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DOJ Adds Revisionist Dollop to '82 Merger Guidelines

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Analysis and Perspective

Antitrust

On June 14, 1982, the Antitrust Division of the Justice Department issued its long-awaited revision of the 1968 merger guidelines. The 1982 guidelines introduced a whole new official vocabulary for merger analysis and attempted to set forth, with almost mathematical precision, a set of rules that could guide business behavior. According to Attorney General William French Smith, their new Merger Guidelines should reduce much uncertainty by delineating the general principles and specific standards used by the Antitrust Division in evaluating mergers.

Despite considerable criticism at the time (including from one of the authors) for their occasional ambiguity, it is clear that the 1982 guidelines have in fact been very successful. Business behavior has been influenced, the predictability of enforcement action was enhanced, and the analytical approach of the guidelines has in fact become the general working standard in the field.

At the time the 1982 guidelines were issued, the Antitrust Division promised they would not wait another 14 years to update and revise them, but instead would do so whenever scholarship and practice required. Instead of 14 years, however, the 1982 guidelines lasted two, being superseded on their second anniversary by the 1984 guidelines—which to avoid confusion we will refer to as the 1984 revisions. This raises two obvious questions: (1) Were changes needed now? (2) Were the changes improvements?

In 1982, Smith conceded that a constant tension exists between the desire to include every relevant factor and the need to provide clear guidance to the business community. The Guidelines would therefore never fully cover every circumstance in which the Department could or would not challenge a merger. Nevertheless, their relative clarity, broad scope and economic reasonableness convince me that they will make an important and enduring contribution to this area of the law.

At the time, it seemed that the attorney general had more than two years in mind. Certainly, there have been no radical developments in economic learning since 1982, and the same administration is still in power. Indeed, it could be argued that the 1982 guidelines have been one of the most successful efforts in the entire government. Of the 1,128 transactions for which Hart-Scott premerger notification filings were required last year, fewer than 2 percent were challenged in any way by the enforcement agencies. There is no doubt that other transactions were considered and rejected by businesses and their lawyers, because they believed that they would not pass muster under the guidelines. Assuming the agencies were
faithfully applying the guidelines, and putting aside your views about the policy merits, a 98 percent success rate seems to show that the private sector had a very good understanding of what the rules were. This would have to be considered a fabulously successful government program.

So what would make the department want to change such a successful effort? Obviously, revisions based on changing policies or changing economic circumstances would be appropriate, but these do not appear to be the impetus for action here. Instead, the Justice Department’s press release cites continued refinements in the department’s analytical approach and ambiguities in the 1982 guidelines as the reason for the 1984 revisions. At least to some extent, this seems disingenuous. In fact, the 1984 revisions appear to be generated not so much by changes in the Antitrust Division’s approach to merger analysis as by the general acceptance of the 1982 analytical approach, an interest in carrying that effort even further, and a relatively low valuation of the social benefits of clear—albeit arbitrary—rules.

The 1982 guidelines represented a dramatic break from the public past. While they did not represent a marked change in direction for the actual enforcement approach of the Antitrust Division, they did represent a major change in vocabulary and public recognition of the direction in which the enforcement process had been evolving. As with any guidelines prepared by a law enforcement agency, there were great tensions between the policy makers and the prosecutors, with the latter wanting to preserve all possible litigation flexibility and the former more interested in clear guidance—both to the private sector and to the division staff. The result, as always, was a compromise. There were bright-line rules for guidance, but there were also caveats to justify exceptions. The statement issued by the Federal Trade Commission (FTC), by contrast, offered practically no guidance at all, except that it stated that it would give considerable weight to the DOJ guidelines.

The 1982 guidelines were in fact widely accepted, both in concept and in detail. As a result, some of the compromises made in 1982 came under increasing pressure from both inside and outside the Antitrust Division. Some will no doubt point to the hullabaloo over the LTV-Republic merger as the impetus for the 1984 revisions, but in fact the possibility of guidelines revisions had been under consideration, both within the Antitrust Division and more broadly in the administration, before that transaction was announced. Indeed, it was the very success of the 1982 guidelines that encouraged some to seek even more movement away from historically arbitrary—and what they believed were outmoded—rules.

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The 1984 revisions represent such a movement. Unfortunately, while they no doubt illustrate and explain the actual thinking process inside the Antitrust Division today better than the 1982 guidelines, they do so at the price of decreasing the predictability of enforcement actions and dimming the bright lines set out in the 1982 guidelines. Some will find these differences an improvement; some will not.

The 1984 revisions have one other, no doubt completely unintended result: They make it easier for successor administrations to feel free to revise the guidelines in the opposite direction. The 1982 guidelines were really quite moderate in their analysis and approach, even though they appeared radical when issued. The Herfindahl-Hirshman Index (HHI) thresholds were not greatly different from the concentration levels generally used to identify possible problems, and were far below the thresholds urged by many economists. The key market definition analysis specifically rejected various more extreme approaches articulated by some economists. While economics was obviously the preferred religion, the approach was not that of a fanatic. The 1982 document was at once new and old, a clever change in the rules in a way that was not an obvious rejection of all that came before. As a result of this approach, and its subsequent broad acceptance, it would have been difficult for a new administration to simply throw the 1982 guidelines out and start over.

That job may be easier now, because the principal of regular revision has been established. Why should a Democratic administration be bound by Paul McGrath’s guidelines when McGrath felt free to change William Baxter’s? This may not be a major point—after all, new administrations, like that of Ronald Reagan, are frequently quite willing to begin new initiatives. Still, there is value in continuity, and the Baxter guidelines would have been more likely to endure, to use the attorney general’s words, if they had survived the administration that issued them.

Nevertheless, the 1984 revisions are out. What did they change? Will the changes result in different decisions? Will the changes influence business behavior? Without the benefit of any significant time to reflect, some general observations can nonetheless be made. First, there are no substantial numbers changes, such as changes in HHI thresholds or the like.
Second, there are some very significant changes in approach, which may or may not result in changes in outcomes. Third, the net effect of the changes is to increase prosecutorial discretion and decrease enforcement predictability.

First, the changes themselves. There are a large number of stylistic changes-- which to that, switching the order within a list, moving material from footnotes to text--but there are five major changes.

1. Market Definition

The 1982 guidelines defined product and geographic markets largely by using the so-called 5 percent test--by asking what would happen on the supply and demand side in response to a 5 percent price increase lasting for six months or one year. By contrast, the 1984 revisions stress that the department may at times postulate a price increase that is much larger or smaller than five percent and continually refer to a small but significant and nontransitory price increase in places in which the old guidelines referred to a 5 percent price increase for six months or one year. Further, the 1982 guidelines six-month standard for determining supply side substitutability in geographic markets was changed to conform to the one year standard already governing demand side substitutability. In sum, the 5 percent concept is generally retained, but the revisions deliberately denigrate the notion that it would be regularly important.

2. Factors Affecting the Significance of Concentration and Market Share Data

The department was concerned that the HHI levels in the 1982 guidelines were perceived as a set of strict mathematical rules and stressed at length that they are not. Of course, the emphasis on mathematical precision, even if somewhat misleading, was indeed one of the strengths of the 1982 guidelines. Nevertheless, the 1984 revisions seek to downplay the math, and add to the list of other relevant factors that will be considered in making merger enforcement decisions.

The 1984 revisions also subtly change the language dealing with the top and bottom of the HHI spectrum. Where the 1982 guidelines had said that the department is unlikely to challenge mergers that would lead to a postmerger HHI of less than 1000, the 1984 revisions state that the department will not challenge such mergers except in extraordinary circumstances. Similarly, the 1982 guidelines had said that the department was likely to challenge mergers that would lead to an HHI in excess of 1800 and would result in an HHI increase of more than 100; the 1984 revisions state that it will challenge mergers resulting in a postmerger HHI of substantially more than 1800 and an HHI increase of more than 100 points in all but extraordinary cases.

Thus, for the extreme cases, the 1984 revisions arguably increase certainty. For everything between the extremes, the revisions seem to say that the department virtually always will consider virtually everything.

3. Treatment of Foreign Competition

The 1982 guidelines were downright miserly on the treatment of foreign competition. According to the guidelines, firms located outside the United States may be subject to additional constraints not present in the purely domestic context. Thus, said the guidelines, the department would be somewhat more cautious, both in expanding market boundaries beyond the United States and in assessing the likely supply response of specific foreign firms. In fact, there was no clear and consistent approach to foreign production, culminating in the decision in the Republic-LTV merger to completely ignore important foreign sales in the United States because of various alleged formal and informal constraints on increased imports.

That decision drew criticism from almost all observers, interested and otherwise, and the 1984 revisions clearly reject that approach. Instead, say the revisions, foreign producers will be treated just like domestic producers, to the extent data permits. Any constraints, such as a quota, will be dealt with on a case-by-case basis, as will any indication that the foreign firm’s market share understates its competitive significance.

This is a significant procedural change, but it is difficult to predict its impact. It will focus debate between the parties to a transaction and the division on the subjective significance to be attached to an import restraint, rather than a numbers battle, but whether this will mean any difference in outcomes remains to be seen.
4. Efficiencies

The 1982 guidelines stated that efficiencies could be a defense to an otherwise anticompetitive merger only in extraordinary cases that were otherwise close. The 1984 revisions delete the issue from the defenses section, and efficiencies are now another factor to be considered when the department decides whether a merger is anticompetitive. According to the 1984 revisions, where the parties to the merger establish by clear and convincing evidence that a merger will achieve such efficiencies, the Department will consider those efficiencies in deciding whether to challenge the merger. Further, the 1982 guidelines had carefully limited the types of efficiencies that would be considered to scale economies, integration of production facilities, or multiplant efficiencies that already exist in that industry--the relatively provable types. The 1984 revisions indicate that the department will recognize every possible type of efficiency, including reductions in general selling, administrative, and overhead expenses [and other efficiencies] that otherwise do not relate to specific manufacturing, servicing, or distribution operations. The department does concede that these types of efficiencies may be difficult to demonstrate, but it clearly invites efforts to do so.

5. Failing Firms and Divisions

The section on failing companies was unchanged. However, the 1982 guidelines stated that the failing division defense would be recognized in appropriate guidelines and from Baxter’s public statements on the issue, that both defenses would be construed narrowly and would only be grudgingly accepted. The 1984 revisions are much more encouraging on the failing division issue. They specify two of the conditions that would successfully give rise to it--whether the division would be liquidated in the near future if not sold, and whether a competitively preferable purchaser can be found--and one is left with the impression that the department will openly consider other failing division arguments as they arise.

Further, the revisions elsewhere state that if a firm has been earning a low rate of profits for several years and is in poor financial condition, the division may conclude that the firms current market share overstates its true competitive strength. Together, the loosening of standards for floundering firms and failing divisions represents a significant change in the guidelines, although the revisions probably still don’t go as far as the division’s actual practice.

These are the major changes; whether they are desirable depends in part on the goals sought to be served. Enforcement guidelines have a variety of possible goals. First, guidelines should, to the extent possible, enable businesses to predict in advance with reasonable certainty whether a particular merger will be challenged. Second, they should permit a flexible approach so that unusual situations are not challenged merely for the sake of foolish consistency. Third, they should guide judges as to the proper way to analyze those cases that do get to court. Fourth, they should reflect the actual enforcement policy of the agency. There are other possibilities, of course, such as the vocabulary change that was obviously one of the goals of the 1982 guidelines, but these seem the relevant standards by which the 1984 revisions should be measured.

Accomplishing Objectives

The revisions generally accomplish the last of these objectives quite well. Of course, sophisticated antitrust observers already knew that, even though the 1982 guidelines only stated that it was unlikely that the department would challenge mergers leading to a postmerger HHI of less than 1000, the fact was, as the revisions state, that the Department will not challenge mergers falling in this region, except in extraordinary circumstances. Nevertheless, it is useful to generally inform the world what the department policy really is. Further, the changes in tone that appear in several places will more accurately convey the division’s true approach to problems, although even the revisions remain fairly coy on some points.

In addition, the 1984 revisions include some real changes from the 1982 guidelines, even if they don’t reflect changes in actual department practice, and it is desirable for the department to have set these forth. Perhaps the largest change concerns the treatment of efficiencies. The 1982 guidelines stated that efficiencies will only constitute a defense to an otherwise illegal merger in extraordinary cases. The 1984 revisions say that the department will consider efficiencies proven by clear and convincing evidence and will consider just about any type of efficiencies imaginable.

Misleading Statement

Of course, the statement in the introduction to the 1984 revisions that the earlier guidelines had a somewhat misleading tone on efficiencies is itself somewhat misleading. It seems unlikely that Baxter did not know what he was saying when he wrote
that efficiencies would only be a defense in extraordinary cases. In fact, the language of the revisions represents a real change from the 1982 guidelines, even if the division is reluctant to admit it.

The 1984 revisions also continue to provide guidance to federal courts on how mergers should be analyzed. Few of the changes should affect this, although the very fact that the guidelines were changed so quickly could make courts less likely to believe that they are carved in stone. And it will be interesting to see whether the department resists the use of the 1984 revisions analysis once they decide to sue. For example, the introduction to the 1984 revisions notes that efficiencies do not constitute a defense to an otherwise anticompetitive merger but are one of many factors that will be considered by the Department in determining whether to challenge a merger.

Does this mean that the department, like the FTC, will always consider efficiencies in deciding whether to challenge the merger, but if the merger goes to court the department will argue that they are irrelevant? Or that they are relevant but that the department already took them into account and so the judge should ignore them? Defendants are likely to ask the court, since efficiencies were relevant last week, why aren’t they still relevant? Defendants can also be expected to respectfully ask judges to Listen to the efficiencies evidence and give it appropriate weight, just like the department does--after all, since the department is capable of engaging in a case-by-case market power/efficiencies tradeoff analysis, surely the learned judge is also capable of doing this.

More generally, defendants in government merger cases are likely to use the 1984 revisions to justify the introduction of evidence on every factor mentioned therein. It will be interesting to see what litigation stance the division takes.

This brings us to the first two criteria for evaluating guidelines-- flexibility and predictability--and they should be discussed together, since flexibility and predictability are in many ways inseparable. Both are desirable goals, but since they are inherently contradictory, they require a delicate balance.

The 1984 revisions score high on flexibility--that is to say, they cannot be described as inflexible. Not only do they continually emphasize that-their-- long list of relevant factors is not all-inclusive, they add a wide variety of new or substantially new factors, including changing market conditions, the financial condition of firms in the relevant market, and whether small or fringe sellers are able to significantly increase sales. It is hard to dispute that each of these factors will be important on occasions. Yet, on the whole, as we read through this impressive list of economic questions, which is added to an even longer list already in the 1982 guidelines, we cannot help but think of the approach to the brand new Celler-Kefauver Act taken by the 1955 Report of the Attorney General’s National Committee To Study The Antitrust Laws and Derek Bok’s 1960 analysis of that report. Bok noted that often the approach of an expert body, like the national committee, was to [recoil] from the conceptual grossness of the quantitative substantiality doctrine; at least where the market share of the acquired firm is not extremely large. Instead, a flexible approach is recommended in which different market factors may be equally important and no one pattern of proof can meet the requirements of all cases. Bok went on to note that the report sets forth a dizzying list of factors for possible use. Among the many matters which might be considered are the long-run supply and demand picture, the incentive of sellers or potential sellers to enter new markets and to improve their products or services, adjustments by other companies to the actual and expected shifts in markets affected, and the opportunities for innovation in products ... [or] in methods of sale. Further matters of possible interest are special technologies or know how, growth history, changes in the opportunity for sellers to make independent decisions as to products, prices, advertising, sales methods, channels of sales, classes of customers, and business activities in which they will engage, and other matters too numerous to mention.

Bok ominously concluded that the really striking aspect of the discussion is the lack of any suggestion as to the manner in which these factors may be applied in any given case let alone be combined with other relevant factors. He accordingly condemns the approach for lack of clarity, predictability, and administrability.

Does all this sound familiar? Have all our economic advances in the last 30 years merely led us back to where we were in 1955? Was Bok simply a misguided but influential advocate of clarity over reason who we have finally recovered from? Is clarity, with its necessary companion arbitrariness, not a value worth seeking? Is an occasional wrong result too high a price to pay for clear guidance and predictability?
Of course, the 1984 revisions are not a one-way street, and there are some areas in which predictability is improved. Some we have already mentioned. In addition, the 1982 guidelines were ambiguous concerning how the time periods that were the benchmarks for market definition and entry barrier analysis were defined. As a practical matter, the market often would take some time to notice a price rise of 5 percent and to decide that it represented supracompetitive pricing rather than a normal change in price. It was unclear whether this recognition lag period counted in the time period benchmarks, or whether the time period benchmarks started after the market decided that the change represented supracompetitive pricing. The 1984 guidelines clarify the issue by assuming the recognition lag away.9

Diminishing Predictability

But for the middle range of mergers, those falling in industries with HHI’s between 1000 and not significantly over 1800, with increases of more than 50 to 100,10 predictability diminishes dramatically, and creative lawyers and economists have been invited to show their stuff. This range is, of course, the range where most of the close calls have been for the last few years.

For example, the old approach on efficiencies was reasonably clear-- efficiencies would not be a defense except in extraordinary cases. Now the department will always look at every type of efficiency. But how much efficiency in terms of cost savings (and/or increases in quality, which are not mentioned) is enough to offset an otherwise anticompetitive merger that is otherwise somewhat more anticompetitive? To perform a precise analysis on a case by case basis would often be a litigation nightmare,11 and for this and other reasons leading conservative scholars such as judges (then professors) Robert Bork12 and Richard Posner13 would not permit an efficiency defense.

Others disagree, of course, and it is perhaps curious that while the two leading conservative antitrust scholars would not permit an efficiency defense, the two leading moderate antitrust scholars would. The Areeda and Turner approach, however, includes a requirement of a five percent cost savings,14 and provides that [p]roof meeting [this test] ... should constitute an absolute defense.15 Regardless of what you think about the merits of such an approach, at least the result is clear--five percent is the magic number, and if you can prove it, your merger goes through.

Regrettably, the 1984 revisions contain no such benchmark. We have no idea how the department will take efficiencies into the calculus. The introduction to the guidelines has a tone that is very inviting to efficiency claims, stating that the Department considers and gives appropriate weight to efficiency claims in all cases in which they are established by clear and convincing evidence. But the guidelines themselves state that the parties must establish by clear and convincing evidence that the merger will achieve such efficiencies. The use of the term will could imply that it must be certain that the efficiencies will arise, although one doubts that the department will really require such a rigorous standard of proof. Nevertheless, the language of the revisions is sufficiently ambiguous that a different assistant attorney general could certainly use the will language to dismiss any efficiency claims presented to him, since in the foggy atmosphere of antitrust virtually nothing is certain.

Another area made less predictable concerns the 5 percent test for defining markets. Under the 1982 guidelines, it was never quite clear whether 5 percent of total price or of value added would be the relevant measure. Under the 1984 revisions, this problem is, if anything, exacerbated. The revisions state that sometimes 5 percent will be used, but sometimes more, and sometimes less, and that sometimes that 5 percent will be figured on total price, but sometimes on value added. If the 1984 goal was to clarify the test, why didn’t the revisions state that either 5 percent of value added or of price will be used, or that the amount used will always be somewhere between these two figures? Or they could have said that 5 percent of total price or 10 percent of value added will be used, or a number of other formulations. Instead, the revisions take a clever test (which admittedly was ambiguous and could only be applied in a minority of cases) and virtually eliminate it, substituting nothing in return. Perhaps there was some fear of newspaper headlines saying, Department Declines to Challenge Merger Because It Predicts that the Merger Will Only Raise Prices to Consumers by 4%, but there must be some proxy for the elasticity that is the key to analysis under both the guidelines and the 1984 revisions.

In conclusion, the major change in the Guidelines is the move to a full-blown rule of reason analysis for most mergers, and the resulting limitation on the usefulness of the guidelines as guidelines.
For all the mergers that realistically will be the close calls, a future assistant attorney general could use the 1984 guidelines to challenge virtually any merger. If McGrath will use these guidelines to challenge five of the 25 close calls that he sees in a year, a future AAG could use them to challenge 20. The result is a reduction in long-run predictability and, as Baxter pointed out, an invitation both for input from other agencies and more litigation by the parties to a merger. On the other hand, the 1984 revisions do make some substantial moves, especially on the treatment of efficiencies and foreign imports. Whether these, on balance, are desirable developments depends on your perspective.

At least the FTC should be very enthusiastic about the changes. That agency has not yet made a formal statement concerning the 1984 revisions, but the revisions have clearly moved the DOJ much closer to the approach taken by the commission in its 1982 merger statement.\(^6\)

In sum, the 1984 revisions are difficult to argue with as merger policy. As guidelines, however, they may be less useful than the 1982 merger guidelines. The only obvious winner is the antitrust bar, which no doubt would be more than happy to sponsor an annual revision effort.

1. This change is an improvement, since there was never much of a good reason for a difference. If we care about the adverse effects of a 5 percent price rise lasting for one year when we are examining demand substitutability, why do we only care about the adverse effects of a 5 percent price rise for six months when we examine supply substitutability? Regardless of what the correct time period is, it should be the same for both.

One wonders, moreover, why these periods were not also brought into conformity with the two-year entry barrier standard either by raising the market definition periods to two years or by reducing the entry barrier period to one year. The concepts are very similar. If we are asking whether market power will be constrained by new suppliers so that prices cannot be significantly raised for an undue period of time, why should there be a time difference when we ask whether those suppliers come in for market definition purposes rather than for entry barrier purposes?

2. A further clarification would have even been useful here. How concentrated must a market be in order to be significantly more concentrated than an HHI 1800?

3. Although the guidelines state that such mergers will be challenged in all but extraordinary cases, the guidelines state elsewhere that if entry into a market is so easy that existing competitors could not succeed in raising price for any significant period of time, the department is unlikely to challenge mergers in that market. Perhaps these two statements together imply that virtually the only time that such mergers will be not be challenged is when entry barriers are low, and that entry barriers will only be found to be sufficiently low in those circumstances in extraordinary cases.

4. More specifically, the revisions state that the department is unlikely to challenge a merger producing an HHI increase of less than 100 points if the postmerger HHI is 1000 to 1800. It also states that if such mergers result in an HHI increase of more than 100 points the department is likely to challenge them unless, because of factors discussed elsewhere in the guidelines, the department concludes that the merger is not likely substantially to lessen competition. For mergers resulting in a postmerger HHI greater than 1800, the department is unlikely to challenge mergers resulting in an HHI increase of less than 50 points, and likely to challenge mergers producing an HHI increase of more than 50 points, unless other relevant factors are present.

5. Joe Sims and others at Jones, Day, Reavis & Pogue represented Republic Steel Corp. in the LTV merger transaction.


7. Interestingly, the Supreme Court opinion in Copperweld Corp. v. Independent Tube Corp., No. 82-1260, decided June 19, 1984, cites this report in both the majority opinion (p. 15) and the dissent (pp. 6, 14, and 17).


9. This assumption has the effect of significantly lengthening the real time of the benchmarks.
10. See note 4 supra.


15. Id. at 148.

16. Although the FTC has not publicly reacted to the new guidelines, the 1982 FTC statement on horizontal mergers stated that the commission would give considerable weight to the 1982 DOJ guidelines. Since the 1984 revisions have moved the guidelines closer to the FTC approach, one can assume that the commission will give them even greater weight.

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Correction

In an article by Joe Sims and Robert Lande on the Justice Department’s revision of its merger guidelines (see Legal Times, June 25, 1984, p. 15), two portions of the text were missing. The two separate passages on p. 19 should read as follows (the portions that were dropped are in italics):

The section on failing companies was unchanged. However, the 1982 guidelines stated that the failing division defense would be recognized in appropriate cases. The message was clear, both from the guidelines and from Baxter’s public statements on the issue, that both defenses would be construed narrowly and would only be grudgingly accepted.

For example, the old approach on efficiencies was reasonably clear-- efficiencies would not be a defense except in extraordinary cases. Now, the department will always look at every type of efficiency. But how much efficiency in terms of cost savings (and/or increases in quality, which are not mentioned) is enough to offset an otherwise anticompetitive merger? How much is required for a merger that is otherwise slightly anticompetitive, and how much is required for a merger that is otherwise somewhat more anticompetitive? ...

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