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Comments on Merger Enforcement,
Antitrust Modernization Commission,
Topic VII: A. *Federal Antitrust Merger Enforcement Policy Generally* 1. Has current U.S. merger enforcement policy been effective in ensuring competitively operating markets without unduly hampering the ability of companies to operate efficiently and compete in global markets? Please identify specific examples, evidence, or analyses supporting your assessment.

THIS IS ONE OF THE QUESTIONS ON WHICH COMMISSION MEMBERS SHOULD FOCUS THEIR UNIQUE EXPERIENCE AND EXPERTISE TO LEAD A CHANGE IN MERGER POLICY AND ENFORCEMENT FROM CONCENTRATION AND EFFICIENCY THEORY, WHICH HAS BEEN A FAILURE FOR DECADES, TO MICHAEL PORTER'S NEW ECONOMIC THEORY AND MERGER ANALYSIS BASED ON PRODUCTIVITY, INNOVATION AND UNIQUE VALUE ALREADY AVAILABLE IN DRAFT FORM

One hundred years ago this year, Einstein changed the course of science from one of the greatest scientific theories of all times, Newtonian physics, to a new theory, Quantum physics, because Newtonian physics simply did not work at the atomic level. A new theory was needed.

The same is true today for antitrust merger policy. Concentration theory and static economic efficiency theory, like Newtonian physics 100 years ago, are elegant but inadequate for the dynamic global markets of our times, especially for the United States.

Fortunately, there is an alternative, highly developed economic theory used worldwide, although outside the specialized world of antitrust and economics departments, that has already been applied to mergers, the Theory of Productivity, Innovation and Unique Value principally developed by Harvard's Michael Porter.

I strongly urge the Commission to focus on this question and as a result recommend to Congress, the federal agencies, state attorneys general and governments, the courts and international governments and antitrust agencies that antitrust merger policy should evolve by replacing current policy and guidelines based on static efficiency economic theory and concentration theory with a merger policy applying a dynamic economic theory based on productivity, not efficiency, Prof. Porter's Theory of Productivity, Innovation and Unique Value, and to do so as soon as possible in the same way the 1982 merger guidelines were adopted as a matter of policy without requiring a change in antitrust legislation. Changing the antitrust policy focus to productivity, which is widely understood, from efficiency and HHIs, is likely to eliminate more bad mergers from a competitive point of view than current merger policy, without new merger guidelines. Reasons for the above are summarized below and elaborated in Prof. Porter's "Competition and Antitrust: A Productivity-Based Approach" chapter and the rest

of the book *Unique Value: Competition Based on Innovation Creating Unique Value,* Charles Weller, Ed., Michael Porter, Peter Staudhammer & Scott Stern, (2004 & 2005).[1]

1. The Long Time Failure of U.S. Merger Law and Policy: Facts

Antitrust merger policy, law and enforcement have failed the American economy for decades, e.g.:

- Gretchen Morgenson of the *N. Y. Times* most recently reports:

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> Academic research suggests that few mergers add up to significantly more prosperous or successful companies and also that acquisitions during buyout booms, like the one we are in now, are more likely to fail than those made in other periods. *** What's worse, there is a disturbing trend among some of the most aggressive corporate acquirers to use deals to mask deteriorating financial results at their companies and to reap outsize executive pay. Morgenson, "What Are Mergers Good For?," *N.Y. Times Sunday Magazine* (June 5, 2005).

- Prof. Porter examined the merger history of a sample of companies over time going back to World War II. He calculated the percentage of mergers that failed (the companies were liquidated or divested) as well over 50%. Porter, "From Competitive Advantage to Corporate Strategy," *Harvard Business Review* 43 *(*May 1987).

- McKinsey examined 160 mergers and found that the average buyer "materially overestimates the synergies the merger will yield." Where Mergers Go Wrong, *McKinsey Quarterly* (2004).

- Prof. Scherer reports that "study after study" shows that the acquiring company's stock price declined by "significant magnitudes" within just three years of the merger. Scherer, "Some Principles for Post-Chicago Antitrust Analysis," 52 *CWRU Law Rev.* 5, 11-12 (2002).

- Frank & Sidel, "Firms That Lived by the Deal Are Now Sinking by the Dozens," *Wall St. J.* A1 (June 6, 2002).

- Leigh Trevor, a Jones Day corporate partner (now deceased) analyzed 181 hostile takeovers of at least $100 million between 1985-88, and used the "Killing Fields" in Cambodia as the appropriate analogy to best describe the results: 87% of the takeover target companies were either "dead" or "walking wounded." Trevor, "Hostile Takeovers -- the Killing Field of Corporate America" (Mar. 11, 1986 unpublished paper), discussed in Weller, "Antitrust Economics as Science after *Daubert*," 42 *Antitrust Bulletin* 871, 927 (1997).

- The failure of U.S. merger policy for many years is also detailed by a past Chair of the ABA Antitrust Section in Rowe, "The Decline of Antitrust and The Delusions of Models," 72 *Georgetown L.J.* 1511 (1984).

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[1] http://www.atlasbooks.com/marktplc/01314.htm Portions of this comment are also used in the author's Comments to the Commission on International and New Economy questions.

Thus factually, for many years, "U.S. merger enforcement policy" has not been "effective in ensuring competitively operating markets without unduly hampering the ability of companies to operate efficiently and compete in global markets," looking at the outcomes of the mergers for the resulting companies.

This failed performance, it is suggested, is the result of antitrust law and policy using the wrong metrics and theories for merger -- concentration theory and static efficiency economics. Further, antitrust merger enforcement in the U.S. in court, unless changed, is increasingly likely, as *Oracle* and *California Dental* illustrate, fail, for legal and factual reasons covered next.

2. Legally, Static Economic Efficiency Theory-Based Antitrust Will Increasingly Lose in Court and the PNB Presumption is Doomed

As the defense bar takes increasing advantage of a new combination of Supreme Court precedents, *Oracle* and *California Dental* will increasingly represents the government's future in court -- they will lose. The Supreme Court in a number of decisions, if used in the right combination factually and legally, has made antitrust policy based on efficiency economic theory effectively unenforceable. Some of the Court's key decisions are:[2]

- the "Daubert 6," two decisions identifying a methodological flaw in efficiency economic theory -- "'in the real economic world rather than an economist's hypothetical model,' the latter's drastic simplifications generally must be abandoned," and the four unanimous Daubert"[3] decisions on when experts can, and cannot, be admitted at trial, make economic experts using efficiency theory vulnerable to exclusion from trial.
- California Dental[4] and the Court's 22-year string of precedents, sharply narrows when per se and other presumptions can be used.

The Daubert Quartet's mandate that expert evidence be reliable or be excluded at trial, and the economic literature after PNB in 1963, seem certain to doom the PNB[5] presumption in joint venture and merger litigation in the Supreme Court. [6]

For example, as to the economic literature, Judge Posner points out in a 1994 opinion that "it is many years since anyone knowledgeable about antitrust policy thought that concentration by itself imported a diminution in competition."[7] He also explained how his views on concentration had changed 180° from Von's Grocery, which he supported at the time because he then "accepted the oligopoly theory of economists Joe Bain and Edward Chamberlin," but then

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[2] For an extensive roadmap for defense litigators, see Weller, "Winning Antitrust Litigation for Defendants and Advancing Antitrust Beyond Static Economic Theory Unconventionally," Chap. 7, *Unique Value*.

[3] Daubert v. Merrell Pharmaceutical, Inc., 509 U.S. 579 (1993); General Electric Co. v. Joiner, 522 U.S. 136 (1997); Kumho Tire Co. v. Carmichael, 143 L. Ed. 2d 238 (1999); Weisgram v. Marley Co., 145 L. Ed. 2d 958 (2000).

[4] Calif. Dental Assn v. FTC, 143 L. Ed 2d 935 (1999), remand, 224 F.3d 942 (9th Cir. 2000) (the Supreme Court held no "quick look" presumption could be used; on remand, the FTC lost their Rule of Reason theory; the FTC did not appeal).

[5] U.S. v. Philadelphia National Bank, 374 U.S. 321 (1963) ("PNB").

[6] See Weller, "Winning Antitrust Litigation for Defendants and Advancing Antitrust Beyond Static Economic Theory Unconventionally," Chap. 7, Unique Value for more detail.

[7] Capital Cities/ABC, Inc. v. F.C.C., 29 F.3d 309, 315 (7th Cir. 1994).

explained that later "empirical studies about profits as a function of concentration" undermined concentration theory and he now concludes that "the Von's merger was completely harmless."[8]

Professor Bain's work, of course, is the seminal work underlying the 1963 PNB presumption. Professors Scherer and Ross in their 1990 text state that we now know that Bain's work at the foundation of the PNB presumption was "almost surely spurious:"[9]

> [R]ecent work has demonstrated that most, if not all, of the correlation between profitability and concentration found by Bain and his descendants (at least for the United States) was almost surely spurious -- the result of aggregating a positive relationship between sellers' market shares and profitability to the industry level.

In 1999, Harris and Smith published an extensive review of both the "theoretical and empirical economics literature that addresses these issues." They concluded, inter alia, that "[m]uch of the empirical literature suffers from fundamental problems (e.g., the failure to define antitrust markets) that cause their results to be unreliable," and that the "empirical literature does not indicate the existence of any unique critical concentration level, including the 1,800 HHI level used in the [Merger] Guidelines."[10]

Without citing Daubert or PNB specifically, the Supreme Court majority in California Dental showed how readily Daubert would apply to the PNB presumption, making clear that "before a theoretical claim of anticompetitive effects can justify shifting to a defendant the burden to show empirical evidence of procompetitive effects," a court must consider both "the theoretical basis for the anticompetitive effects" and "whether the effects actually are anticompetitive."[11] The PNB presumption, of course, like the "quick look" presumption, is a "theoretical claim of anticompetitive effects" that "shift[s]" to a defendant "the burden" to show "procompetitive effects." Given the economic research after 1963, when a judge at a Daubert hearing asks the plaintiff to put on their expert to testify regarding the PNB presumption, it seems unlikely the economist or any other expert can meet the "reliability" test to be used at trial.

Finally, current merger policy and guidelines are based on static efficiency economic theory, and thus are vulnerable because the antitrust laws have always focused on dynamic economics, not static economics, a critical distinction covered next.

3. Static Economic Efficiency Theory Can Only Produce "Miniscule" Increases in the Standard of Living

Every day, headlines blare "Why Asia Will Eat Out Lunch," "Cutting Here But Hiring Over There," "China Economy Rising At Pace To Rival U.S.," "The Three Scariest Words in U.S. Industry: 'The China Price,'" "How Long Can Workers Tread Water," "As Rich-Poor Gap Widens in the U.S., Class Mobility Stalls."

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8 "From Von's to Schwinn to the Chicago School: Interview with Judge Richard Posner, Seventh Circuit Court of Appeals," ABA, Antitrust 4, 5 (Spring 1992).

9 F. Scherer & D. Ross, Industrial Market Structure and Economic Performance 411 (3d ed. 1990).

10 "The Merger Guidelines v. Economics: A Survey of Economic Studies," Antitrust Report 23, 24-25 (Sept. 1999).

11 143 L. Ed 2d at 953-54 n.12.

Yet antitrust doctrine in the U.S. today (and for the last 30 years) is based on static economic efficiency theory, an economic theory that, in effect, tells American workers, companies and communities:

> "Our antitrust and economic theory says you must compete with the Chinese and others in the new global economy on the basis of efficiency."

"[F]ormal economic theory of the market" emphasizes its "static-efficiency characteristics," a former Chairman of the President's Council of Economic Advisor (Charles Schultze) explains, but efficiency theory can only produce "miniscule" increases in the standard of living, in sharp contrast to the facts that show that "what is far more important" about a competitive market is its "capacity to stimulate and take advantage of advancing technology" -- to innovate: [12]

> Had the triumph of the market meant only a more efficient use of the technologies and resources then available, the gains in living standards would have been minuscule by comparison.

"Innovation" is "a distinguishing characteristic of the United States," and "Americans over two centuries used their freedom to provide comfort and security, and so came to advance the well-being of all mankind." Herold Evans, *They Made America* 10 (2004). Thus "[u]nderstanding just what innovation is and how it comes about is a vital subject for the 21st century, when intensifying competition from around the world requires Americans to innovate as briskly as did those first adventurers." *Id.*

Static economic efficiency theory does not do that. As Peter Drucker bluntly puts it: economic efficiency theory is a theory of "an economy that is briskly standing still," and innovation is "an event they cannot deal with, a sort of uncontrollable and unpredictable catastrophe, like earthquakes or pestilence." *Age of Discontinuity* 143, 148 (1968).

An economic theory that can only produce "miniscule" increases in the American standard of living and provides no real understanding of innovation or how it comes about -- static economic efficiency theory -- cannot be an acceptable antitrust merger policy, especially when there is an alternative, covered next.

4. New Economic Theory for Antitrust Merger Policy: The Theory of Productivity, Innovation and Unique Value

The Theory of Productivity, Innovation and Unique Value is a dynamic economic theory of wealth, prosperity, human dignity and long-term consumer welfare principally developed over the last quarter century by Michael Porter of Harvard Business School.

It is not the economics I was taught in college, it is not the economics taught in any economics department or law school antitrust course I'm aware of, nor is it in any antitrust text

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[12] C. Schultze, *The Public Use of Private Interest* 25 (1977). Congress has also specifically found that "technological innovation" is "critical" to the "ability of the United States to raise the living standards of Americans." The National Cooperative Research and Production Act of 1993 ("NCRPA"), 15 U.S.C. secs. 4301-05.

I'm aware of (which is basically why I published a book on it, *Unique Value,* with 5 chapters by Prof. Porter).

However, it is taught in business schools around the world, and it is used all over the world. To illustrate, in February the *N. Y. Times* reported that in China in June 2004 "an overflow crowd paid $1,000 a ticket" to hear Mr. Porter because of his "international reputation" for "works on competition between companies and across national borders." Barboza, "Seven Habits of Highly Effective Cadres," *N.Y. Times* B1 (Feb. 19, 2005). In the words of several prominent antitrust practitioners and scholars:

> Terry Calvani, Former Commissioner, U.S. Federal Trade Commission, Member & Director of Cartel Division, The Competition Authority of Ireland; Lecturer on Law, Trinity College, Dublin:
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> > "[T]he work of Michael Porter" is an "antidote to the conventional welfare economics that has served as the foundation for modern competition policy for the last thirty years."
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> Ky Ewing, Chair, American Bar Association Antitrust Section 2000-2001; former Deputy Assistant Attorney General, U.S. Department of Justice, Antitrust Division:
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> > "UNIQUE VALUE: COMPETITION BASED ON INNOVATION CREATING UNIQUE VALUE …is a book to be relished by thoughtful people who want to explore new dimensions of the competitive process, the very nature of which is changing as the 'knowledge economy' innovatively expands."
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> Thomas A. Piraino, Jr., Vice President, General Counsel and Secretary, Parker-Hannifin Corporation, Cleveland, Ohio
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> > "Michael Porter's economic analysis can revolutionize the way we think about markets and competition. Business executives, antitrust practitioners and anyone who cares about the economic organization of our society can gain valuable insights from Charles Weller's collection of some of Michael Porter's most original thinking. Mr. Weller's summaries and commentaries will be an invaluable aid to any interested reader."

The Theory of Productivity, Innovation and Unique Value (my name for it) is a new theory, and is as different from economic department economics as Quantum physics is from Newtonian physics, e.g.:

- <u>Productivity</u>, not <u>Efficiency</u>, is the central focus for raising the standard of living and for consumer welfare.
- <u>"Positive Sum" Competition</u>, competition that increases wealth through innovation creating unique value and raising productivity, is distinguished from <u>"Zero Sum" Competition</u>, a static theory that assumes scare resources, that wealth is fixed, and that the key competitive issues are allocative efficiency and wealth transfer.

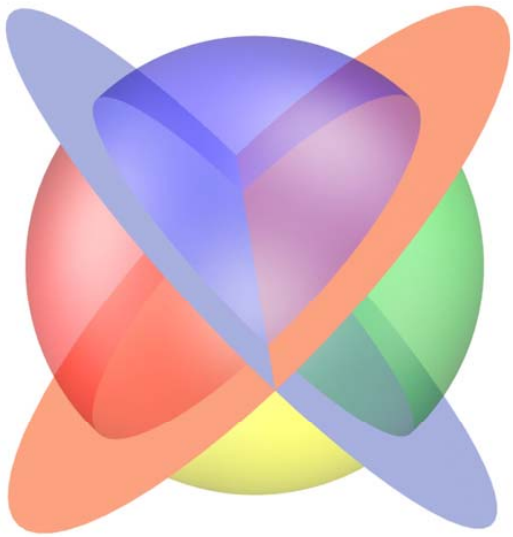
- Long-Term Consumer Welfare, not just Short-Term Consumer Welfare, is the goal.
- High Wages and High Profits are celebrated as the result of "Positive Sum" Competition based on innovation creating unique value, greater productivity, and long-term consumer welfare.
- Unlimited Resources and Unlimited Wealth empirically replace the theoretical assumption of Scarce Resources because the historically unprecedented shift to an applied knowledge economy makes knowledge the largest driver of wealth -- and knowledge is an unlimited resource.
- The Theory Uses Three Key Variables -- (1) Five Forces, (2) the Type of Competition, and (3) the Business Environment "Diamond" (see Figs. 1 & 2).
- There are Two Key Types of Competition, not just one:
    - "Type I Competition" over efficiency ("operational effectiveness")
    - "Type II Competition" over innovation creating unique value to customers.

Competition based on innovation creating unique value means doing things differently from competitors. It involves choosing a unique position to deliver value to customers and tailoring business activities to that position. Creating unique value means companies and their employees must develop new products and new services, and new ways of conducting the activities of their business to set them apart from their competitors -- a form of competition in which the U.S. can excel, particularly in the rapidly growing new economy -- the knowledge economy.

Conclusion. The Commission, of course, is an advisory body and has no authority to act. Only Congress, the federal agencies, state attorneys general and governments, the courts and international governments and antitrust agencies, individually and collectively, have the authority to act. Yet rarely in antitrust is a group of such distinguished antitrust practitioners assembled.

Specifically, I urge the Commission to seize this historic opportunity, and lead an evolution of antitrust merger policy by recommending that the current policy and guidelines based on static efficiency economic theory and concentration theory be replaced and evolve to a merger policy using dynamic economic theory based on productivity, Prof. Porter's Theory of Productivity, Innovation and Unique Value, and to do so as soon as possible in the same way the 1982 merger guidelines were adopted as a matter of policy without requiring a change in antitrust legislation.

Figure 1:
Theory of Productivity, Innovation and Unique Value



Five Forces	**(red "slice")**
Type (Sophistication) of Competition	**(blue "slice")**
Business Environment "Diamond"	**(4 color "globe")**

Figure 2:
Applying the Three Variables

Diamond **Five Forces** **Type of Competition**