Potential Competition: Analysis of an Antitrust Case

Wilbur L. Tomlinson

Follow this and additional works at: http://scholarship.law.missouri.edu/mlr

Part of the Law Commons

Recommended Citation
Wilbur L. Tomlinson, Potential Competition: Analysis of an Antitrust Case, 44 Mo. L. Rev. (1979)
Available at: http://scholarship.law.missouri.edu/mlr/vol44/iss3/4

This Comment is brought to you for free and open access by the Law Journals at University of Missouri School of Law Scholarship Repository. It has been accepted for inclusion in Missouri Law Review by an authorized administrator of University of Missouri School of Law Scholarship Repository.
COMMENTS

POTENTIAL COMPETITION: ANALYSIS OF AN ANTITRUST CASE

I. INTRODUCTION

Prior to the 1950 amendments to section 7 of the Clayton Act, it was generally believed that section 7 barred only the acquisition of stock of a direct competitor. Consequently, the development of the law governing conglomerate mergers did not begin in earnest until the passage of the Celler-Kefauver Amendment of 1950. This amendment made it plain that section 7 applied not only to the merger of direct competitors, but to vertical and conglomerate mergers as well. Thus, the amendment of section 7 set the stage for the development of what has become known as the potential competition doctrine.

Before proceeding directly to the potential competition doctrine, it should first be observed that potential competition is but one of three theories that have been developed to deal with the special problems of conglomerate mergers. Either alone, or in conjunction with the loss of potential competition, the reciprocity or entrenchment theories have also been

4. Section 7 has been the primary tool of antimerger litigation. Although some authors have suggested that § 5 of the Federal Trade Commission Act might prove more effective, see Carstensen & Questal, The Use of Section 5 of the Federal Trade Commission Act to Attack Large Conglomerate Mergers, 63 CORNELL L. REV. 841 (1978), the courts have not as yet adopted such a view. See FTC v. Atlantic Richfield Co., 549 F.2d 289, 291 n.1 (4th Cir. 1977).
6. Reciprocity is the willingness of one company to buy from another, conditioned upon the expectation that the other will make reciprocal purchases. In the leading case of FTC v. Consolidated Foods Corp., 380 U.S. 592, 595 (1965), the Court held that “reciprocity in trading as a result of an acquisition violates § 7, if the probability of a lessening of competition is shown.”
7. The basic concept of the entrenchment theory is that “an acquisition by a firm with extraordinary resources might raise entry barriers in a particular industry by discouraging other potential entrants, or it might discourage competitive challenges from smaller rivals fearful of provoking the giant.” Missouri Portland Cement Co. v. Cargill, Inc., 498 F.2d 851, 865 (2d Cir.), cert. denied, 419 U.S. 883 (1974). For example, in FTC v. Procter & Gamble Co., 386 U.S. 568 (1967), the Court held that Procter’s acquisition of Clorox violated § 7. In doing so, the Court expressed the fear that if Procter were permitted to acquire the already dominant Clorox, the smaller firms in the market would become more
the basis for prohibiting mergers which were essentially conglomerate in nature. This comment necessarily will consider only a portion of the analysis of a conglomerate merger. Complete analysis may also require consideration of the reciprocity or entrenchment theories and perhaps the special failing company defense as well. These, however, are matters outside the scope of this work and are mentioned here only as a caveat.

The origin of the potential competition theory is generally attributed to United States v. El Paso Natural Gas Co. where the Supreme Court found that the merger of two natural gas companies violated section 7 even though they did not actually sell natural gas in the same geographic markets. Since the decision in El Paso, the potential competition theory has reached the Supreme Court in four other major cases and has been the subject of numerous lower court decisions. Yet in spite of the frequency with which the theory has been litigated, it is still a developing concept, the boundaries of which are undergoing substantial evolution.

The purpose of this comment is to give an organized statement of the present status of the potential competition theory and supply a framework for analysis of the law and the facts of the given case. Occasional forays into theory have been unavoidable, but for the most part economic theory has been deferred to those whose credentials qualify them for such discussion. In an effort to provide meaningful and practical guidelines, substantial reliance has been placed upon lower court and Federal Trade Commission decisions.

The analysis of a potential competition case may be broken down into three broad aspects: (1) defining the relevant markets; (2) determining cautious in competing due to their fear of retaliation by Procter. The Court also thought that it was probable Procter would become the price leader and that the oligopoly would become more rigid. Id. at 578.

8. The government has also advanced a fourth theory which, if accepted, would prohibit mergers which tend to increase economic concentration in general. So far, however, the courts have not accepted this expansive reading of § 7. See United States v. IT & T, 324 F. Supp. 19 (D. Conn. 1970); United States v. Northwest Indus., Inc., 301 F. Supp. 1066 (N.D. Ill. 1969).

9. Simply stated, the failing company doctrine permits a merger to escape § 7 prohibitions if it can be shown that (1) the acquired company faced a grave probability of business failure and (2) the acquired company had no other available purchasers whose merger with it would have had a less anticompetitive effect. See Citizen Publishing Co. v. United States, 394 U.S. 131 (1969).


12. For a comprehensive listing of all the significant conglomerate merger cases, categorized on the basis of whether the government prevailed or lost, see Bauer, Challenging Conglomerate Mergers Under Section 7 of the Clayton Act: Today's Law and Tomorrow's Legislation, 58 B.U.L. REV. 199, 200-01 & n.8 (1978).
whether the acquiring firm was a potential entrant into one or more of those markets; and (3) evaluating whether the loss of the acquiring firm as a potential entrant may substantially lessen competition or tend to create a monopoly.

II. RELEVANT MARKET

The analysis of any section 7 problem begins with the determination of the relevant markets. Section 7 proscribes acquisitions "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or tend to create a monopoly." Consequently, "[d]etermination of the relevant product and geographic markets is a 'necessary predicate' to deciding whether a merger contravenes the Clayton Act."14

Determination of the breadth of the relevant market has been the decisive factor in several section 7 cases.15 Typically, the Government (or private plaintiff) will attempt to define the market as narrowly as possible to take advantage of high levels of concentration which exist in such markets.16 In other cases, however, the Government has sought to define the market broadly, thereby characterizing the merger as horizontal rather than conglomerate.17 The market definition has always been important since the breadth of the market affects the determination of the legality of the acquisition. However, it has become even more significant because of the possibility of limiting the Government's remedy to less-than-

16. For example, in United States v. Hughes Tool Co., 415 F. Supp. 637 (C.D. Cal. 1976), the Government challenged the acquisition of Byron Jackson, Inc., by the Hughes Tool Company. In addition to claiming a loss of potential competition in the overall "oil field pipe-handling tools" market, the Government also charged that each tool constituted a relevant product submarket. In Missouri Portland Cement Co. v. Cargill, Inc., 375 F. Supp. 249 (S.D.N.Y.), rev'd on other grounds, 498 F.2d 851 (2d Cir.), cert. denied, 419 U.S. 883 (1974), the geographic market was narrowly defined as the metropolitan areas in which the acquired firm, Portland Cement, had plants or terminals.
complete divestiture. The Hart-Scott-Rodino Antitrust Improvements Acts of 1976 may reduce the frequency in which the remedy of divestiture is necessary, but the extent of the competitive overlap may still be a consideration in an action for a temporary injunction or in formulating a consent decree.

A. Geographic Market—"Section of the Country"

Determination of the relevant geographic market is a question of fact; no hard and fast rules can be established whereby the practitioner can determine with certainty what the proper market(s) should be. In the past decade, however, the courts have dealt with the question on numerous occasions and from these cases certain factors have emerged as considerations in delineating the geographic market. In light of the dearth of commentary on this subject, it will be treated briefly herein merely so that the subsequent discussion of potential competition can be viewed, as it must, with an awareness of the problems of defining the relevant market.

The statutory mandate is that a merger may not lawfully proceed "where in any . . . section of the country, the effect . . . may be substantially to lessen competition, or tend to create a monopoly." The burden is upon the Government to produce evidence of the relevant geographic

---


market, but it is well recognized that there is some degree of "fuzziness" inherent in any section 7 geographic market. Consequently, although a "metes and bounds" description cannot reasonably be required, the Government must come forward with evidence delineating the "rough approximation" of the geographic market.

Determination of the relevant geographic market actually involves two concepts: (1) determination of the outermost boundaries of the geographic area, and (2) designation of smaller "submarkets" within the overall territory. Because these two concepts are often confused they will be dealt with separately.

1. Overall Market

The breadth with which the Government may define the geographic market is sometimes outcome determinative. Although a broad geographic market will benefit the defendant in most cases—hence the nation as a whole is frequently stipulated as the outer boundary—occasionally the Government will attempt to give an expansive definition to the geographic market so as to cast what otherwise would have been a market extension merger into a horizontal merger.

The outer boundary of the geographic market in potential competition cases is described in United States v. Marine Bancorporation, Inc. as "the area in which the acquired firm is in actual, direct competition;" i.e., "the area in which the goods or services at issue are marketed to a significant degree by the acquired company." According to this test, the acquired company may do an insubstantial amount of business in the same area as the acquiring company without the merger being treated as horizontal. Thus, in a companion case, the Court held that a statewide market was inappropriate for the evaluation of a merger between two multibranch banks doing business in various local markets throughout the state.
Despite evidence that the banks did compete on a broad geographical scale for very large customers, the court concluded that the vast bulk of business was local in nature. Accordingly, the Government could not legitimately claim that the merger was horizontal merely because of a few far-flung accounts.

The question, therefore, is whether the Government's market description sweeps so broadly as to include areas where the acquired company does not do a significant amount of business. This is a question of fact and courts naturally differ in their approach. It should be mentioned, however, that the courts have tended to be less analytical in cases which are clearly not geographic market extension cases.

2. Geographic Submarkets

Defendants have argued from time to time that submarkets are inconsistent with the notion that an overall market exists. To a defendant it seems unreasonable that the Government may have its cake and eat it too, so-to-speak, by claiming that competition is both national and regional in scope. Regardless of the merits of this argument, the law appears to be well-settled that the Government may challenge a merger on the basis of multiple geographic markets.

34. Compare United States v. Amsted Indus., 1974-2 Trade Cases ¶ 75,208 (N.D. Ill. 1974) with RSR Corp., 88 F.T.C. 800, 3 Trade Reg. Rep. (CCH) ¶ 21,252 (1976). In Amsted the court rejected the Government's claim that a nation-wide market existed for "water pressure pipe." Despite evidence that both companies occasionally made bids throughout the country, the court concluded that distant sales were so unusual that neither company was a national competitor. In RSR, however, the commission found that a national market had been proven even though sales outside areas contiguous to defendant's lead plants were infrequent.

35. See FTC v. Procter & Gamble Co., 386 U.S. 568 (1967); British Oxygen Co., 86 F.T.C. 1241, [1973-76 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 21,063 (1975), rev'd on other grounds and remanded sub nom. BOC Int'l, Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977); Kennecott Copper Corp., 78 F.T.C. 744 [1970-73 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 19,619 (1971), aff'd, 467 F.2d 67 (10th Cir. 1972), cert. denied, 416 U.S. 909 (1974). In each of these cases the acquired firm operated facilities scattered throughout the country, each of which competed in a small geographical area near the point of production because transportation costs prevented competition from extending over large geographical areas. Nevertheless, the courts viewed the acquisitions in terms of their effect upon the overall national market. Although such market definitions may be technically improper, the courts tend to lump these regional markets together as a matter of convenience where there is little risk of distorting the competitive effects of the merger.


The general test for determining the validity of a geographic market was first set out in *Brown Shoe Co. v. United States.* 38 "The geographic market selected must . . . both 'correspond to the commercial realities' of the industry and be economically significant." 39 To be commercially realistic a submarket must be distinguishable from the overall market. 40 That is, there must be a sufficient showing that there are significant barriers which prevent companies within the overall market from entering the submarket as equally effective competitors. 41 Superficially this notion may seem at odds with the finding that an overall market exists, but such is not the case.

There are actually two reasons why it is conceptually possible to have geographic submarkets: competition is measured from the point of view of both the buyer and the seller; and because the overall market is not always homogeneous, there may be room for differentiation within the market even from the point of view of either buyers or sellers. The first of these two concepts is clearly the easier to appreciate. Consider an industry such as that of producing liquid laundry bleach where the cost of transportation restricts effective competition to approximately a 300-mile radius around each plant. 42 From a manufacturer’s point of view, the market may be national in scope because the acquired firm has numerous plants and is “in actual, direct competition” throughout the entire nation. 43 From a buyer’s point of view, however, the market is the area where he can reasonably turn for supplies, i.e., those plants within 300 miles of his business. Therefore, there is an overall national market, and at least as many submarkets as the acquired firm has plants.

The second situation in which submarkets may occur is more difficult to understand, primarily because it is simply a question of degree. To establish the outer boundaries of the market the court may include all the areas where the acquired company markets its goods or services to a


39. Id. at 336-37.
40. See, e.g., United States v. Federal Co., 403 F. Supp. 161 (W.D. Tenn. 1975). The parties stipulated that "southeastern United States" (10 states) was a relevant market, but the Government attempted to show that within this market a six state submarket existed. In rejecting the Government's claim the court stated: [T]he record shows that there are no commercial factors which would serve to distinguish the six-state area from the Southeast generally, and that the factors which distinguish the Southeast from the rest of the country exist throughout the Southeast.

Id. at 164.
42. These are basically the facts presented in FTC v. Procter & Gamble Co., 386 U.S. 568 (1967).
Within this area, however, competitive conditions may not be uniform. There may be certain areas within the overall market where the acquired company has greater market strength than it generally has throughout the larger market.

Assuming that holding a ten percent or larger market share is doing business to a "significant degree," the acquired firm may have at least a ten percent market share throughout the country, and the nation as a whole will be viewed as the overall market. Notwithstanding that fact, there may be certain areas of the country where, because of barriers to entry by other firms, the acquired company has a substantially greater market share. For example, a company which deals in bulk commodities might through the use of rail transportation be capable of obtaining at least the minimum market penetration required to be a significant competitor throughout the Midwest. However, if one of its facilities is located on a waterway which, because of inexpensive barge transportation, allows the company to compete more effectively, there may be a valid submarket consisting of the markets on or near the waterway. In this case it is transportation costs which are a barrier to firms outside the market and create a commercially realistic submarket.

Transportation costs are not the only basis for distinguishing submarkets. For example, with products such as agricultural herbicides the type of soil on which they are used has a substantial effect on their performance. Some perform better on light soils, while others must be used on heavy soil. Therefore, in a merger between two competing herbicide manufacturers, a geographic submarket might be defined in terms of soil type. In this case, soil type might be a substantial barrier to entry into the submarket.

Though the factors which might be considered in defining a geographic submarket are infinite, there are several major categories of factors which the courts have recognized:

1. transportation costs;\textsuperscript{45}
2. convenience and quick service;\textsuperscript{46}
3. unique economic and competitive conditions within the submarket.\textsuperscript{47}

(4) established consumer preference; and
(5) industry or public recognition of the submarket as such.

Because the weight given each factor will vary according to its applicability in a given case, no one factor is determinative. Moreover, it is clearly not necessary that all five factors be satisfied before a valid submarket is shown.

In theory the burden is upon the Government to show that submarkets conform to economic reality, but in practice the defendants who have prevailed on this issue have vigorously contested the Government's markets through the use of economic data of their own. Generally, the defendant desires to counter the Government's claim that its submarkets are valid with evidence that no substantial barriers to competition exist; i.e., that the submarket advocated by the Government is not shielded from competition from without. In several cases defendants have succeeded in doing just that. While none of them appear to have negated all five factors, they generally were able to convince the trier of fact that the submarkets designated by the Government did not follow the lines of significant economic barriers and hence were invalid.

Although the potential competition cases to date have seldom involved disputes over geographic submarkets, it may be presumed that the Government will not ignore the submarket concept if a proper case arises. As shall be discussed later, the Government must show that the industry is concentrated and that the acquired company is a substantial competitor in

---


50. See, e.g., Crown Zellerbach Corp. v. FTC, 296 F.2d 800, 817 (9th Cir. 1961) (convenience and service, common economic factors); FTC v. Procter & Gamble Co., 386 U.S. 568, 571 (1967) (court mentions only transportation costs).


the target market before the potential competition doctrine is applicable. Accordingly, if the Government is unable to satisfy either of these requirements with reference to the overall market, it will have an incentive to utilize the submarket concept. Thus far the cases have typically involved dominant firms in highly concentrated overall markets and resort to submarkets has been unnecessary. Moreover, the Government is undoubtedly reluctant to tackle the difficult problems of applying the submarket concept to the potential competition doctrine.\footnote{53}

B. Product Market—"Line of Commerce"

In addition to the geographic dimensions of the market, the Government (or private plaintiff) must also establish the extent of the product market. As in the case of the geographic market, the product market may consist of an overall market, within which there may be one or more distinct submarkets.\footnote{4} Unlike the geographic market, however, there has been considerable dispute in potential competition cases over the definition of the relevant product market.\footnote{5\textsuperscript{5}}

In spite of the abundance of litigation, there still appears to be considerable confusion regarding the manner of determining the product market. As with geographic market determination, the problem stems in part from a failure to distinguish between the test for the outer boundaries of the market and the test for submarkets therein. Once again, therefore, the rules for defining the overall market shall be discussed separately from

\footnote{53. Neither case cited in note 52 \textit{supra} considered whether it must be proven that the acquiring firm was a potential entrant as to each submarket. In \textit{Procter & Gamble} the acquiring firm clearly desired to become a national competitor; hence it might be assumed that the de novo entry of Procter & Gamble would improve competition in the regional markets around the acquired firm's plants. In \textit{Missouri Portland}, however, there appeared to be no basis for assuming that the acquiring company would have entered the four metropolitan markets considered by the trial court if the merger had been prohibited. It seems just as likely that the acquiring company would have entered the market in an entirely different area. The courts may be presuming from the location of the company acquired that the acquiring company intends to enter the same area, a questionable assumption.}

\footnote{54. \textit{Brown Shoe Co.} v. United States, 370 U.S. 294, 325 (1962).}

the test for submarkets. It should be noted, however, that the Government frequently prosecutes cases on the basis of a single submarket without designating it as such. Whether the defendant can successfully expand the market advocated by the Government in such a case will depend upon the rules governing the validity of submarkets.\textsuperscript{56}

1. The Overall Market

In considering whether a product market advocated by the Government is too broad, the courts essentially attempt to determine if the Government's definition sweeps so broadly as to encompass a significant number of products which lack any competitive relationship to one another. For instance, in \textit{United States v. Ling-Temco Electric, Inc.},\textsuperscript{57} the court rejected the "aerospace industry" as a relevant line of commerce. In doing so the court stated:

> The field includes such a broad range of heterogeneous products and research activities that the "aerospace industry" is not an identifiable business activity which can be bound either in terms of companies in the field or services performed or products manufactured. The concept of such an amorphous and nebulous field is of no value in measuring the competition between Chance Vaught and Ling-Temco.\textsuperscript{58}

Although \textit{Ling-Temco} is an extreme example, it nevertheless clearly illustrates that the Government may not expand the product market indefinitely. If there were no limits upon the scope of the market, the potential competition doctrine would inevitably be swallowed up for all practical purposes by the horizontal theory of merger.

In determining the outer limits of the product market, the courts have applied several theories, including cross-elasticity of demand, cross-elasticity of supply, and cluster of products.\textsuperscript{59} If the product market advocated by the Government can fairly fit within any of these theories, the market is not overly broad. Even though one test may suggest that a

\textsuperscript{56} See, e.g., \textit{Beatrice Foods Co. v. FTC}, 540 F.2d 303, 308 (7th Cir. 1976). Although defendant was correct in arguing that brushes, rollers, aerosols and sprayers constitute a market, this was of no avail to defendant. The question was whether the Commission could properly find that rollers and brushes alone properly constituted a line of commerce.


\textsuperscript{58} 1961 Trade Cases at ¶ 78,643.

\textsuperscript{59} For a more extensive treatment of this subject see Rosenthal, \textit{Continental Can Revisited: Limits Upon the Breadth of a Line of Commerce in a Section 7 Case}, 14 Hous. L. Rev. 973 (1977).
market is not valid, it may nevertheless be sustained on another; the tests are not mutually exclusive.

a. Cross-Elasticity of Demand

The cross-elasticity of demand test focuses upon the degree to which consumers view various products as interchangeable. Under this test "[t]he outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it."60 The products need not be so interchangeable that they are fungible,61 nor must the products be interchangeable in every segment of the proposed market.62 As one court has acknowledged, "[f]or every product, substitutes exist. But a relevant market cannot meaningfully encompass that entire range."63 Therefore, whether there is sufficient cross-elasticity of demand is a question of degree.64

In applying this test courts have found metal containers to be reasonably interchangeable with glass containers;65 beet sugar with cane sugar;66 coal with natural gas, oil and uranium;67 and cellophane with other "flexible packaging materials."68 On the other hand, gas turbines are not

62. Id. at 457. "There may be some end uses for which glass and metal do not and could not compete, but complete interindustry competitive overlap need not be shown."
66. American Crystal Sugar Co. v. Cuban-American Sugar Co., 259 F.2d 524, 529-30 (2d Cir. 1958) (court found that the two products were almost completely functionally interchangeable and that there was sensitivity to price change).
67. United States v. General Dynamics Corp., 341 F. Supp. 554, 555-56 (N.D. Ill. 1972), aff'd on other grounds, 415 U.S. 486 (1974). The district court concluded that the line of commerce for measuring the effect of the merger of a deep-mine coal producer with a strip mine coal producer was the "energy market." But see Kennecott Copper Corp. v. FTC, 467 F.2d 67 (10th Cir. 1972), cert. denied, 416 U.S. 909 (1974) (coal is a valid market). General Dynamics is particularly unusual because the court concluded not only that they may be combined, but that they must be combined.
reasonably interchangeable with steam generation systems for production of electricity; nor watchman services with central alarm systems; nor "family flour" with "ingredient flour," "durum flour," "baking flour" and "millfeed."

In attempting to determine the reasonable interchangeability of one product for another, "the factors that normally determine the choice or preference of the user must be considered." The threshold question is whether the products are "functionally interchangeable," i.e., whether they are reasonably adaptable to the same uses. If so, it must next be determined whether purchasers are willing to substitute one for another. Price, quality, and consumer taste may prevent the substitution of one for the other almost as surely as functional incompatibility. Consequently, although differences may exist, a substantial number of users must be willing to make a trade-off if price or quality vary within a reasonable range. In most cases this element of reasonable interchangeability has

74. See authorities cited note 73 supra. See also Rosenthal, Continental Can Revisited: Limits Upon the Breadth of a Line of Commerce in a Section 7 Case, 14 HOUS. L. REV. 973, 1018-19 (1977) (cautioning that evidence of actual alternate purchasing should be a sine qua non of reasonable interchangeability).
75. See, e.g., Babcock & Wilcox Co. v. United Technologies Corp., 435 F. Supp. 1249 (N.D. Ohio 1977). The court rejected plaintiff's "electrical generation equipment" market because gas turbines manufactured by U.T. were not reasonably interchangeable with the steam generation systems produced by B & W. Although both could produce the same end product (electricity), the cost of operating gas turbines was prohibitive except for "peaking" operations.
been established by proof of actual conduct. Where proof of actual conduct is lacking, the courts are reluctant to rely upon what users theoretically might do.

b. Cross-Elasticity of Supply

The cross-elasticity of supply test is essentially the antithesis of the cross-elasticity of demand theory. While the latter focuses upon what the user may do, the former looks to the capabilities of the producer. In *Twin City Sportservice, Inc. v. Charles O. Finley & Co.*, the court stated:

Substitutability in production refers to the ability of firms in a given line of commerce to turn their productive facilities toward the production of commodities in another line because of similarities in technology between them. Where the degree of substitutability in production is high, cross-elasticities of supply will also be high, and again the two commodities in question should be treated as part of the same market.

The concept of cross-elasticity of supply is very similar to the theory of potential competition. The difference is that cross-elasticity of supply should require a much stronger showing of resource flexibility. A company within a market encompassed by the cross-elasticity of supply concept must be capable of switching its resources from the production of one product to another within the immediate or near future. The potential competition doctrine, however, embraces those firms which, although not able to respond in the near future, possess actual or apparent capability to do so in the future.

Although the cross-elasticity of supply theory has received judicial recognition in several cases, the Government has placed little emphasis on forms of energy as reasonably interchangeable despite obvious long term nature of a decision to switch.


80. *See generally Rosenthal, supra note 74, at 996-1002.*

81. 512 F.2d 1264 (9th Cir. 1975).

82. *Id.* at 1271.


on it. Indeed, *Sterling Drug, Inc.* appears to be the only case in which the Government has made a full-blown attempt to utilize the cross-elasticity of supply theory. The Government attempted to prove that the merger of Sterling Drug, Inc., whose primary business was the manufacture of proprietary drugs, with Lehn & Fink Products Corp., whose primary business was cosmetics and other beauty aids, was a horizontal merger. The market advocated by the Government was a "health and beauty aids" market. In support of this market definition the Government produced evidence of similarity in advertising and distribution, but the Federal Trade Commission rejected the Government's definition because the Government had failed to prove common production techniques and resources.

The high standard of resource flexibility required in *Sterling* may partially explain the Government's reluctance to rely on this theory. The Commission correctly noted that the ability to switch from one product to another requires flexibility in both production and marketing resources. While a potential entrant will frequently have significant capability in one of these areas, it is seldom the case that a high degree of resource flexibility will be present in both. Therefore, courts should proceed with caution in utilizing the cross-elasticity of supply concept, lest it be expanded to the point that the potential competition concept is lost.

c. Cluster of Products

The "cluster of products" approach is a concept which purportedly supports broad market definitions which combine groups of non-interchangeable products into single lines of commerce. For example, burglar


alarms, fire alarms, water overflow alarms, etc., have been grouped together as a single central station alarm services market under the cluster of products approach.\textsuperscript{87}

The cluster of products concept is particularly difficult to understand because the courts have never articulated a test for determining what constitutes a "cluster of products." The only guidance offered by a leading cluster of products case is that the cluster must reflect commercial realities.\textsuperscript{88} Such a vague test is of course little help in analyzing the facts of other cases.

Although a helpful test has not yet been articulated in any of the cases, a recent Commission decision has noted several factors relevant to identifying a "cluster of products":\textsuperscript{89} (1) all or substantially all of the significant members of the industry provide all or substantially all of the services or products within the cluster; (2) user preference for companies which do supply the full range of products or services; (3) industry recognition of the cluster of products as a distinct line of commerce; (4) significant cross-elasticity of supply between most of the products within the group; and (5) intent on the part of the acquiring firm to engage in the full line of products. Of these five factors, however, only two have true economic significance—cross-elasticity of supply and consumer preference for a company offering the entire mix. If there is sufficient cross-elasticity of supply, as previously discussed, the various products may be lumped together. The consumer preference aspect of the product cluster market is then used, not to justify broadening the market, but to exclude other products which would otherwise be includible in the cluster.\textsuperscript{90}

When there is not a high degree of cross-elasticity of supply the doctrine becomes one of questionable economic merit,\textsuperscript{91} yet the courts appear to rely on the other factors to justify a lesser degree of cross-elasticity of

\textsuperscript{88.} Id. at 572.
\textsuperscript{90.} In both United States v. Grinnell Corp., 384 U.S. 563 (1966) and United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963), the defendant was primarily concerned with the limiting aspect of the cluster of products doctrine. For example, in Philadelphia Nat'l, the defendant was chiefly concerned with the fact that competition from non-commercial banks was not being considered. The lumping together of the services into a single line of commerce was not the central issue.
\textsuperscript{91.} See Rosenthal, supra note 74, at 1019.
supply than was suggested in *Sterling Drug, Inc.* In particular, the courts appear to place considerable emphasis on whether most of the major producers within the industry produce the full line, or nearly the full line, of products within the cluster. Where most companies within the industry produce almost the entire line of products in the cluster, the courts apparently are willing to group the products into a single line of commerce even though cross-elasticity of supply is not particularly high. However, where it does not appear that most firms in the industry produce substantially the entire line of products, and cross-elasticity of supply is not particularly high, there may be a greater reluctance to apply the doctrine.

2. Product Submarkets

As with the geographic submarket, the product submarket is a manipulative concept which greatly favors the Government. In general the Government may subdivide the product market as it pleases so long as the resulting submarkets are "economically significant." The defendant, however, cannot insist that a narrower market be adopted unless the Government has attempted to define the relevant market more broadly than permitted under the tests previously discussed.


93. In British Oxygen Co., 86 F.T.C. 1241, [1973-76 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 21,063 (1975), *rev’d on other grounds and remanded sub nom.* BOC Intl Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977), the Commission applied the cluster of products approach to industrial gases but did not apply it to "inhalation anesthetic equipment and accessories" because, unlike industrial gases, few companies made the complete line of products included in the cluster. The Supreme Court, in United States v. Grinnell Corp., 384 U.S. 563 (1966), also emphasized that most companies provided the full line of services in the cluster.

94. See note 92 supra.


96. See Brown Shoe Co. v. United States, 370 U.S. 294 (1962). "[I]t is necessary to examine the effects of a merger in each economically significant submarket. . . ." Id. at 325 (emphasis supplied).

97. See, e.g., Beatrice Foods Co., 86 F.T.C. 1, [1973-76 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 20,944 (1975), *modified,* 540 F.2d 305 (7th Cir. 1976). In rejecting the defendants' attempt to narrow the market, the Commission stated: "It may well be that paint brushes and paint rollers could be divided into product submarkets according to quality-derived price distinctions. However, the question presented by respondent is whether brushes and rollers must be segre-
To determine whether a given submarket is "economically significant," Brown Shoe states that the following "practical indicia" should be considered:

1. industry or public recognition of the submarket as a separate economic entity;
2. the product's peculiar characteristics and uses;
3. unique production facilities;
4. distinct customers;
5. distinct prices;
6. sensitivity to price changes; and
7. specialized vendors.

Clearly the Government need not establish all of the above factors to prove the existence of a valid submarket. Proof of as few as three of these factors has been held to be sufficient. Conversely, however, the presence of one or more of these factors does not necessarily mandate the finding of a valid submarket. In several cases submarkets have been rejected even where several of the indicia were present.

The question then is one of fact, and the courts have reached conflicting results in nearly indistinguishable cases. All that can be said with certainty is that while the Government has considerable discretion in defining submarkets, the courts will not permit a market to be subdivided into entirely separate product markets. . . . " Id. at 56, (CCH) at ¶ 20,786-87.

98. 370 U.S. 294.
99. Id. at 825.
101. See Reynolds Metals Co. v. FTC, 309 F.2d 223 (D.C. Cir. 1962). Public recognition, distinct prices, and distinct customers were held to be sufficient to distinguish florist foil from decorator foil. See also General Foods Corp. v. FTC, 386 F.2d 936 (3d Cir. 1967), cert. denied, 391 U.S. 919 (1968).
104. In Calnetics Corp. v. Volkswagen of America, Inc., 348 F. Supp. 606, 617 (C.D. Cal. 1972), rev'd in part and remanded, 552 F.2d 674 (9th Cir.), cert. denied, 429 U.S. 940 (1976), the Court noted: "Reported cases have largely been
vided to the point that commercial reality is ignored. Where a high degree of elasticity of supply or demand exists between the alleged submarkets, other "practical indicia" may be ignored and the submarkets rejected.\textsuperscript{105}

III. THE POTENTIAL COMPETITION THEORY

Once the relevant markets are determined, the next step of the analysis is to determine whether the acquiring company is a potential entrant into the overall market or any submarket thereof.\textsuperscript{106} The potential competition theory must be applied to each and every relevant market to determine if the merger violates section 7. If the effect of the loss of potential competition in any relevant market "may be substantially to lessen competition, or tend to create a monopoly,"\textsuperscript{107} a section 7 violation exists. However, as discussed previously, the extent of the violation may have a bearing upon the consequences of such a finding.\textsuperscript{108}

The potential competition doctrine consists of two distinct theories: the actual potential entrant theory and the perceived potential entrant theory.\textsuperscript{109} The perceived potential entrant theory is concerned with the present effect that the potential competitor has upon the market place. According to economic theory, if competitors within an oligopolistic market recognize that a company outside the market is a likely entrant they will keep prices and profits lower so as to discourage that company's entry.\textsuperscript{110} If the perceived potential entrant then acquires a substantial firm

\textsuperscript{105}. In Erie Sand & Gravel Co. v. FTC, 291 F.2d 279 (3d Cir. 1961), for example, the court held that lake sand could not be distinguished from pit sand. Although \textit{Erie} is a pre-\textit{Brown Shoe} case, the result would probably the same since the court found almost perfect cross-elasticity of demand. See also The Budd Co., 86 F.T.C. 518, [1973-76 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 20,998 (1975), where the Commission rejected the Government's proposed "open top trailer" market because it found that there was an extremely high cross-elasticity of supply between open and closed top trailers.

\textsuperscript{106}. Although analysis normally focuses upon whether the acquiring company is a potential entrant into any relevant market where the acquired company is a competitor, the doctrine is not so limited. The inverse situation may be unlawful as well. See, e.g., United States v. El Paso Natural Gas Co., 376 U.S. 651 (1964). Moreover, if each is a potential entrant into the other's market, competition is hurt twice. Beatrice Foods Co., 67 F.T.C. 473, 720, [1965-67 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 17,244 at 22,332 (1965).


\textsuperscript{108}. See text accompanying notes 18-21 supra.


\textsuperscript{110}. This so-called "limit-pricing" theory has not gone without criticism. See Note, \textit{United States v. Falstaff Brewing Corporation: Potential Competition Re-examined}, 72 MICH. L. REV. 837, 848-51 (1974). Nevertheless, judicial accep-
already within the relevant market, the "edge effect," which formerly induced procompetitive behavior in the market place, is lost.\textsuperscript{111}

The other theory, actual potential entry, deals with the loss of future rather than present competition. As stated in \textit{United States v. Marine Bancorporation, Inc.}:\textsuperscript{112}

[T]he [actual] potential-competition doctrine proscribes a . . . merger solely on the ground that such a merger eliminates the prospect for long term deconcentration of an oligopolistic market that in theory might result if the acquiring firm were forbidden to enter except through a de novo undertaking or through the acquisition of a small existing entrant (a so-called foothold or toe hold acquisition).\textsuperscript{113}

Thus under the actual potential entrant theory, awareness of the potential entrant is unnecessary. It is the prospect of a more procompetitive form of entry that is sought to be preserved. If the potential entrant acquires a larger company already in the relevant market and simply steps into the shoes of the established firm, competition is left just the way it existed before the merger.\textsuperscript{114} On the other hand, if the potential entrant can be dissuaded from entering through a major acquisition, and thereby encouraged to enter by internal development or the acquisition and expansion of a small firm already within the market,\textsuperscript{115} a new procompetitive force is added to the market place. This is the thrust of the actual potential entrant theory.

Although the actual and perceived potential entrant theories are similar in many respects, they are sufficiently distinct to warrant their separate discussion and analysis. However, it is important to consider their interrelationship as the Government typically will allege the loss of both.\textsuperscript{116} Moreover, their combined effects may be considered in determining whether the effects of the merger "may be substantially to lessen competition, or tend to create a monopoly."\textsuperscript{117}
A. Actual Potential Entrant Theory

1. Validity of the Theory

The first question to be answered when considering the likelihood of a successful governmental challenge based upon the actual potential entrant theory is whether the theory itself is a valid basis for determining the legality of a merger. Until *United States v. Falstaff Brewing Corp.*, it was generally assumed that the theory was valid and most lower courts applied it without question. In *Falstaff*, however, the Supreme Court stated:

Because we remand for proper assessment of Falstaff as an on-the-fringe potential competitor, it is not necessary to reach the question of whether § 7 bars a market-extension merger by a company whose entry into the market would have no influence whatsoever on the present state of competition in the market—that is, the entrant will not be a dominant force in the market and has no current influence in the market place. We leave to another day the question of the applicability of § 7 to a merger that will leave competition in the market place exactly as it was, neither hurt nor helped, and that is challengeable under § 7 only on grounds that the company could, but did not, enter de novo or through “toehold” acquisition and that there is less competition than there would have been had entry been in such a manner.

Two years later, in *United States v. Marine Bancorporation, Inc.*, the Supreme Court again declined to rule on the validity of this theory.

As a consequence of *Falstaff*, the law of potential competition is left in a state of uncertainty. Although several lower court and Commission decisions have upheld the validity of the actual potential entrant theory, the theory apparently has not yet received the approval of an appellate

---

119. See *Ekco Products Co. v. FTC*, 347 F.2d 745 (7th Cir. 1965); *United States v. Wilson Sporting Goods Co.*, 288 F. Supp. 543, 559-63 (N.D. Ill. 1968); *Ford Motor Co. v. United States*, 286 F. Supp. 407, 438-42 (E.D. Mich. 1968), aff'd on other grounds, 405 U.S. 562 (1972); *United States v. Standard Oil Co.*, 253 F. Supp. 196, 227 (D. N.J. 1966). These early cases tended to slur the distinction between actual and perceived potential competition so badly that it is impossible to determine the actual grounds for their holdings. In *Ekco*, however, it appears that the court relied primarily upon what is now known as the actual potential entrant theory.
120. 410 U.S. at 537.
In the cases which have been appealed and decided in favor of the Government, there has always been present some additional anticompetitive consequence other than the loss of an actual potential entrant. Hence the question whether the loss of an actual potential entrant is in-and-of-itself enough to constitute a violation of section 7 is still open.

The crux of the controversy raised in *Falstaff* centers around the views expressed by two commentators regarding the scope of the then newly revised section 7. In 1958, Professor James A. Rahl argued in his article, *Applicability of the Clayton Act to Potential Competition*, that:

[Section 7] does not prescribe a program for increasing competition. Its prohibition runs to conduct which actually or probably *lessens* competition. To treat an election not to augment competition as a lessening of competition is a neat trick, perhaps facilitated by the enveloping propensities of the phrase, "potential competition." It is, however, plainly not authorized by the language of the statute, nor by the philosophy of antitrust, which does not affirmatively seek to compel competition.

In rebuttal to Professor Rahl, Donald F. Turner, then Professor of Law at Harvard Law School, argued that the proper manner of analysis is to compare the level of competition that would exist if the merger did not take place, in which case the acquiring company would presumably enter de novo or through a toehold acquisition, with the level of competition which would exist if the merger were permitted. Thus viewed, the loss of an actual potential entrant might lessen competition, which is the result prescribed by section 7.

Although the views of Professor Turner have been influential in the development of other aspects of the potential competition doctrine, with regard to the validity of the actual potential entrant theory, Professor Rahl's view appears to be the sounder position. In the legislative history of the 1950 amendments to section 7, the committee makes repeated reference to the fact that it is the purpose of section 7 to arrest restraints of trade before they develop into violations of the Sherman Act. A merger between two competitors, although it may increase market concentration only one percent, may be proscribed under this "incipiency approach." Section 7 was intended to prevent a series of actions, each insignificant in-

123. The courts of appeal have been directly confronted with this question twice since *Marine Bancorporation*, but have ducked the issue on both occasions. See *BOC Int'l, Ltd. v. FTC*, 557 F.2d 24 (2d Cir. 1977); *FTC v. Atlantic Richfield Co.*, 549 F.2d 289 (4th Cir. 1977). See also *Babcock & Wilcox Co. v. United Technologies Corp.*, 435 F. Supp. 1249, 1286 (N.D. Ohio 1977).

124. 12 ABA Antitrust Section 128 (1958).

125. *Id.* at 143.


and-of-itself, from slowly converting a market into a monopoly or tight oligopoly.\(^{128}\)

The basic premise underlying the incipiency concept is that the conduct in question, if left unabated, will develop into a Sherman Act violation. Applying this notion to the actual potential competition doctrine, it appears that Professor Rahl correctly stated the limits of section 7. If an industry contains fifty firms and each of them merges with a mere actual potential entrant, there would not be the slightest movement towards a monopoly or restraint on trade. Such mergers could continue *ad infinitum* without ever reaching a full scale restraint. Although it may be desirable to deconcentrate certain industries, neither the language of the act nor its legislative history suggest that section 7 was intended to have such an effect. Thus, an actual potential entrant should not be precluded from entering a market by acquisition absent other grounds establishing the proscribed anticompetitive effects.

2. Standard of Proof

Aside from creating uncertainty about the validity of the actual potential entrant theory, the language in *Falstaff* has indirectly generated several attempts to refine the standard of proof needed to justify the application of the theory. In *FTC v. Atlantic Richfield Co.*,\(^{129}\) the Fourth Circuit found it unnecessary to decide the validity of the actual potential entrant theory because the Government had failed to produce the required quantum of proof. Relying on Professor Turner's article and some "peripheral support" from *Marine Bancorporation*,\(^{130}\) the court concluded that in order to reach the actual potential entrant question the Government must produce "unequivocal proof" that the acquiring firm would actually enter the market de novo or through a toehold acquisition if the challenged merger was not permitted.\(^{131}\) Since the Federal Trade Commission had based its findings on a less rigorous standard, the court reversed the Commission's decision.

The "unequivocal proof" standard, which represented a substantial departure from the previously established "reasonable likelihood of entry" test,\(^{132}\) did not long go without criticism. In *BOC International Ltd. v.*

---

128. *Id.* at 4297.
129. 549 F.2d 289 (4th Cir. 1977).
130. 418 U.S. 602 (1974). The peripheral support the court of appeals referred to was the following language:
   Unequivocal proof that an acquiring firm actually would have entered de novo but for a merger is rarely available. Thus, as Falstaff indicates, the principal focus of the doctrine is on the likely effects of the premerger position of the acquiring firm on the fringe of the target market.
   *Id.* at 624.
131. 549 F.2d at 294.
132. *See, e.g.*, Ekco Products Co. v. FTC, 347 F.2d 745, 753-54 (7th Cir. 1965).
FTC\textsuperscript{133} the Second Circuit flatly rejected the "unequivocal proof" standard and applied the "reasonable probability" test.\textsuperscript{134} Had the court stopped there, however, it would have had to face the difficult question of the viability of the actual potential entrant theory. Rather than do that, the Second Circuit found language in \textit{Marine Bancorporation} which supported a different gloss upon the actual potential entrant theory. The court concluded that proof of the reasonable probability of eventful entry was not enough, and instead, found that the probable entry test must "contain some reasonable temporal estimate related to the near future, with 'near' defined in terms of the entry barriers and lead time necessary for entry into the particular industry."\textsuperscript{135}

The "near future" requirement of \textit{BOC} is too current to have been the subject of a substantial amount of comment, but it is surely to become a source of litigation. What the court intended by this new addition to the actual potential competition theory is somewhat unclear. Presumably, by defining "near" with reference to lead time, the court meant that the Government must show that the \textit{decision or commitment} to enter will be made in the near future. If this is proven, it is irrelevant that the lead time required to enter the market may forestall \textit{actual} entry for a long period of time. Otherwise, industries which require several years of research and development to perfect a marketable product would be immunized from the actual potential entrant theory.

What the court meant by defining "near" with reference to entry barriers is a more difficult question. In \textit{Fruehauf Corp.}\textsuperscript{136} the Commission concluded that the "near future" requirement in \textit{BOC} did not require that the likely time of entry be specified in absolute terms. Rather, the Commission concluded that \textit{BOC}, by defining "near" with reference to entry barriers, intended that the time of entry could be specified in contingent terms.\textsuperscript{137} Hence, \textit{Fruehauf} would permit the Government to prove its case by showing that the acquiring firm would enter the target market at some indeterminate time in the future, given a shift in conditions within the market. For example, prices may currently be too low to entice the potential entrant into the market. However, should they rise ten or twenty percent, the potential entrant might rapidly commence the process of entering the market. \textit{Fruehauf}, in dicta, stated that the "near future" requirement did not prevent the Commission from prohibiting the potential entrant from entering via a major acquisition under such conditions. The purpose of the potential competition doctrine, the Commission reasoned, was to keep the acquiring firm out of the market until such time as sufficiently supracompetitive price levels make it worthwhile to enter de novo.

\textsuperscript{133} 557 F.2d 24 (2d Cir. 1977).
\textsuperscript{134} \textit{Id.} at 28-29 n.7.
\textsuperscript{136} 3 Trade Reg. Rep. (CCH) \textsuperscript{137} 21,402 (1978).
\textsuperscript{137} \textit{Id.} at 21,396-97 & n.35.
or by a toehold acquisition. If the "near future" test were applied literally, this object would be defeated.

Although the Commission may have correctly stated the purpose of the actual potential entrant theory, it could not disguise the fact that it was circumventing the BOC decision. Unless Fruehauf also requires proof that the shift in the market would occur within a brief period of time, the position the Commission has taken is contrary to the rule laid down in BOC. BOC itself was a reaction to a Commission finding of a section 7 violation where the potential entrant would not have entered under the prevailing market conditions, but would have done so if profits in the target industry improved. Consequently, it appears that BOC was attempting to limit speculation on future market conditions when assessing whether a company is a potential entrant. The court's reference to entry barriers, therefore, does not seem susceptible to the interpretation Fruehauf would put on it. Rather, BOC was probably referring to entry barriers in the same context as lead time. The court apparently intended to require proof that the acquiring firm would commit itself to enter the target market within the near future, even though actual entry might not occur until some years later when the barriers to entry had been overcome. This requirement may, as the Commission suggested, take much of the air out of the sails of the actual potential entrant theory, and perhaps BOC is wrong, but the decision ought to be recognized for what it says.

3. Nature and Manner of Proof

In spite of the uncertainties which attend the actual potential entrant theory, lower courts continue to hear evidence and make findings with respect to this theory. Hence, consideration must be given to the manner in which "reasonable probability" (or "unequivocal proof") of entry may be shown. The basic test stated in Marine Bancorporation is that the Government must show that "feasible alternative methods of entry in fact existed." The "feasible alternative means of entry" requirement announced by Marine Bancorporation goes to the very heart of the actual potential entrant theory, and hinges upon the likelihood that the acquiring company would actually enter the target market de novo or through a toehold acquisition if the more attractive method—acquiring the target firm—were not possible. In evaluating whether a company has a feasible means of entry other than the challenged acquisition, it is necessary to analyze both the incentive and the capability of the acquiring firm to enter the relevant
market either de novo or by toehold acquisition.\textsuperscript{141} If either factor is absent, the actual potential entrant theory is inapplicable.

a. Subjective Evidence of Capability and Incentive

Obviously, the most forthright manner of proving that a company is a potential entrant is evidence of management's intentions. If the acquiring company's board of directors decided that the company would enter de novo or through a toehold acquisition if the desired merger could not be arranged, such a decision would ipso facto make the acquiring company an actual potential entrant.\textsuperscript{142} Assuming that the actual potential competitor theory is valid, the only remaining question would be whether the merger had sufficient anticompetitive consequences to constitute a violation.

In the cases which have been litigated thus far, however, the Government has not been able to produce such conclusive subjective evidence. Instead, the Government has frequently attempted to utilize lower management reports and recommendations, as well as indecisive studies done by or on behalf of upper management.\textsuperscript{143} Generally the courts have recognized that recommendations of lower management are often only sales pitches and therefore should not be given undue weight.\textsuperscript{144} Nevertheless, such reports might be considered an indication of corporate interest in the target market which, along with objective evidence, may establish that the acquiring firm was a potential entrant.\textsuperscript{145}

While internal memoranda favoring de novo or toehold entry may constitute fairly persuasive evidence against the acquiring company, the converse is clearly not the case. The courts tend to be rather reluctant to give credence to internal decisions rejecting de novo or toehold entry, particularly when objective evidence indicates that the acquiring firm has the incentive and capability to enter the market.\textsuperscript{146} Such memoranda or testi-

\begin{itemize}
\item \textsuperscript{142} Turner, \textit{supra} note 126, at 1383.
\item \textsuperscript{146} See United States v. Falstaff Brewing Corp., 410 U.S. 526, 563-70 (1973)
\end{itemize}
mony, generated with an eye towards a more favorable manner of entry, obviously are self-serving and will not be conclusive, or even particularly persuasive.\textsuperscript{147}

Where the objective evidence is inconclusive, subjective evidence of management's rejection of de novo or toehold entry may tip the scales in favor of the defendant.\textsuperscript{148} Hence, if upper management does not believe feasible alternative means of entry are open, it may be advantageous to get that decision on record and the reasons therefor so as to avoid an inference that such other means of entry were never given fair consideration.\textsuperscript{149}

b. Objective Evidence of Capability and Incentive

The Government may be able to prove that the acquiring firm had the incentive and capability to enter the target market de novo (or through a toehold acquisition) solely by the use of objective evidence although most cases thus far use both. Objective factors which the courts have considered in evaluating incentive to enter the target market include:

(1) The rate of growth and profit margins within the target market;\textsuperscript{150}

(2) Lead time required for de novo or toehold entry;\textsuperscript{151}

\textsuperscript{147} Subjective evidence generated in contemplation of merger should be distinguished, however, from established company policies developed without regard to possible litigation. While the former is suspect, the latter may be persuasive evidence. For example, in United States v. Penn-Olin Chem. Co., 246 F. Supp. 917, 931 (D. Del. 1965), \textit{aff'd per curiam}, 389 U.S. 308 (1967), the trial court placed considerable emphasis on evidence that Pensalt had an established investment policy requiring a rate of return in excess of 25\% on new investments. On the basis of this evidence, the court rejected all modes of entry suggested by the Government which were not likely to provide such a return.


\textsuperscript{150} See United States v. Black & Decker Mfg. Co., 430 F. Supp. 729, 755 (D. Md. 1976); United States v. Phillips Petroleum Co., 367 F. Supp. 1226, 1245 (C.D. Cal. 1973), \textit{aff'd mem.}, 418 U.S. 906 (1974); United States v. Wilson Sporting Goods Co., 288 F. Supp. 543, 561 (N.D. Ill. 1968). Corporations are presumed to follow their economic best interests. Therefore, where a company has the capability to enter a rapidly expanding or highly profitable market, it is assumed that the company desires to do so. As it will be shown later, however, such markets tend to be attractive to many companies if the barriers to entry are not too high. Thus the loss of one potential entrant may be insignificant.

(3) Degree of risk involved in a de novo or toehold entry;\textsuperscript{152}

(4) Complementary nature of the target market in relation to markets in which the acquiring firm is currently a competitor;\textsuperscript{153}

(5) Acquiring firm's history and commitment to diversification;\textsuperscript{154}

(6) Overt actions taken by the acquiring firm which indicate an interest in the target market.\textsuperscript{155}

1976); United States v. Ford Motor Co., 286 F. Supp. 407, 439 (E.D. Mich. 1968), \textit{aff'd}, 405 U.S. 562 (1972). Long lead times for de novo or toehold entry may result in unacceptable payback periods or prevent the acquiring company from taking advantage of short term increases in demand. For example, a rapidly expanding market may not be an attractive area for internal expansion if the time needed to develop a viable product will prevent the entering firm from getting into the market before the surge in demand has leveled off. See United States v. Black & Decker Mfg. Co., 450 F. Supp. at 760.

152. See FTC v. Atlantic Richfield Co., 549 F.2d 289, 299 (4th Cir. 1977); United States v. Penn-Olin Chem. Co., 246 F. Supp. 917 (D. Del. 1965), \textit{aff'd per curiam}, 418 U.S. 906 (1974). Obviously the greater the risk, the lesser the incentive to enter the target market. In \textit{Penn-Olin}, the risk involved in entering a field dependent upon defense spending was a major factor influencing the court's decision that independent entry of Pennsalt Chemicals Corporation or Olin Mathieson Chemical Corporation was unlikely.

153. See United States v. Falstaff Brewing Corp., 410 U.S. 526 (1972); FTC v. Procter & Gamble Co., 386 U.S. 568 (1967); FTC v. Atlantic Richfield Co., 549 F.2d 289, 295 (4th Cir. 1977); United States v. Phillips Petroleum Co., 367 F. Supp. 1226 (C.D. Cal. 1973), \textit{aff'd mem.}, 418 U.S. 906 (1974); United States v. Wilson Sporting Goods Co., 288 F. Supp. 543, 561 (N.D. Ill. 1968). The cases generally suggest a presumption that a company is most likely to fill out its product lines and expand its geographic markets before undertaking entry into an unrelated field. For example, in \textit{Falstaff}, the acquiring company sold beer throughout the United States, except in New England. There was also evidence that being a national brewer enhanced a beer's prestige and reduced the risk of sales fluctuations due to unfavorable weather conditions. Such evidence indicated an incentive for the acquiring company to enter the target market.


This, of course, is by no means an exhaustive list of relevant considerations. Any factor which management might consider significant in choosing the company's course of action would undoubtedly be relevant. However, the six factors listed above are those which the courts thus far have considered most relevant.

In addition to incentive, the Government must show that the acquiring company has the capability of entering the target market de novo or through a toehold acquisition. Objective evidence plays a particularly important role in proving the criteria.

Capability is measured in terms of the economic,\textsuperscript{156} technological\textsuperscript{157} and marketing\textsuperscript{158} strengths needed to make a successful de novo or toehold entry. Often it is simply a battle of expert witnesses as to the degree of resource flexibility which exists. There are some facts, however, that may not need expert analysis. For instance, the prior failure or success of other companies attempting to enter the target market,\textsuperscript{159} or the acquiring company's prior success or failure in entering similar markets,\textsuperscript{160} may tend to speak for themselves.

\textsuperscript{906} (1974), have been considered indicative of an interest in the target market. Indeed, in United States v. Wilson Sporting Goods Co., 288 F. Supp. 543, 561 (N.D. Ill. 1968), the court said that the acquisition being challenged was itself evidence of the acquiring company's interest in the target market. Courts should be cautious, however, in considering a company's interest in merger as indicative of interest in de novo entry. The desire to enter the target market cannot be divorced from the means to be employed, otherwise there would be a presumption of incentive to enter de novo in every case. See United States v. Crocker-Anglo Nat'l Bank, 277 F. Supp. 133, 184 (N.D. Cal. 1967). See also Ekco Products Co. v. FTC, 347 F.2d 745, 752 (7th Cir. 1965).


\textsuperscript{159} In United States v. Black & Decker Mfg. Co., 430 F. Supp. 729 (D. Md. 1976), the court considered it unlikely that a company possessing only electric motor technology could successfully enter the two-cycle engine market when a company like Ford Motor Company, with its vast gasoline engine experience, had felt it necessary to acquire the technology of a toehold firm and even then failed to become a significant competitor. Cf. United States v. Phillips Petroleum Co., 367 F. Supp. 1226 (C.D. Cal. 1973), aff'd mem., 418 U.S. 906 (1974) (successful entry of another firm undercut defendant's argument that barriers were too high); British Oxygen Co., 86 F.T.C. 1224, 1356-57, [1973-76 Transfer Binder] Trade Reg. Rep. (CCH) \$ 21,063 at 20,914 (1975), rev'd on other grounds and remanded sub nom. BOC Int'l Ltd. v. FTC, 557 F.2d 24 (2d Cir. 1977) (successful entry by another firm indicates BOC's capability).

As with the factors evidencing incentive, no one aspect of capability will always control. The absence of marketing capability may be crucial if such capability cannot easily be acquired, but may be of no importance if it can be obtained easily. The weight of each element of capability will generally vary according to the circumstances of a given case, making it a factual question as to whether the acquiring company possessed the requisite capability. This is, of course, frustrating to the businessman who wants an answer, but it is simply an unavoidable result of the full rule of reason type of analysis which still prevails in the area of potential competition.

B. Perceived Potential Entrant Theory

Even though the acquiring company is not an actual potential entrant, it may still constitute a potential competitor under the perceived potential entrant theory, which focuses on the appearance of the company as a potential entrant, rather than on the likelihood of actual entry. This does not mean, however, that the factors considered in evaluating whether the acquiring company is an actual potential entrant are irrelevant to the perceived potential entrant theory. The burden is still on the Government to show that “the acquiring firm has the characteristics, capabilities and economic incentive to render it a perceived potential de novo or toehold entrant.” Consequently, most of the factors which are relevant to the actual potential entrant theory are also germane to the perceived potential entrant theory.

While the evidence supporting the two theories will overlap substantially, there are significant differences in the manner and type of proof. Because the perceived potential competition theory is based upon the effect of the perceived threat of entry, only conditions which competitors within the target market could be aware of are relevant. Thus, an undisclosed internal decision not to enter the target market is of no relevance to
the question of perceived potential competition, nor, conversely, are undisclosed efforts and discussions favoring entry. Companies naturally must evaluate competition with less than complete knowledge; therefore, it is in this light that the acquiring company's potential for entry should be viewed.

1. Subjective Proof of "Fringe Effects"

As with actual potential competition, perceived potential competition may be proven by subjective evidence. Existing competitors within the market may simply be called as witnesses and asked whether they had considered the acquiring firm a potential competitor and, if so, whether or not this possibility influenced their behavior. Such evidence may be produced by either the Government or the defendant in the case.

Although this may seem to be a simple, reliable manner of getting to the ultimate question in such cases, such evidence is suspect since a competitor's testimony may be self-serving and thus slanted towards an anticompetitive result. Furthermore, businessmen may not always be consciously aware of the fact that they are considering potential competitors in their business decisions, even though empirical evidence supposedly bears out that they do. Nevertheless, such testimony may be very convincing when it appears to be in accord with objective evidence. Moreover, such evidence is easily understood, and may be quite influential in a close case involving complicated objective evidence. In fact, several recent lower court decisions have apparently placed considerable reliance on subjective testimony, particularly those finding for the defendant companies.

2. Objective Evidence of "Fringe Effects"

In spite of the simplicity of subjective evidence, most potential competition cases appear to have been decided primarily upon objective (circumstantial) evidence. To establish that a company is a perceived potential entrant through the use of circumstantial evidence, there must be evidence from which it can be inferred that firms within the target

169. See cases cited note 167 supra.
market: (1) were aware of the acquiring firm's interest in entering de novo (or through a toehold acquisition); (2) believed that it had the capability and incentive to do so; and (3) reacted to the threat.

In some cases the first requirement may be established by the proximity of the acquiring firm to the target market. Typically these cases are geographic market extension mergers,170 or product extension mergers involving closely related or complementary products.171 Because of the logical nexus between the acquiring company and the target market, the very nature of the acquiring company will alert competitors within the target market of the threat the acquiring company poses. In mergers which are more purely conglomerate in nature, however, there must be some proof of conduct on the part of the acquiring firm which identifies it as a potential entrant. Such conduct may take the form of a minor acquisition in the industry,172 prior negotiations with other potential merger partners,173 or public announcements by management174 which signal the acquiring company's interest in the target market.

Aspects of the second requirement, perceived capability and incentive, are generally established by much the same evidence used to prove capability and incentive under the actual potential entrant theory.175 Companies within the target market are generally presumed to be aware of the major barriers to entry, as well as the capabilities and goals of the acquiring company insofar as that information is known to the industry. If, taking into account the major barriers to entry, a reasonable competitor within the target market would perceive the acquiring firm as a potential de novo or toehold entrant, then the second requirement is satisfied.176 However, where the acquiring firm obviously lacks necessary economic, technical, or marketing capabilities, firms within the target market are assumed to have been unaffected by the acquiring firm.177


175. Id. at 533-34 & n.13.

176. Id. at 535.

Finally, it must be shown that the firms within the market reacted to the presence of the acquiring company, *i.e.*, that the company did produce fringe effects. There is some language in *Marine Bancorporation* which suggests that proof of actual fringe effects may be required, but it is doubtful that the court actually meant to rule out circumstantial proof of such effects. Only a year before in *Falstaff* the Supreme Court had said: "Circumstantial evidence is the lifeblood of antitrust law; ... [p]otential competition cannot be put to a subjective test." Thus, it is probably permissible to infer substantial fringe effects if the target market is highly concentrated.

C. The Toehold Acquisition Theory

Up until this point the potential competition doctrine has been discussed primarily in terms of the probability (either actual or perceived) that the acquiring company would have entered the target market through internal growth, *i.e.*, de novo entry. This was the theory behind the Government's early cases, and continues to be the primary thrust of the potential competition doctrine even today. However, analysis of the potential competition doctrine would not be complete without considering the "toehold" or "foothold" theory.

The development of the toehold theory began with the 1965 Federal Trade Commission decision in *Beatrice Foods Co.*, wherein the Commission noted that the acquisition of a small concern by a substantial potential competitor may increase competition in the market "by injecting a substantial firm, one capable of challenging the dominant firms in the market, in place of a firm too small to be a significant competitive factor." In other words, *Beatrice* recognized that the acquisition and expansion of a small firm already within the target market may have much the same procompetitive effect as a de novo entry.

Though *Beatrice* set the stage by articulating the concept, it was not until five years later in *The Bendix Corp.* that the toehold theory was...
recognized as a possible complement to the Government's arsenal against conglomerate mergers. In *Bendix* the Commission, relying upon the language in *Beatrice*, concluded that the potential competition doctrine did not depend exclusively upon the probability of de novo entry into the target market. Accepting arguendo the hearing examiner's finding that the acquiring company would not have entered the target market through internal development, the Commission nonetheless found that the acquiring company was a potential entrant via the acquisition of a small toehold firm. Although later reversed on procedural grounds, the *Bendix* decision remains the leading case on the toehold theory.

The significance of the toehold theory is that, to some extent, it may lessen the Government's burden of proof. Obviously it is less difficult to show that a firm can enter a market through a small acquisition than it is to prove that the company is capable of entering the market solely on the basis of its own internal development. Indeed, language in two Commission decisions has led some commentators to conclude that the toehold theory has created a presumption of illegality for non-toehold acquisition. Subsequent case law, however, has shown that the toehold theory has not had such a radical effect, and has not drastically altered the manner of potential competition analysis. The Government still must show that the acquiring firm had the incentive and capability to enter the target market. The major difference is that the analysis focuses on the capability and incentive to become an effective competitor by development of a small established firm within the target market, rather than entry through internal development.

In spite of the fact that the toehold theory has been around for nearly a decade, the courts have failed to provide adequate guidance as to what constitutes a toehold acquisition. Probably the best general definition of a toehold firm was enunciated in *FTC v. Tenneco, Inc.*, where the court stated:

A toehold may be defined as (1) a small available corporation with (2) the relevant technical expertise (3) which is not dominant or otherwise significant in the American or foreign market and which (4) has a reasonable likelihood of serving as a viable market entry vehicle.

---

184. *Bendix Corp. v. FTC*, 450 F.2d 534 (6th Cir. 1971). The court of appeals found that the Government had never given Bendix notice that it was proceeding under the toehold theory. Consequently, basing a finding upon this theory violated § 5 of the Administrative Procedure Act.


188. *Id.* at 112 (footnotes omitted).
Although this is the most comprehensive judicial definition of toehold company, it offers little in the way of concrete guidance, particularly with respect to the permissible size of a toehold firm.

There have, however, been some attempts to quantify the term “toehold.” In United States v. Phillips Petroleum Co., the court stated that a toehold acquisition is “one which is sufficient to assist the potential entrant over the barriers and into the market, but not so large that the entrant merely replaces the acquired company; the acquiring company must have a substantial need to build upon the acquisition.” The court then proceeded to reject the defendant’s argument that the acquisition in question was a toehold acquisition. In doing so, the court stated that “acquisition of a company which ranks seventh in a concentrated market, holding a 6-7% share of the market, is simply not small enough to constitute a mere ‘foothold acquisition.’” Consequently, after Phillips it appeared that a toehold company could not have a market share in excess of 5%, at least where it was among the top five or ten firms in the industry.

It was not long after Phillips, however, before the Federal Trade Commission had an opportunity to state its views on what constitutes an appropriate toehold firm. In The Budd Co., the Commission arrived at the following conclusion:

We believe it to be desirable to observe a general rule in potential competition cases that firms possessing no more than 10% in a target market (where, as here, the 4-firm concentration ratio is approximately 60% or more) should ordinarily be presumed to be toehold or foothold firms. This presumption by no means is conclusive and the inference of lack of anticompetitive effects flowing from acquisition of such a firm may be rebutted in particular cases.

In formulating this test the Commission acknowledged the holding in Phillips, but ruled that it and the Budd case were distinguishable. Despite the unambiguous language of Phillips, the Commission stated that the court’s holding had not been based upon the size of the acquired firm, but rather on the fact that Phillips did not need to build on the acquisition. The Commission thus found that its test did not conflict with Phillips because, upon a showing that there was no need to expand the acquired firm, the Budd presumption would be rebutted and the result reached would be the same as in Phillips.

Since Budd the courts have continued to rely upon Phillips, while
the Commission has adhered to the ten percent cutoff suggested in *Budd* . As a result, a firm with six to ten percent of the relevant market is presumptively a toehold firm in litigation before the Commission, but presumptively too large to be a toehold insofar as the courts are concerned. Which rule is better from a defendant's point of view will vary. If the Government is claiming that a major acquisition was made when a toehold entry was possible, a defendant obviously would prefer the *Phillips* test which would limit the number of toehold firms more severely than the *Budd* standard. On the other hand, if the defendant is trying to make use of the toehold doctrine as a defense, the *Budd* rule will permit the acquisition of a fairly substantial firm without exceeding the presumptively lawful toehold size. The test which is ultimately adopted may well depend upon the context in which the question arises.

Before going further, it should be noted that in spite of the widespread reference to the toehold theory in the language of judicial opinions, the validity of the theory is still an open question. *Falstaff*, in addition to questioning the soundness of the actual potential entry theory, casts doubt upon the toehold doctrine. Since the toehold theory is premised largely upon the desire to preserve the opportunity for actual future deconcentration, as is the actual potential entrant theory, much of the toehold theory will be undercut if the actual potential entrant theory is ultimately found to be invalid.

It is important also to note at this point that there does not appear to be even a single appellate decision based upon the toehold theory. Consequently, the validity of the doctrine should not be presumed. Indeed, there is no indication in any of the cases that the theory has ever been seriously questioned. Therefore, like many other aspects of the potential competition doctrine, the toehold theory is an embryonic concept, the eventful fate of which is still unknown.

### IV. NECESSARY SUBSTANTIAL EFFECT

Even assuming that the acquiring company is found to be a potential entrant, entry into the target market via acquisition of a major firm is not necessarily illegal. Section 7 proscribes only those mergers which may...
substantially lessen competition, or tend to create a monopoly. Thus, if there is a less-than-substantial loss of procompetitive potential, its loss does not violate section 7.

In assessing whether the loss of a potential entrant may substantially lessen competition, there are several factors which the courts have considered: (1) the likelihood that de novo or toehold entry would ultimately produce deconcentration in the target market; (2) the number of potential entrants; (3) the degree of concentration within the target market; and (4) the size of the acquired firm.

A. Substantial Likelihood of Deconcentration

In United States v. Marine Bancorporation, Inc., the Supreme Court stated that before the actual potential entrant theory may be applied, the Government must show that there were available to the acquiring firm feasible means of entering the target market other than by the acquisition in question. Further, the Government must show “that those means offer a substantial likelihood of ultimately producing deconcentration of that market or other significant procompetitive effects.” Although Marine Bancorporation expressly stated this requirement only in terms of the actual potential entrant theory, the requirement would seem equally applicable to the perceived potential entrant theory.

A brief statement of the facts from Marine Bancorporation will illustrate this requirement. In that case a large Seattle-based bank acquired a medium-sized bank whose headquarters and branches were located in Spokane. The Government challenged the merger and argued that the Seattle bank should have used a toehold acquisition to enter the Spokane market. Under Washington banking laws, however, there could have been no further branching of any bank so acquired. Accordingly, the Supreme Court concluded that a toehold entry under such regulations would not allow the expansion necessary to offer a substantial likelihood of producing deconcentration. In essence, limiting the acquiring firm to a toehold entry would have simply amounted to requiring the firm to step into the shoes of a small firm rather than a large one, even though neither course of action would have a substantial likelihood of altering the market.

Although Marine Bancorporation dealt with a regulated industry, lower courts have imposed this requirement in non-regulated industries as

201. Id. at 633.
202. United States v. Black & Decker Mfg. Co., 430 F. Supp. 729, 745 (D. Md. 1976). If competitors within the target market know that de novo or toehold entry does not offer a likelihood of producing significant procompetitive effects, they will not be influenced by the presence of the potential entrant on the edge of the market. Hence no significant procompetitive effects would be lost if the potential entrant entered the market via a major acquisition.
well. For example, in United States v. Black & Decker Mfg. Co.,\textsuperscript{204} the court found that technological barriers prevented a de novo or toehold entry by Black & Decker from offering a substantial likelihood of deconcentrating the gasoline powered chain saw market. The court noted that Ford Motor Company, which presumably was substantially better qualified to attempt such an entry than Black & Decker, had failed to develop its toehold company into a significant competitor. Where it appears that a de novo or toehold entry will fail to produce meaningful competition in the target market, little is lost by permitting the merger to proceed. Consequently, such mergers do not violate section 7.\textsuperscript{205}

Another situation in which de novo or toehold entry may not offer a substantial likelihood of deconcentration occurs when the acquiring firm is simply too small to become a substantial competitor. There have been no such cases, undoubtedly because the Government does not concern itself with such mergers. However, the size of the acquiring company is a relevant factor in the potential competition analysis and should not be overlooked in a proper case.\textsuperscript{206}

B. Number of Potential Entrants

It is fairly well established that in order to prove that the loss of a perceived potential entrant may substantially lessen competition, it must be shown that the acquiring firm was one of the few most likely entrants into the target market.\textsuperscript{207} That is, if there are a substantial number of firms similarly situated on the edge of the market, the loss of one will not significantly lessen the disciplining effect of perceived potential competition because the remaining firms will continue to pose a threat.\textsuperscript{208} Consequently, an acquisition under such circumstances would not violate the perceived potential entrant theory.

\textsuperscript{204} 430 F. Supp. 729 (D. Md. 1976).

\textsuperscript{205} But see Turner, supra note 126, at 1383. Turner suggests that even though the potential entrant may ultimately fail to make substantial inroads into the market, the process of making the attempt will "shake things up." Therefore Turner presumably would prohibit a merger unless the inability to become a significant competitor was so clear from the outset that significant in ter ro rem effects were unlikely.


\textsuperscript{208} See generally Turner, supra note 126, at 1363.
Although it is reasonably clear that a perceived potential entrant must be one of the few most likely entrants, it is not clear whether a similar requirement applies to the actual potential entrant. Professor Swennes concludes that it does not, but case law, though unclear, seems to suggest otherwise. As of yet, however, there does not appear to be any definitive holding on this question.

Assuming the requirement is applicable, either because the case at hand involves perceived potential competition, or because the requirement is extended to actual potential entrants, the question then becomes one of proof. In theory the Government should have to produce evidence with respect to each and every potential entrant, and establish that only a few could match the incentive and capability of the acquiring firm. This, of course, is impossible as a practical matter. Instead, the cases seem to proceed upon the assumption that if the entry barriers are high, the number of likely potential entrants will be few. When a company is shown to be a likely de novo entrant into an industry where entry barriers are high, it is presumed that the acquiring firm was one of the few most likely potential entrants. Several cases have indicated that the acquiring company may be able to rebut this presumption by showing that there are other firms which are also likely entrants. In a few cases the courts have actually undertaken a perfunctory comparative analysis to determine how many firms appear to be as likely as to enter the market as the acquiring firm.


210. In FTC v. Atlantic Richfield Co., 549 F.2d 289 (4th Cir. 1977), the Government challenged a merger exclusively upon the actual potential entrant theory. Id. at 293 n.6. In its decision, the court noted that the Government had failed to prove that the acquiring firm was one of the few most likely entrants. Id. at 294 n.8. See also Missouri Portland Cement Co. v. Cargill, Inc., 498 F.2d 851, 865 n.30 (2d Cir.), cert. denied, 419 U.S. 883 (1974).

211. See generally Dunfee & Stern, *supra* note 5. Even the Department of Justice Merger Guidelines [1968] suggest that such a comparative analysis is required. 1 Trade Reg. Rep. (CCH) ¶ 4,510 at 6,888.


The likelihood of entry is not the only factor, however. The potential competition theory is primarily concerned with those firms whose entry is likely to lead to eventual deconcentration of the market. In determining the number of potential entrants, insignificant potential entrants should be ignored. This concept was implicitly recognized in *FTC v. Procter & Gamble Co.*\(^{215}\) where the Supreme Court concluded that "the number of potential entrants [into the liquid bleach market] was not so large that the elimination of one would be insignificant."\(^{216}\) The Court evidently considered only those entrants who could challenge Clorox, the industry leader, because the evidence showed that the technology needed to produce bleach was simple and the capital investment relatively nominal. There were obviously many potential small scale entrants, but the need for massive advertising made it unlikely that other than a few firms could challenge Clorox. The Court apparently believed that these smaller firms were insignificant potential entrants, since it concluded that Procter & Gamble was one of only a few likely entrants.\(^{217}\) The test, therefore, appears to be whether the potential entrant is one of the few most capable of challenging the industry leaders.

**C. Market Structure—Need For Concentration**

The fundamental rationale of the potential competition theory hinges largely upon conditions within the target market. As stated in *Marine Bancorporation*:

The potential-competition doctrine has meaning only as applied to concentrated markets. That is, the doctrine comes into play only where there are dominant participants in the target market engaging in interdependent or parallel behavior and with the capacity effectively to determine price and total output of goods or services. If the target market performs as a competitive market in traditional antitrust terms, the participants in the market will have no occasion to fashion their behavior to take into account the presence of a potential entrant. The present procompetitive effects that a perceived potential entrant may produce in an oligopolistic market will already have been accomplished if the target market is performing competitively. Likewise, there would be no need for concern about the prospect for long-term deconcentration of a market which is in fact genuinely competitive.\(^{218}\)

Having thus established the type of behavior which must exist in the target market, the Court went on to conclude that the Government could estab-
lish a prima facie case for the application of the potential competition theory through concentration ratios.\textsuperscript{219} If the concentration ratios were unreliable indicators of the market's actual behavior, the burden was cast upon the defendant to prove their unreliability.\textsuperscript{220}

Although under *Marine Bancorporation* the Government presumably can dispense with concentration ratios and simply produce direct evidence of oligopolistic behavior in the target market, as a practical matter concentration ratios have been the linch-pin of the potential competition doctrine. Unfortunately, even though it is a key element of the doctrine, the courts have not yet determined what level of concentration is needed to establish a prima facie case.

The Department of Justice Merger Guidelines released May 30, 1968, appear to suggest a cutoff at the 75%/eight-firm concentration level.\textsuperscript{221} However, the guidelines are by no means conclusive, even as to the actions of the Department of Justice, and the FTC has already challenged mergers which clearly were not within the merger guidelines.\textsuperscript{222}

Although the courts have not yet developed a definite market share requirement, several decisions have cited favorably the Kaysen and Turner definition of a "tight oligopoly" in evaluating whether a market was sufficiently concentrated to create a prima facie case of oligopolistic behavior.\textsuperscript{223} According to their definition, a "tight oligopoly" is an industry having "a very small number (eight or fewer) firms supplying 50 percent of the market, with the largest firm having a 20 percent or higher share, and with or without a fringe of small suppliers."\textsuperscript{224} While for the most part the decisions support the Kayser and Turner definition,\textsuperscript{225} there is one exceptional case.

\textsuperscript{219} Id. at 631.
\textsuperscript{220} Id. In *Marine Bancorporation* the defendant failed to sustain the burden of rebutting the presumption.
\textsuperscript{221} Department of Justice Merger Guidelines, [1968] 1 Trade Reg. Rep. (CCH) ¶ 4,510 at 6,888.
\textsuperscript{222} See, e.g., Kennecott Copper Corp. v. FTC, 467 F.2d 67 (10th Cir. 1972), cert. denied, 416 U.S. 909 (1974) (4 firm 29.2%, 8 firm 39.7%).
\textsuperscript{224} C. KAYSSEN & D. TURNER, ANTITRUST POLICY 72 (1959).
In *Kennecott Copper Corp. v. FTC*, the Tenth Circuit upheld the FTC's ruling that Kennecott's acquisition of Peabody Coal violated section 7. The court accepted the finding of the Commission that at the time of the merger the industry, with an eight-firm concentration ratio of 39.7%, was not a "tight oligopoly." The court concluded, however, that evidence of the coal industry's rapidly increasing concentration was sufficient reason to proscribe the merger. If *Kennecott* is still good law, the case raises additional questions regarding the required level of concentration in situations where the target market is moving towards a "tight oligopoly," as well as the definition of what constitutes a "trend towards concentration." Unfortunately, few cases have considered these problems since *Kennecott*.

Once the Government has shown sufficient levels of concentration in the target market to establish a prima facie case of oligopolistic behavior, the burden is on the defendant to rebut the presumption by showing that, in spite of its structure, the market is competitive. The only potential competition case to have dealt with this problem thus far is *United States v. Black & Decker Mfg. Co.* In *Black & Decker* the eight-firm concentration ratio of ninety-six percent clearly created a prima facie case for the application of the potential competition doctrine. With this established, the court went on to examine several factors relevant to the issue of whether the prima facie case had been rebutted. Among the factors considered were the recent entry of several new competitors; the level of concentration in the target market; the nature of the product; and the relative importance of that market.

227. Id. at 73, 76.
228. Id. at 76.
229. *Marine Bancorporation* casts some doubt upon the validity of *Kennecott* in that *Marine* suggested that market concentration was a condition precedent to application of the potential competition doctrine. 418 U.S. at 630-31.
230. In *Kennecott*, the market share of the top four firms had risen from 15.8% in 1954 to 29.2% in 1967, and the market share of the top eight increased from 23.6% to 39.7% during the same period. The 160.5% increase for the top firms accounted for 63% of the market expansion during this time period, thus indicating that the sale of coal was being concentrated in a few hands. Id. at 73. Though the market was not yet oligopolistic, the court concluded that when such a trend is evident the potential competition theory is applicable. See also Department of Justice Merger Guidelines, [1968] 1 Trade Reg. Rep. (CCH) ¶ 4,510 at 6,884, which state that a trend towards concentration is a 7% increase in the market share of any combination of the top eight firms over a five to ten-year period prior to the merger.
231. The only other significant potential competition case to consider these questions is *Warner-Lambert Co.*, 87 F.T.C. 812, [1973-76 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 21,141 (1976), where the Commission said that an eight-firm concentration ratio of 45.71% was not sufficient in the absence of evidence of a trend towards concentration. No such trend was found.
entry barriers;\textsuperscript{234} the expansion of production in response to growing demand;\textsuperscript{235} the record of product innovation and improvement within the industry;\textsuperscript{236} and price competitiveness.\textsuperscript{237}

Although the market manifested several indicia of a competitive market, the court nonetheless concluded that the defendant had failed to prove that the concentration ratios and structural analysis offered by the Government "did not accurately depict the economic characteristics" of the market.\textsuperscript{238} This result is not too surprising when, as in \textit{Black & Decker}, the eight-firm concentration ratio is in the ninety-plus percentile bracket. In such cases the burden of proof required to rebut the prima facie case will undoubtedly be very formidable. Indeed, Professors Dunfee and Stern suggest the following analysis:\textsuperscript{239}

<table>
<thead>
<tr>
<th>Four Firm Ratio</th>
<th>Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>70%</td>
<td>Irrebuttable presumption of sufficient concen-</td>
</tr>
<tr>
<td>50-70%</td>
<td>Rebuttable presumption of concentration.</td>
</tr>
<tr>
<td>under 50%</td>
<td>Rebuttable presumption of insufficient concen-</td>
</tr>
</tbody>
</table>

Under this approach the \textit{Black & Decker} court would not have had to consider the additional factors noted above, since the four-firm ratio was approximately eighty percent. As of yet, however, no court has adopted these or other general guidelines.

D. Size Of The Acquired Firm

In almost every potential competition case which has resulted in a Government victory, the enterprise acquired was a leading firm in the target market. As discussed earlier, when a potential competitor enters the target market through a large acquisition, the entry is unlikely to produce any significant long term benefit to competition. If the entrant simply steps into the acquired firm's shoes and sits tight, nothing is gained by the entry. On the other hand, if the acquiring company merges with a leading firm and thereafter undertakes an aggressive expansion of its market, short term competition might be improved, but the entrenchment of the acquired firm may adversely affect competition in the long run. Assuming that the other requirements of a potential competition case are satisfied, the acquisition of a dominant firm in the target market may substantially lessen competition.

When the acquired firm is not a dominant firm in the industry, how-
ever, there may be procompetitive effects engendered by the acquisition which offset or diminish the injury to competition caused by the removal of the acquiring firm as a potential entrant. Indeed, the toehold theory is premised on the assumption that the acquisition and expansion of a small firm within the target market may produce substantially the same procompetitive effects as a de novo entry. Therefore, the acquisition of a small firm may be permissible whereas the acquisition of a dominant firm would not.

In *The Budd Co.*, the Commission converted the preceding reasoning into a rule of law. In that case the Commission held that the acquisition of a toehold firm should normally be permitted and created a rebuttable presumption of legality for toehold acquisitions. As a result, at least insofar as the Commission is concerned, the acquisition of a firm controlling less than 10% of the market (in an industry where the top four firms possess 60% or more of the market) will be presumed to be procompetitive unless the Government can prove special circumstances which indicate otherwise.

As one might suspect, however, the toehold defense is by no means settled law. Although *Budd* presumably would permit a company capable of entering de novo to enter by acquisition of a toehold firm instead, in *United States v. Phillips Petroleum Co.*, the court rejected that approach. In essence the *Phillips* decision interprets section 7 as requiring not only that the form of entry be procompetitive, but that it be the *most* procompetitive form possible. To this end the court stated:

>[F]oothold acquisitions cannot be looked upon with favor unless . . . the potential entrant could not have achieved a substantial market entry on a unilateral basis, perhaps supplemented only by incidental acquisitions of a de minimis nature.

This language in *Phillips* has rightly been criticized, since taken literally, *Phillips* would hold any merger illegal where the acquisition of a smaller firm would have been possible. Indeed, this de minimis test would place potential entrants on essentially the same footing as an actual competitor. Whether a potential entrant will in fact ever enter the market is always uncertain. Consequently, if the manner of entry offers some procompetitive potential, the courts should refrain from preventing such an

---

242. *Id.*
244. *Id.* at 1258.
entry where the chances of a slightly more competitive form of entry being made are speculative. Moreover, where the competitive difference is slight, there is no justification for depriving the acquired company of the freedom to dispose of its assets as it may choose.

V. CONCLUSION

Although the law regarding potential competition is still in a state of evolution, the following general principles have become fairly well established:

1. The relevant market(s) must be defined both in terms of geographic and product dimensions.
2. The acquiring company must either be perceived to be a probable entrant, or actually be a probable entrant, by a more competitive means such as internal expansion or toehold acquisition.
3. Internal expansion or toehold acquisition must offer a substantial likelihood of ultimately producing deconcentration in the target market.
4. In the case of perceived potential competition, and perhaps in the case of actual potential competition, the acquiring company must be one of the few most likely potential entrants capable of challenging the industry leaders.
5. The target market must be oligopolistic, or at least evidence a strong tendency towards oligopoly.
6. The acquired company must have been a significant competitive factor in the target market.

Although the basic concepts of the potential competition theory have been established, numerous questions remain unanswered. Undoubtedly the most fundamental of these is whether the actual potential entrant theory is in and of itself a sufficient ground for a section 7 violation. If this question is answered in the affirmative, the courts must resolve the controversy over the proper standard of proof, as well as the dispute over the need to show that the merger will take place in the near future.

In addition to these basic conceptual problems, numerous practical policy questions also remain unresolved. For example, the courts have not yet firmly settled upon the concentration level needed to establish a prima facie case, nor the maximum size of a toehold firm. These questions present substantial difficulties for the practitioner who must advise his client, but it is unlikely that many of these problems will be resolved for many years to come.

Wilbur L. Tomlinson

Published by University of Missouri School of Law Scholarship Repository, 1979