.⁴⁵ Customer evidence can there-

⁴³ Customer evidence may still have value in cases where the theory of competitive harm is based on coordinated interaction. Although the FTC in *Arch Coal* relied too heavily on customer testimony, it could perhaps have used this evidence more effectively to establish facts from which an inference of likely anticompetitive effects could be drawn (for example, by asking the customers who buy coal from the PRB whether they had historic experience with possible coordinated conduct among suppliers), rather than merely having the utilities predict the ultimate conclusion regarding prices.

⁴⁴ In *Oracle*, for example, a number of DOJ’s customer witnesses stated that they did not consider providers of so-called “best of breed” solutions as a suitable alternative to the software packages offered by the defendants, and would not switch to such a solution in response to a price increase by Oracle or PeopleSoft (“best of breed” vendors sell individual software modules rather than an integrated suite of products). This testimony did not hold much sway over the court. In fact, one of the defendants’ economists, Professor Jerry Hausman, performed an analysis of discounting practices that showed the presence of best of breed vendors was already constraining the prices charged by providers of software bundles, including the defendants. *Oracle*, 331 F. Supp. 2d at 1155.

⁴⁵ Inframarginal customers are those who would not switch to another product in response to a

fore be used to build a foundation for economic testimony regarding market definition and competitive effects. However, such evidence may be of limited probativeness when current prices are at historically high levels and past price increases may not have been sufficiently high to cause shifting.

* Even when there appear to be legitimate grounds for customer complaints, it is in the interests of both sides (including the investigating agencies) to explore *all* the motivations for customer apprehensions to determine the relative importance of competitive concerns.⁴⁶ The transaction parties may use such information to challenge the complainant's testimony. Agency knowledge of such motivations may minimize the risk of being surprised by a court's criticism (or entire disregard) of the testimony.

* Transaction parties seeking to obtain written customer affidavits prior to or during an agency investigation should interview each customer individually and tailor the affidavits to reflect each customer's specific circumstances. Courts are likely to afford greater weight to personalized customer affidavits rather than standard form customer statements. Note that sending affidavits to customers may cause problems with preserving the privilege and/or confidentiality of draft affidavits.

* Both *SunGard* and *Oracle* suggest that customer opinions are less helpful where the customer base is very large and/or heterogeneous because of difficulties in selecting a sample that is truly representative of the entire customer base.⁴⁷ This is true whether customer testimony is being used to define the relevant market or to prove anticompetitive effects, as it requires showing that there are not enough customers who would defeat an attempted price increase⁴⁸ by a hypothetical monopolist, in the market definition context, or by the merged firm, in the case of anticompetitive effects.⁴⁹ However, when applying the SSNIP test in the context of mergers involving differentiated products or services to a variegated customer base, the focus should not typically be on whether the chosen sample is representa-

price increase, while marginal customers are those who would switch. If, for a hypothesized product or geographic market definition, the volume of sales represented by marginal customers (*i.e.*, those that would switch in response to a price increase) is greater than the critical loss level (*i.e.*, the level of lost sales at which a price increase is unprofitable), then a hypothetical monopolist would not find it profitable to raise price, thereby suggesting that a broader market definition is appropriate. See discussion on economic analysis *infra* Part II.

⁴⁶ See Lande & Langenfeld, *supra* note 13, at 95.

⁴⁷ Formal surveys may be helpful in these situations.

⁴⁸ J. Stephen Stockum & O. Andrew Garibaldi, *The Oracle Decision and Evidentiary Issues on Substitutability in Merger Cases*, 14 *ECONOMISTS INK* 1, 4 (2004).

⁴⁹ "Drawing generalized conclusions about an extremely heterogeneous customer market based upon testimony from a small sample is not only unreliable, it is nearly impossible." *Oracle*, 331 F. Supp. 2d at 1167 (citation omitted). See also *supra* note 24.

tive of the whole customer base. Rather, the focus should be on whether there are narrower markets consisting of subsets of customers that are vulnerable to a post-merger price increase, even if the remaining customers are able to take care of themselves. Testimony from customers sharing particular characteristics, together with evidence of differential pricing to those customers, can aid in this determination.

* Agency concerns in most mergers are resolved without litigation. Accordingly, notwithstanding the skepticism towards customer testimony expressed by some courts, transaction parties should not discount the significant weight attributed to customer opinions by the agencies.⁵⁰ Indeed, FTC Chairman Deborah Majoras recently affirmed the importance of customer information in her decision making.⁵¹ Moreover, agency staff continue to rely heavily on customer interviews as their first “screen” regarding whether to investigate and ultimately to challenge (or accept relief).⁵² It is therefore common, and advisable, for transaction parties to solicit customer reactions to the proposed transaction early in the process and to take appropriate steps so that customers have an accurate sense of the post-merger firm, including its plans regarding continuation of existing operations and policies, and likely customer benefits from the transaction.⁵³

⁵⁰ Interpretation of customer evidence is ultimately about interpretation of facts, which is influenced by ideology. Agencies are receptive to customer evidence and focus on consumer harm as their mission; whether courts are receptive will vary, and may depend on the court’s view of the theory of competitive harm that is alleged and the standard of proof that is appropriate.

⁵¹ Deborah Platt Majoras, Chairman, Fed. Trade Comm’n, Remarks before the Studienvereinigung Kartellrecht, Brussels, Belgium: U.S. Antitrust Practice—How Does It Affect European Business? (Apr. 7, 2005), <http://www.ftc.gov/speeches/majoras/050411brussels.pdf>. Chairman Majoras notes that customers have the most to lose from an anticompetitive transaction and therefore are valuable sources of information about competitive effects. *Id.* at 10.

⁵² The FTC published statistics from past horizontal merger investigations that show it is much more likely to seek relief in merger cases where strong customer complaints are received. *See* FED. TRADE COMM’N, HORIZONTAL MERGER INVESTIGATIONS DATA, FISCAL YEARS 1996-2003, 27-30 (2004), available at <http://www.ftc.gov/os/2004/08/040831horizmergersdata96-03.pdf>.

⁵³ There are also sound business reasons for seeking customer feedback, unrelated to antitrust concerns. If a substantial proportion of the merging parties’ customers (or a small number of key customers) are hostile to the merger then the merged firm risks losing significant business. Thus, even if the merger receives antitrust clearance, it may turn out to be unsuccessful from a financial standpoint. Scheffman, *supra* note 10, at 4. Transaction parties should be careful, however, not to rely too heavily on positive customer feedback—it is not unheard of for customers to convey very different messages to the merging parties, on the one hand, and the agency staff, on the other. *See, e.g.*, *United States v. SunGard Data Systems, Inc.*, 172 F. Supp. 2d 172, 192 (D.D.C. 2001) (“Finally, several customers submitted conflicting statements, telling the defendants one thing and the government another”). There may also be differences of opinion among employees of the same customer. *See, e.g.*, *United States v. Long Island Jewish Med. Ctr.*, 983 F. Supp. 121, 131-32, 138-39, 144 (E.D.N.Y. 1997).

II. ECONOMIC EVIDENCE

A. *Role of Economic/Econometric Evidence in Agency Investigations*

“The challenge of economic analysis in antitrust investigations is to develop empirical analyses that can shed light on market definition, competitive effects, barriers-to-entry, and efficiencies.”⁵⁴

For the last few decades, economic evidence has played an important, sometimes critical, role in U.S. merger investigations. Economic methodologies can potentially be used at every stage of merger analysis. “Economic evidence” encompasses a wide spectrum of techniques and information of varying complexity, ranging from merely organizing and presenting a set of quantitative data (e.g., prices, revenues, production capacities) in a specific manner, to performing in-depth econometric (statistical) analyses.⁵⁵ There are many types of econometric and other economic analyses, although in investigations of most transactions only some of these will be both possible and worthwhile. Examples include:

* Estimating own and cross-price elasticities of demand,⁵⁶ which can be used, together with a critical loss analysis,⁵⁷ to perform the hypothetical

⁵⁴ David T. Scheffman & Mary T. Coleman, *Current Economic Issues at the FTC*, 21 REV. OF INDUS. ORG. 357, 359 (2002).

⁵⁵ Econometrics is “the application of statistical techniques and inferences to observed data in order to evaluate economic theories and their predictions.” ABA SECTION OF ANTITRUST LAW, *ECONOMETRICS 1* (John D. Harkrider & Daniel Rubinfeld eds., 2005) [hereinafter *ECONOMETRICS*]. It has been asserted that “the principal value of econometrics for antitrust analysis and litigation lies in its use for developing an empirical foundation in order to prove or disprove assertions that are based on a particular economic theory.” *Id.*

⁵⁶ “Own price elasticity” is a measure of the responsiveness of a product’s quantity demanded to a change in its own price; “cross-price elasticity” is a measure of the responsiveness of a product’s quantity demanded to a change in the price of some other product. See Gregory J. Werden, *A Perspective on the Use of Econometrics in Merger Investigations and Litigation*, 16 ANTITRUST 55, 56 (2002). One commonly used means of estimating demand elasticities in branded consumer products cases is through analysis of retail scanner data. See Daniel Hosken, Daniel O’Brien, David Scheffman & Michael Vita, *Demand System Estimation and its Application to Horizontal Merger Analysis* (Fed. Trade Comm’n, Working Paper No. 246, 2002), available at <http://www.ftc.gov/be/workpapers/wp246.pdf>.

⁵⁷ Critical loss analysis seeks to identify, for any given price increase, the quantity of sales that can be lost before the price increase becomes unprofitable. For a detailed discussion of critical loss analysis, see Barry C. Harris & Joseph J. Simons, *Focusing Market Definition: How Much Substitution is Necessary?*, 12 RESEARCH IN LAW AND ECONOMICS 207 (1989); James Langenfeld & Wenqing Li, *Critical Loss Analysis in Evaluating Mergers*, 46 THE ANTITRUST BULLETIN 299 (2001); Kenneth L. Danger & H.E. French III, *Critical Thinking about ‘Critical Loss’ in Antitrust*, 46 THE ANTITRUST BULLETIN 339 (2001); Michael L. Katz & Carl Shapiro, *Critical Loss: Let’s Tell the Whole Story*, 17

monopolist test for market definition as set out in the 1992 DOJ/FTC Merger Guidelines.⁵⁸ This test involves determining what volume of lost sales will make a SSNIP unprofitable (the critical loss), and whether the actual volume of sales likely to be lost because of a SSNIP will exceed this amount.⁵⁹

* Natural experiments, that “try to exploit differences in data over space, time, and competitors to shed light on market definition, barriers, and potential competitive effects.”⁶⁰ For example, in an industry characterized by frequent merger activity, a natural experiment analysis might look at the impact on price (or other competitive factors) of changes in concentration resulting from past mergers, from which inferences may be drawn regarding the likely impact on price of the merger presently under investigation.⁶¹ A similar, and more commonly used, natural experiment analysis focuses on differences in market structure across geographic regions to determine whether prices vary based on market structure.⁶²

* Merger simulations, which utilize estimated demand elasticities, in conjunction with a model of firm behavior, to predict the merger’s likely effect on price.⁶³

Economic evidence can provide valuable additional support for (or help to refute) theoretical arguments regarding market definition, competitive effects, entry, etc.⁶⁴ Nevertheless, there are several potential problems with economic and econometric analysis,⁶⁵ including:

ANTITRUST 49 (2003); Daniel P. O’Brien & Abraham L. Wickelgren, *A Critical Analysis of Critical Loss Analysis* (Fed. Trade Comm’n, Working Paper No. 254, 2003), available at <http://www.ftc.gov/be/workpapers/wp254.pdf>.

⁵⁸ See HORIZONTAL MERGER GUIDELINES, *supra* note 27.

⁵⁹ John D. Harkrider, *Operationalizing the Hypothetical Monopolist Test*, in FTC/DOJ JOINT WORKSHOP ON MERGER ENFORCEMENT 2-3 (2004), available at <http://www.usdoj.gov/atr/public/workshops/docs/202598.pdf>.

⁶⁰ David Scheffman & Mary Coleman, *FTC Perspectives on the Use of Econometric Analyses in Antitrust Cases*, in ECONOMETRICS, *supra* note 55, at 124, available at <http://www.ftc.gov/be/ftcperspectivesoneconometrics.pdf>.

⁶¹ As Scheffman and Coleman point out, such an econometric analysis must control for factors other than market structure that can affect prices over time. ECONOMETRICS, *supra* note 55, at 124.

⁶² Another type of natural experiment involves assessing the impact of new entry on prices. *Id.*

⁶³ For a detailed overview of merger simulation, see Gregory J. Werden, Luke M. Froeb, & David T. Scheffman, *A Daubert Discipline for Merger Simulation*, 18 ANTITRUST 89 (2004).

⁶⁴ The advantages of econometric evidence include: (1) it can be used “to show whether certain factors” (e.g., inflation or demographic changes) “affect or do not affect another particular factor or event” (e.g., a price rise following a merger); (2) it can be used to show the likelihood that one event or fact (e.g., a merger) is causally related to another (e.g., a rise in price); and (3) it “allows for the aggregation of all the material data on a particular issue” (e.g., all attempts at entry over a relevant time period), thereby avoiding the danger of selecting and evaluating only a limited and unrepresentative set

(1) Such analyses (as with any statistical analysis) are based on methodologies that frequently rely on a series of assumptions that are, at best, only approximations of reality.⁶⁶ Moreover, the results of the analysis can be very sensitive to one or more of the model's assumptions, thus their reliability can be significantly reduced if one or more of those assumptions are wrong.

(2) The results of economic/econometric analyses are only as reliable as the data on which they are based. Where the source of the underlying data is suspect, or where data are inaccurate, and such deficiencies are not appropriately accounted for, caution must be exercised before relying upon the resulting analytical conclusions.⁶⁷

(3) It is important to choose methodologies that fit the particular facts and are relevant to the key issues under consideration.⁶⁸ Failure to exercise care can produce results that are meaningless or, even worse, misleading.

(4) Even when the economic analysis is sound, explaining the analysis and its conclusions so that they are properly incorporated into the decision-making of non-economists (e.g., most judges) can present a significant practical hurdle. Confusion can result for a variety of reasons, such as lack of transparency in the underlying data or model (and its assumptions), failure to show how the analysis fits in with "key institutional factors and facts,"⁶⁹ or the sheer complexity of the statistical methodologies used. Decision makers may treat conflicting economic/econometric studies as simply "canceling each other out."⁷⁰

More generally, it is important to recognize that economic models have inherent limitations, since they only reflect the structure of a market as it exists today and as it is expected to look tomorrow. The models then attempt to predict from this structure how firms will behave post-merger. Thus, economic evidence is often the application of particular theories regarding market structure rather than direct evidence of actual market per-

of data points (e.g., a single example of successful or unsuccessful entry). *ECONOMETRICS*, *supra* note 55, at 3-4.

⁶⁵ For a list of suggested "best practices" for econometric/empirical analyses, see *ECONOMETRICS*, *supra* note 55, at 118-22.

⁶⁶ *See id.* at 117; Lande & Langenfeld, *supra* note 13, at 79-80.

⁶⁷ *See* Werden, *supra* note 56, at 57.

⁶⁸ *ECONOMETRICS*, *supra* note 55, at 115.

⁶⁹ *Id.* at 119.

⁷⁰ *Id.* at 117. As Scheffman and Coleman note, there is no such thing as a perfect econometric analysis, and "lack of unachievable perfection should not prevent an econometric study from being given weight." *Id.* at 118.

formance. It is not surprising, therefore, that economic experts can reach different conclusions from the same set of underlying facts. It is important to note, however, that the same potential limitations and concerns arise outside of the economic aspects and apply to other analyses used to predict the merger's outcome (other than the relatively unusual analysis by the parties where they assume a price increase).

Despite these potential pitfalls, both the FTC and DOJ have large staffs of economists and, in complex transactions, hire outside experts to perform economic/econometric analyses in merger investigations. Transaction parties generally hire private economic consultants to act as advisers and to liaise with the government economists (and, if necessary, to appear as expert witnesses in court). In some instances, the economic evidence, together with the recommendation of staff economists, can play a pivotal role in the ultimate agency decision regarding whether or not to challenge a transaction.

Perhaps the best-known recent example in which a U.S. antitrust agency closed its investigation primarily on the basis of the economic analyses is the FTC's 2002 decision (by a 3-2 vote) not to challenge either of two potential transactions in the cruise industry: the proposed friendly creation of a dual-listed company combining Royal Caribbean Cruises, Ltd. and P&O Princess Cruises plc, and the competing hostile tender offer by Carnival Corporation for Princess.⁷¹ In that case, the FTC issued a detailed statement explaining its decision, accompanied by a lengthy dissent. The majority statement notes:

Of particular importance, the staff conducted extensive empirical analyses of a very large volume of quantitative data on prices, bookings, ship deployments, and the financial characteristics of the industry and the parties. Ultimately, the investigating staff as well as the management of the Bureau of Competition and the Bureau of Economics recommended that the Commission close the investigation without challenging either transaction.⁷²

The "extensive empirical analyses" relied on by the FTC staff (and, ultimately, by a majority of the Commissioners) involved relatively straightforward data analyses rather than complex econometrics. For example, the staff considered whether, post-merger, the cruise companies could more easily use yield management systems (containing data on cruise purchase characteristics, such as time of booking and type of cabin) in a coordinated

⁷¹ FED. TRADE COMM'N, FILE NO. 021 0041 (2002), STATEMENT OF THE FEDERAL TRADE COMMISSION CONCERNING ROYAL CARIBBEAN CRUISES, LTD./P&O PRINCESS CRUISES PLC AND CARNIVAL CORPORATION/P&O PRINCESS CRUISES PLC, <http://www.ftc.gov/os/2002/10/cruisestatement.htm>.

⁷² *Id.*

manner to price discriminate.⁷³ This strategy could involve raising prices early to capture the inelastic customers, and then using aggressive discounting closer to the cruise date to get the more elastic customers. In order to test this theory, the FTC performed empirical analyses using actual transaction data on prices paid by passengers at different times and for different cabins to determine if there is a systematic relationship between either of these factors and price. The results showed significant price variability with no persistent patterns, thus making coordinated effects post-merger unlikely.⁷⁴

B. *Attitude of the Courts to Economic Evidence*

Parties have proffered economic (including econometric) evidence in litigated merger cases for over a decade,⁷⁵ particularly in recent years. It is now almost customary for each party to present its own group of well-credentialed economic experts. While courts will usually permit such expert

⁷³ *Id.*

⁷⁴ *Id.* See also FED. TRADE COMM'N, BUREAU OF ECON., CRUISE INVESTIGATION: EMPIRICAL ECONOMIC & FINANCIAL ANALYSES (2002), <http://www.ftc.gov/be/hilites/ftcbeababrownbag.pdf>. A similar kind of pricing analysis was performed in connection with the proposed acquisition of Mandalay Resort Group by MGM Mirage Inc. in order to determine the likelihood of price coordination among hotels in Las Vegas. Economists involved in that matter examined the pattern of prices paid by guests for hotel rooms over the course of a booking cycle (number of days before the night of stay). The data showed that pricing was complex and volatile, not only across different hotels but even for the same hotel over time, thereby suggesting that tacit or explicit collusion would be difficult. Janusz A. Ordover, Address before the Federal Court/Law Council Joint Seminar on Competition Law, Sydney, Australia: Economics in the Courtroom (Mar. 2005) (on file with the authors). The FTC ultimately closed its investigation. Letters from Donald S. Clark, FTC Secretary, to Jan McDavid and Charles S. Rule, counsel for MGM Mirage and Mandalay Resort Group (Feb. 16, 2005), <http://www.ftc.gov/os/closings/staff/050216mgmmandalay.pdf>. Another recent example of an FTC investigation in which relatively uncomplicated economic data played an important role is Omnicare Inc.'s tender offer for NeighborCare Inc. Omnicare and NeighborCare were the two largest institutional pharmacies ("IPs") in the U.S. that deliver prescription drugs to residents of long-term care facilities. The combined company would have had a market share well above 50% in some states, prompting the FTC to investigate the transaction. Ultimately, the FTC closed its investigation, concluding, based on an investigatory record including (among other evidence) pricing data, customer-loss (bid) data, and testimony from numerous industry participants, that independent IPs provided effective competition to the chain IPs, including Omnicare and NeighborCare. FED. TRADE COMM'N., FILE NO. 041 0146, STATEMENT OF THE COMMISSION: IN THE MATTER OF OMNICARE, INC./NEIGHBORCARE, INC.,(2005), <http://www.ftc.gov/os/caselist/0410146/050616stmtcomm0410146.pdf>.

⁷⁵ See, e.g., United States v. United Technologies Corp., 1977-2 Trade Cases. P61,647 (N.D. Ohio 1977).

testimony,⁷⁶ this is no guarantee that courts will give the evidence much credence, as some recent cases illustrate.

1. *Kraft General Foods*

In *State of New York v. Kraft General Foods, Inc.*,⁷⁷ econometric analysis played a central role in the court's decision. That case involved the acquisition by Kraft of the ready-to-eat ("RTE") cereal assets of Nabisco. The FTC decided not to challenge the acquisition; several weeks after the parties consummated the transaction, the Attorney General for the State of New York ("NYAG") brought suit, seeking divestiture or rescission pursuant to Section 7 of the Clayton Act,⁷⁸ as well as under Section 1 of the Sherman Act⁷⁹ and the under Donnelly Act.⁸⁰ The court (Judge Kimba M. Wood) took the unusual step of appointing its own independent economic expert, Dr. Alfred Kahn, with the consent of the defendant Kraft, and over the NYAG's objection.⁸¹ The court evaluated the econometric data at length in connection with the key issues of market definition and competitive effects.

The NYAG contended that there were separate product markets for "adult" and "kid" RTE cereals. In rejecting this argument, Judge Wood relied in part on cross-price elasticities calculated by the defendant's expert economist:

Although the calculation of cross-price elasticities of demand does not in and of itself provide a market definition, it does provide information relevant to assessing whether a proposed market definition is or is not reasonable In this case, cross-price elasticities confirm that there is demand-side substitution between cereals inside and cereals outside plaintiff's proposed 'adult' market There is a consistent and 'robust' pattern of statistically significant positive cross-price elasticities among cereals in each of the five Post⁸² marketing segments.⁸³

⁷⁶ For a discussion of evidentiary issues raised by the use of economics/econometrics in the courts, see *ECONOMETRICS*, *supra* note 55, at 29-60.

⁷⁷ *New York v. Kraft Gen. Foods*, 926 F. Supp. 321 (S.D.N.Y. 1995).

⁷⁸ 15 U.S.C. § 18 (2006).

⁷⁹ 15 U.S.C. § 1 (2006).

⁸⁰ N.Y. GEN. BUS. LAW §§ 340-44 (Consol. 2006).

⁸¹ *Kraft*, 926 F. Supp. 335 n.4. The court elicited a list of acceptable experts from each party, and Dr. Kahn's name appeared on the plaintiff's list. *Id.*

⁸² Kraft produced and sold a variety of RTE cereal products under the "Post" name.

⁸³ *Kraft*, 926 F. Supp. at 333 (footnote added).

The court discredited, on various grounds, the NYAG's econometric evidence on the question of market definition.⁸⁴

The court considered the likelihood that the acquisition would produce either anticompetitive coordinated or unilateral effects. With regard to coordinated effects, the court accepted a wholesale pricing study conducted by Kraft's expert economist as support for the conclusion that close coordination in price was not occurring in the pre-merger RTE cereal industry.⁸⁵ The court cited the study in support of its ultimate finding that the acquisition was not likely to result in anticompetitive coordinated interaction among RTE cereal manufacturers.⁸⁶ With regard to unilateral effects, the court relied on various types of evidence, including econometric analyses,⁸⁷ to conclude that the RTE cereals of Kraft and Nabisco were not the first and second choices of a significant number of consumers (i.e., they were not each other's closest competitors), and therefore it would not be profitable for Kraft to unilaterally raise prices post-acquisition, because not enough of the revenues lost on Kraft's RTE cereals due to a price increase would be diverted to Nabisco's products to recoup those losses. As in its assessment of market definition, the court favored the defendant expert's econometric evidence over the plaintiff's.⁸⁸

2. *Staples*

Both sides offered extensive economic and econometric evidence in *FTC v. Staples, Inc.*, a case in which the FTC successfully challenged the proposed merger of Staples and Office Depot, two office superstore chains

⁸⁴ *Id.* at 333-35.

⁸⁵ *Id.* at 343.

⁸⁶ The court also focused on the heterogeneity of RTE cereals and the multiple dimensions of competition (e.g., price, quality, new product introductions, consumer promotions, trade promotions, and advertising) as tending against a likelihood of anticompetitive coordinated effects. *Id.* at 342.

⁸⁷ The court also considered, *inter alia*, the different physical characteristics of the cereals in issue and the different attributes emphasized in their advertising, evidence concerning the existence of closer "direct form" competing cereals, consumer consumption and purchase data, and testimony of two large retail customers. *Id.* at 352-55.

⁸⁸ *Kraft*, 926 F. Supp. at 357. Kraft's economist used a combination of microeconomic methods and regression analysis to calculate own and cross-price elasticities of demand for a number of RTE cereals. By contrast, NYAG's economic expert based his analysis on shifting and interaction data, which measure the relative propensity of different products to be bought by the same households. The court found that the NYAG expert's analysis was methodologically flawed and that, in any event, the results did not support the conclusion that certain RTE cereals of Kraft and Nabisco were next-best substitutes. *Id.* at 356-58.

(the only other office superstore chain at the time was OfficeMax).⁸⁹ The FTC alleged that the merger would substantially lessen competition in the office supply superstore market.

Much of the debate in the case centered on market definition. The defense argued for a much broader relevant product market than just office supply superstores that included all sales outlets for office products, irrespective of the type of outlet.⁹⁰ In accepting the FTC's market definition, the court (Judge Thomas F. Hogan) considered a combination of documentary evidence and pricing studies conducted by the FTC showing that the prices charged by Staples were directly related to the number of office superstore competitors also present in the geographic market.⁹¹ In particular, these studies demonstrated that Staples charged higher prices in metropolitan areas where it faced competition from only one superstore rival than in those areas where all three superstore chains were present, and it charged even higher prices in areas where it was the only office superstore.⁹² The documents and price data also showed that non-superstore "competitors" such as mass merchandisers, wholesale clubs, computer stores, independent retail office supply stores, mail order firms, and contract stationers did not significantly affect Staples' prices.⁹³ Internal Staples documents describing pricing zones showed that pricing varied only slightly between zones containing a non-superstore competitor (and no other superstore) and zones where no such competitor existed.⁹⁴ The court used some of the same evidence to find that a combined Staples-Office Depot would be able to profitably charge higher prices in some geographic markets (such as the fifteen metropolitan areas where it would be the only office supply superstore), and that the merger would eliminate significant future competition.⁹⁵

⁸⁹ *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997). For a detailed discussion of the facts in *Staples* and the econometric analyses performed by the parties, see *ECONOMETRICS*, *supra* note 55, at 351-73.

⁹⁰ *See Staples*, 970 F. Supp. at 1073.

⁹¹ *Id.* at 1076.

⁹² *Id.* The documentary evidence included internal Staples documents showing price comparisons between the prices of Staples, Office Depot, and OfficeMax within different price zones in which there were one, two, or three superstores. *Id.*

⁹³ *Id.* at 1077.

⁹⁴ *Id.* at 1075-78. The court wrote:

The pricing evidence indicates a low cross-elasticity of demand between consumable office products sold by Staples or Office Depot and those same products sold by other sellers of office supplies. This same evidence indicates that non-superstore sellers of office supplies are not able to effectively constrain the superstores' prices, because a significant number of superstore customers do not turn to a non-superstore alternative when faced with higher prices in the one firm markets.

Id. at 1080.

⁹⁵ *Id.* at 1082.

While the FTC's pricing studies can be described as a form of "economic evidence," the court, in stark contrast to the court in *Kraft General Foods*, provided almost no discussion of the detailed econometrics offered by the parties,⁹⁶ instead focusing on the documentary evidence. In fact, the FTC itself also relied more on the documents and on industry witness testimony, using econometrics to support the conclusions it drew from those other forms of evidence.⁹⁷

3. *Swedish Match*

Not very long after deciding *Staples*, Judge Thomas Hogan adjudicated another merger challenge in which both sides presented economic/econometric evidence. In *FTC v. Swedish Match*, the FTC sought to enjoin the acquisition by Swedish Match North America, Inc. of the loose leaf chewing tobacco business of National Tobacco Company, L.P.⁹⁸

In *Swedish Match*, Judge Hogan discussed the econometric analyses, which included calculations of demand elasticities and critical loss, both in connection with market definition⁹⁹ and likely competitive effects.¹⁰⁰ Judge Hogan did not find either side's economic or econometric evidence persuasive.¹⁰¹ With regard to the defendant's expert economist, the court explained its concerns as follows:

⁹⁶ The FTC's economist in *Staples* notes, however, that Judge Hogan "demonstrably relied on econometric evidence in one instance," when he referred to evidence showing the rate at which Staples had historically passed through cost savings to customers in the form of lower prices. See Jonathan B. Baker, *Econometric Analysis in FTC v. Staples*, 18 J. PUB POL'Y & MARKETING 12 (1999); *Staples*, 970 F. Supp. at 1090. For a more detailed discussion of pass-through effects in the context of *Staples*, see Gregory J. Werden, Luke M. Froeb & Steven Tschantz, *The Effects of Merger Efficiencies on Consumers of Differentiated Products*, 1 EUR. COMPETITION J. 245, 258-60 (2005).

⁹⁷ In contrast, the econometric evidence was reportedly critical to the FTC's decision to challenge the case in court. Baker, *supra* note 96, at 20.

⁹⁸ *FTC v. Swedish Match*, 131 F. Supp. 2d 151 (D.D.C. 2000).

⁹⁹ The market definition issue involved whether moist snuff and loose leaf tobacco were in the same product market.

¹⁰⁰ Only the defense economist actually used econometric analysis; the plaintiff's expert used other non-statistical techniques to estimate demand elasticities. In fact, one of the criticisms leveled at the plaintiff's evidence was that it "follows no objective methodology, and cannot be proven to any statistical significance." *Id.* at 161.

¹⁰¹ In discussing anticompetitive effects, although the court appeared to at least consider economic evidence of diversion ratios presented by the plaintiff's expert (which calculate the percentage of lost sales that would go to National Tobacco if Swedish Match were to raise the price for its loose leaf tobacco product), it stated that there might be flaws in that evidence, and relied instead on "the business realities of the loose leaf market" as sufficient grounds for granting an injunction. *Id.* at 169-70.

The Court simply cannot accept Dr. Train's econometric analyses as credible. Dr. Train issued several different reports, all of which presented new estimates of the elasticity of demand based on new economic models. Dr. Train admitted that he did not report several estimates of demand elasticity for loose leaf that were less than, as well as greater than, the critical elasticity. And Dr. Train has admitted to relying on other undisclosed estimates to support his ultimate conclusions In light of the inconsistent reports and unknown, and therefore untested, bases for Dr. Train's conclusions, the Court is ultimately unwilling to accept Dr. Train's conclusions as credible evidence.¹⁰²

Despite the apparent paucity of useful economic evidence, Judge Hogan granted the FTC's motion for a preliminary injunction. On the question of market definition, he found a distinct loose leaf tobacco product market based on the views of the merging firms' competitors, statements by distributors, and internal documents showing a lack of price-based substitution between loose leaf and moist snuff.¹⁰³ This narrowly defined product market led to a *Philadelphia National Bank* presumption of anticompetitive effects that the defendants were unable to rebut.

4. *Oracle*

Oracle is the current high-water mark regarding the importance of sound economic evidence in a Clayton Act Section 7 case. The court in *Oracle* discussed at great length the evidence presented by the parties' economic experts. In particular, Judge Walker characterized one of plaintiffs' economists, Professor Kenneth Elzinga, as "by far the most important of plaintiffs' witnesses."¹⁰⁴ However, the court had little positive to say about the economic evidence before it.

On the issue of market definition, the court noted that "the full weight of the plaintiffs' product market burden fell at trial upon Elzinga,"¹⁰⁵ yet it found numerous problems with Professor Elzinga's strains of evidence, which it summed up with the following scathing remarks:

In resolving the battle of the expert witnesses on product definition, the court must conclude that Oracle's witnesses presented the better and more convincing case. Elzinga for all his indubitable credentials as an economist seemed mostly to apply the techniques of his avoca-

¹⁰² *Id.* For further discussion of the use of critical loss analysis in *Swedish Match*, see O'Brien & Wickelgren, *supra* note 57, at 28-30.

¹⁰³ *Swedish Match*, 131 F. Supp. 2d at 164-65.

¹⁰⁴ *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1145 (N.D. Cal. 2004).

¹⁰⁵ *Id.* at 1158.

tional interest in mystery writing The evidence Elzinga marshalled was circumstantial and highly qualitative.¹⁰⁶

More specifically, with regard to product market definition, the court held:

Not only does the court find Elzinga's data to be unreliable in establishing a distinct and articulable product market, but Elzinga himself admitted that plaintiffs' product market has no "quantitative metric" that could be used to determine the distinction between a high function product and a mid-market product.¹⁰⁷

With regard to competitive effects, the DOJ focused on a unilateral effects analysis, arguing that Oracle and PeopleSoft were the only active players in a "localized" sphere of competition within the high function financial management systems and human relations management software markets. The court held that there are four prerequisites to a successful differentiated products unilateral effects claim:

- (1) The products controlled by the merging firms must be differentiated;
- (2) The products controlled by the merging firms must be close substitutes;
- (3) Other products must be sufficiently different from the products controlled by the merging firms that a merger would make a SSNIP profitable for the merging firms; and
- (4) Repositioning by other non-merging firms must be unlikely.¹⁰⁸

Of particular note, Judge Walker stated that in such cases, plaintiffs *must* offer expert econometric analysis that can provide the court with some objective basis to find the existence of a "node," (i.e., an area of localized competition within which the merging parties' products are regarded as first and second choices by a significant number of customers).¹⁰⁹ Such evidence could include diversion ratios, cross-elasticities, or price-cost margins to help predict the "recapture effects"¹¹⁰ of a transaction.¹¹¹ Unless the plain-

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 1159.

¹⁰⁸ *Id.* at 1117-18.

¹⁰⁹ *See id.* at 1172.

¹¹⁰ This refers to the theory whereby some of the sales lost due to an increase in price of one merging party's product will be "captured" by the competing product of the other merging party, and may, if the products are sufficiently close substitutes, render profitable a price increase that would not have been profitable pre-merger. The issue is the extent of recapture (and the concomitant increase in revenues for the merged firm) and whether it is sufficient to overcome the potential loss of revenues on

tiff can prove the existence of such localized competition, there is no need to analyze the potential exercise of monopoly power over the “node” or the ability of other firms to reposition themselves within the “node.” Judge Walker also stated that “[i]n a unilateral effects case, a plaintiff is attempting to prove that the merging parties could unilaterally increase prices. Accordingly, a plaintiff must demonstrate that the merging parties would enjoy a post-merger monopoly or dominant position, at least in a ‘localized competition’ space.”¹¹² This view has attracted criticism as being too stringent.¹¹³ It clearly is easier to conclude that harm will occur if a transaction would create a merger to monopoly in some “node.” However, unilateral effects may not require such stringent conditions; rather, under a critical loss analysis an adverse effect can arise without total suppression of competition. To prevail under unilateral effects it may be sufficient to show substantial cross-elasticities between the two parties’ products, particularly if the two firms are not each other’s next best substitutes.

Some commentators have suggested that Judge Walker should have employed a different unilateral effects theory entirely, based on an “English auction” model, rather than a differentiated products or “Bertrand” model. DOJ’s argument was that high function HRM and FMS software was sold through a procurement process having a separate competition, with separate prices, for each customer, much like a so-called English auction, and that the merger would have significantly differing effects on different customers.¹¹⁴ Under the English auction model (unlike the Bertrand model), diversion ratios or similar evidence of lost sales are irrelevant, since there are no lost sales in an English auction model.¹¹⁵

The court in *Oracle* also complained about the lack of econometric evidence offered by the DOJ,¹¹⁶ stating that the DOJ’s evidence was “de-

those sales that disappear altogether.

¹¹¹ *Oracle*, 331 F. Supp. 2d at 1172.

¹¹² *Id.* at 1118.

¹¹³ See Gregory J. Werden, *Unilateral effects from mergers: The Oracle case*, in HANDBOOK OF RESEARCH IN TRANS-ATLANTIC ANTITRUST (Philip Marsden ed., forthcoming 2006). Werden attempts to show that a merger can result in significant unilateral effects even when the merged firm is not “dominant.” Also of note in this scenario is the supposed “gap” in statutory coverage of the prior E.U. dominance test that the new “significantly impede effective competition” (“SIEC”) test seeks to address. *Id.*

¹¹⁴ *Oracle*, 331 F. Supp. 2d at 1160-70.

¹¹⁵ *Id.* at 13.

¹¹⁶ Another of the DOJ’s expert witnesses, Professor McAfee, did perform some regression analyses to show that PeopleSoft and Oracle were engaged in localized competition to which others, such as SAP, were not a party, and also conducted a merger simulation to predict that price would increase following the merger. However, the court gave short shrift to these items of evidence, finding (1) that the regression results merely showed that PeopleSoft and Oracle were frequent rivals, without shedding

void of any thorough econometric analysis Both the *Kraft General Foods* and *Swedish Match* courts, the only other courts explicitly to address unilateral effects, based their rulings in part upon econometric evidence submitted by the parties.”¹¹⁷

Thus, the court appeared to lament the fact that the DOJ’s economic experts, in particular Professor Elzinga, did not offer meaningful econometric data for its review and evaluation. In fact, Judge Walker went so far as to endorse specifically modern econometric methods such as the use of merger simulation models, and he even hinted at the possibility that those methods might eventually replace, or at least supplement, market definition analysis in unilateral effects cases involving differentiated products:

Despite the problems with qualitative analyses, modern econometric methods hold promise in analyzing differentiated products unilateral effects cases. Merger simulation models may allow more precise estimations of likely competitive effects and eliminate the need to, or lessen the impact of, the arbitrariness inherent in defining the relevant market. For example, some merger simulation methods compensate for potential errors in market definition.¹¹⁸

C. *Lessons Learned Regarding Economic/Econometric Evidence in Merger Analysis*

As with customer evidence, the case law is instructive regarding the use of economic and econometric evidence in merger matters:

* Reliable economic evidence has an important role to play in merger cases, both during the merger investigation and in litigation. Such evidence, properly developed and presented, can shed light on each key facet of merger analysis contained in the Horizontal Merger Guidelines, including market definition, competitive effects, entry, and efficiencies. Sometimes, this will require sophisticated econometric studies, but relatively simple data manipulations can also be a powerful tool. Such manipulations can even be the decisive factor in a regulator’s decision whether to challenge a transaction, as the FTC’s cruise lines investigation shows.

any light on whether SAP also competed in the same space; and (2) that the merger simulation results were unreliable, because they were based on Elzinga’s market share statistics, which the court had already disparaged earlier in its decision. *Oracle*, 331 F. Supp. 2d at 1169-70.

¹¹⁷ *Id.* at 1172. As previously indicated, it is unclear to what extent the court in *Swedish Match* actually relied on the government’s economic evidence in assessing the likelihood of anticompetitive effects.

¹¹⁸ *Id.* at 1122. As described in note 105, one of the plaintiff’s experts did perform a merger simulation, but the court found it to be unreliable.

* Given that the results of economic analyses are often very sensitive to the underlying data, methodologies, and assumptions, best practice requires intense sensitivity/robustness testing: in certain situations, transaction parties should consider hiring a second economist to provide a reality check on the work performed by the primary economist. This can be especially important where complex econometrics is involved. Commentators have aptly noted that “fancy tools don’t improve bad data.”¹¹⁹ Antitrust authorities are likely to reject economic analyses presented by transaction parties that are not accompanied by sufficient information to enable the authorities’ in-house economists to reproduce every reported analysis.¹²⁰ There is even a danger that if the economic work is not done carefully, it may be used later by government economists against the transaction parties.

* Even in cases where economic evidence does not occupy the spotlight, it can, as the *Staples* case shows, perform a valuable function in supporting other forms of evidence relied upon by the parties.

* One of the biggest practical hurdles facing economic and econometric evidence lies in explaining the methodologies and results in terms that non-economist lawyers and judges can comprehend. It is difficult to know how much probative weight to give to something one does not understand, especially when the “experts” on both sides reach completely divergent conclusions based on the same set of facts, as is often the case.¹²¹ There is also a broader question of whether non-expert decision-makers can ever be qualified to assess independently whether complex economic/econometric evidence should be accepted as outcome-determinative.¹²²

* Courts’ receptivity towards economic evidence in merger cases is evolving but inconsistent. Courts seem willing to consider carefully such evidence, and may even require it in some circumstances. For example, Judge Walker’s *Oracle* decision shows the importance of using objective econometric methods to calculate demand elasticities in differentiated products cases, in order to measure likely customer responses to hypothetical post-merger price increases.¹²³ Those same courts, however, imposed

¹¹⁹ Ordoover, *supra* note 74, at 33.

¹²⁰ See Gregory J. Werden, *Making Economics More Useful in Competition Cases: Procedural Rules Governing Expert Opinions*, in ANNUAL PROCEEDINGS OF THE FORDHAM CORPORATE LAW INSTITUTE (Berry Hawk ed., forthcoming) (article at 16, on file with the authors).

¹²¹ Werden, *supra* note 56, at 57.

¹²² Tad Lipsky, Latham & Watkins, LLP, Presentation to the FTC/Antitrust Division Merger Workshop: Unilateral Effects: A Case Study of the Role of Economics in Antitrust Decision Making, (Feb. 18, 2004), <http://www.ftc.gov/bc/mergerenforce/presentations/040218lipsky.pdf>.

¹²³ As one senior DOJ economist commented, “Econometrics is most needed, most helpful, and most often used with differentiated consumer products . . . Econometrics often is the most accurate, reliable, and objective basis for evaluating critical questions of degree involving matters of taste.” Werden, *supra* note 56, at 55.

very high standards in evaluating such evidence and affording it any credence. As a practical matter, this places a heavier burden on plaintiffs, since they bear the onus in a preliminary injunction hearing of proving the likelihood that a merger will substantially lessen competition.

* Often there will be an econometrics battle, since the experts for the parties will not agree. If the economists on both sides are good and neither model is totally “off the wall,” what should the court do? In matters likely to entail sophisticated economic evidence, the court should consider using an independent court-appointed economic expert, such as in *Kraft General Foods*.¹²⁴ Some of the considerations include:

(1) Should the court’s appointment of an economic expert depend on the theories of competitive harm advanced by the parties (or only by the plaintiff)? Or should it depend on the types of evidence the parties put before the court, for example, basic quantitative analyses versus complex econometrics? The answer may depend to some extent on the role of the independent expert (see question (3) below).

(2) What procedures ought to be followed in appointing such an expert? Should it be someone that both parties agree upon? If one party objects, should the court choose an economist who is acceptable to the objecting party, as occurred in *Kraft General Foods*? Or should the court have absolute discretion to choose whomever it wants? While frivolous objections should be ignored, objections based on such considerations as lack of expertise or exhibited bias in writing, research, or past testimony could be relevant.

(3) What should the role of a court-appointed economist be? There are a range of possibilities:

(a) to “translate” the economic testimony of the parties into language that the court can understand;

(b) to evaluate the underlying data, methodologies, and assumptions used by the litigants’ economists and advise on whether they are economically sound (without opining on the actual results derived therefrom);

(c) to provide his or her own conclusions based solely on the evidence presented;

(d) to perform a completely separate economic analysis on which to base advice given to the court; or

(e) some combination of the above.

(4) Should a court-appointed economist be subject to cross-examination by the parties? This probably depends on the function being

¹²⁴ It is interesting to note that Alfred Kahn, the court-appointed economist in *Kraft General Foods*, relied on an econometrician (which he was not) in advising the court on econometrics.

performed by the expert: cross-examination is likely warranted where the expert acts as an arbiter between the views of the parties' economists rather than merely educating the judge regarding the parties' economic/econometric evidence.¹²⁵

* In light of some of the challenges facing economic/econometric evidence in merger matters, there would appear to be potential for a court-appointed economist to add real value by performing at least the functions described in (a), and possibly (b), above. In *Kraft General Foods*, however, the independent economist went beyond such a limited role, providing expert opinions that went directly to core substantive issues of market definition and competitive effects. Indeed, the court in that case appeared to rely heavily on this testimony in reaching its ultimate decision. The danger with using court-appointed experts in this way is the possible displacement of the litigants' economists, as there may be a natural tendency for judges to favor the conclusions of their own "neutral" expert adviser over those of the litigants' economists who are partisan to their side's cause.¹²⁶ Such an outcome is undesirable.¹²⁷

* However useful economics may be, as is the case with customer evidence, it will rarely, if ever, prove conclusive. To be most effective, parties will continue to need a combination of documentary, economic, and customer evidence.

CONCLUSION

Customer opinions and economic analysis can be useful tools in merger cases, both during a government investigation and in court. The FTC and DOJ are likely to continue to rely on both forms of evidence, despite their potential pitfalls. As recently litigated mergers show, courts will accord probative weight to such evidence (from both sides) where a litigant

¹²⁵ See Ordover, *supra* note 74, at 44.

¹²⁶ The authors are not suggesting that this is what happened in *Kraft*, just that it is a foreseeable risk from providing an expansive role to an expert economist chosen by the court.

¹²⁷ Apart from the impropriety of effectively nullifying the parties' expert witnesses, a court-appointed expert generally will not have anywhere near the same amount of time or resources as the litigants' economists to learn all the relevant industry-specific facts with which to make a reliable analysis. See Werden, *supra* note 120, at 14. Moreover, just because an economist is appointed by the court rather than hired by one of the litigants does not automatically make that expert "neutral": it has been suggested, for example, that respected economists tend to be either "hawks" or "doves," hence "[t]here might be no neutral expert with relevant expertise, in which event a court-appointed expert would perforce be a partisan." Richard A. Posner, *An Economic Approach to the Law of Evidence*, 51 STAN. L. REV. 1477, 1540 (1999).

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adequately demonstrates its reliability and relevance to the issues in dispute.