Section 7 of the Clayton Act: Its Application to the Conglomerate Merger

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In the 180 year span of industrial development since the advent of the steam driven mill, perhaps the single unifying element permeating American commerce has been its continued and accelerating growth. Apparent from every economic index—aggregate production, annual revenues, net corporate worth, capital reserves—this phenomenal growth is most dramatically demonstrated by the 1970 Gross National Product of one trillion dollars, a 100 percent increase over that of 1960.¹ Concomitant with this national economic growth has been the tremendous accretion in size and power of the leading corporate firms. This concentration of wealth in the leading corporations is itself a response of American business to an era of unprecedented prosperity—prosperity created by cumulative progress in production technology. The process is circular; larger firms are able to allocate greater capital sums to research and development, leading to refinements in production methods which increase efficiency in consumption of base resources, increasing aggregate production and hence gross revenues, a portion of which can then be deployed for further research and development. It is therefore apparent that at least in the major progressive industries optimum size of a firm is of critical significance.

A corporation desiring to expand its operation has two available alternatives: internal expansion, which involves construction of new production facilities, financed either by existing capital reserves or more commonly through some form of deficit funding such as a bond or debenture issue, or merger, i.e. the acquisition of another existing enterprise by the purchase of its stock or assets. There are several legitimate reasons for a growth-oriented firm to prefer the acquisition route over internal expansion. The target firm may hold patents necessary to the proposed production mode. Its established market position and good will may facilitate the conversion. In the fast developing industries such as electronics and organic plastics there may be a considerable lead time advantage in the acquisition of an operating concern. Moreover from the standpoint of financing the expansion, high commercial interest rates or a shortage of capital reserves may favor a

trade-off of existing equities as opposed to an expenditure of "new" capital.

There is one clear hazard to the acquisition method of corporate expansion not shared by the internal method. In 1914 Congress enacted the Clayton Act, section 7 of which generally prohibited the acquisition by a corporation of stock in another corporation where the effect of the acquisition may be to lessen competition. This section was amended by the Celler-Kefauver Act in 1950 so that now any acquisition of stock or assets of another corporation is unlawful where the effect may be substantially to lessen competition in any industry in any region of the country. The breadth and scope of the statute, apparent from its general wording, have greatly hampered the accurate prediction of the legality of proposed mergers. This note will deal with the problem of uncertainty in the enforcement of section 7 through an analysis of the elements of the statute and its application—particularly to conglomerate mergers—and a discussion of the relevant economic policy considerations.

The Statute

Section 7 of the Clayton Act, as amended in 1950, provides in pertinent part that

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\text{[n]o corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.\text{\textsuperscript{6}}}
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Commerce is defined as "trade or commerce among the several States and with foreign nations . . . ," providing the basis for federal jurisdiction. Since the concept of interstate commerce has been extended to its logical limit by judicial decision, the overwhelming ma-

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5. Id.
6. Id.
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CONGLomerate Mergers

jority of corporations, even those carrying no out-of-state accounts, are at least conceivably subject to section 7 control. For this reason, the parameters of the statute's operation are critical to a corporation contemplanting a merger.

The scope of section 7 can best be analyzed by discussion of judicial interpretation regarding each of its component parts.

**Type of Enterprise Affected**

It should be noted at the outset that section 7 extends only to a *corporation* acquiring the stock or assets of another *corporation*. Hence it would seem that a partnership or sole proprietorship could safely acquire corporate stock or assets without fear of a section 7 violation, and similarly a corporation could acquire partnership assets. This apparent loophole is of small consequence, however, as a partnership or sole proprietorship is seldom if ever of sufficient size to be a cynosure of federal antitrust enforcement.9

**Acquisition of Stock or Assets**

For over half a decade the phrase “no corporation . . . shall acquire” was interpreted by the business community to operate only against pending mergers. This interpretation was rendered nugatory in 1957 when in *United States v. E. I. du Pont de Nemours and Co.*10 the Supreme Court held that the 40 years' previous acquisition by du Pont of 23 percent of General Motors stock had blossomed into a section 7 violation.11 The Court further directed that du Pont be ordered to divest itself of the shares.12 Hence no acquisition could ever become free from potential reversal under section 7, regardless of the elapsed time and the consequent hardship of a divestiture.

The *du Pont* holding created alarm in corporate circles for quite another reason. Section 7 had previously been construed to bar only horizontal mergers, *i.e.* those between competitors in the same market. *Du Pont*, however, involved the acquisition by a supplier (of automobile seat cover fabric), of stock in a purchasing corporation, the classic

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9. It should be observed that section 5 of the Federal Trade Commission Act, 38 Stat. 717 (1914) may operate to seal this loophole. Section 5 prohibits any unfair method of competition, and was held to bar an acquisition by a dairy association in Beatrice Foods Co., CCH Trade Reg. Rep. ¶ 17,244 (FTC DKT. 6653, 1965).


11. Id.

12. Id.
vertical acquisition.\textsuperscript{13} By thus extending the scope of the statute, the Court cleared the way for the future mobilization of section 7 against conglomerate acquisitions, leaving no major merger secure against potential section 7 attack.

Prior to the 1950 Celler-Kefauver Amendment, section 7 by its terms operated only against acquisition of stock of another corporation.\textsuperscript{14} Owing to this limitation, in circumstances that would prevent a corporation legally from acquiring the stock of another, the same result could be accomplished by a liquidation and purchase of the target corporation's assets, in return for a redemption of its outstanding shares. The amendment foreclosed this method of short-circuiting section 7, by providing that "no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets" \textsuperscript{15} of another corporation where a substantial lessening of competition may result. Although the terms of the amendment appear to limit its application to FTC-regulated corporations, it was held to invalidate a proposed bank merger,\textsuperscript{16} notwithstanding the merger was to be effectuated through a sale of assets,\textsuperscript{17} and notwithstanding banking is expressly exempt from FTC regulation under section 5 of the FTC Act.\textsuperscript{18} The Court justified this extension of the application of section 7 by a finding that the purpose of the 1950 amendment was to reach all mergers, whether by stock or asset acquisition, and hence the "exception for acquiring corporations not subject to the FTC's jurisdiction excludes from the coverage of § 7 only assets acquisitions by such corporations when not accomplished by merger." \textsuperscript{19} [Emphasis supplied]. It is safe to assume that this rule will be extended to other FTC-exempt industries such as common carriers and certain meat packers.\textsuperscript{20} Hence the exception for mergers involving non-FTC-regulated corporations has been effectively expunged from the amendment, despite the obvious intent of Congress to vest authority to control asset acquisitions in these industries in the appropriate regulatory body.

Insofar as concerns the definition of "assets" within the statute, the term is sufficiently broad to include "property or property rights,

\textsuperscript{13} Id.
\textsuperscript{17} Id.
\textsuperscript{19} 374 U.S. at 342.
real or personal, tangible or intangible, which are subject to transfer and which have been used by the seller and could be used by the buyer competitively." 21 Thus customer lists,22 exclusive licenses,23 trademarks and patents24 have been found to be assets within the purview of section 7.

Relevant Market

The act provides that an acquisition is unlawful where the effect may be substantially to lessen competition "in any line of commerce in any section of the country ...." 25 Therefore to establish a violation, it is necessary to demonstrate the probable effect of the acquisition in two market dimensions—the product market or line of commerce, and the geographic market or section of the country.

The statute lends no assistance in defining the limits of the relevant market, but they have been generally held coterminous with the "area of effective competition." 26 Such a definition is of course patently circular, yielding the analytic proposition that an acquisition which restrains trade in the "area of effective competition" thereby lessens competition in the relevant market. This circularity endows the relevant market requirement with a remarkable accordian-like flexibility, allowing courts to extend or compress the bounds of the statutory relevant market to coincide with any "market" shown to be affected. As a result, the market provision of section 7 has been substantially vitiated.27

A sampling of section 7 decisions will illustrate this point. Relevant geographic markets have been found to be as large as the entire country,28 or as small as a single metropolis.29 In regard to the product market, its flexibility is demonstrated by the observations of Chief Justice Warren in Brown Shoe Co. v. United States:30

21. CCH TRADE REG. REP. ¶ 4259 (FTC DKT. 6388).
22. Id.
The 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. However, within this broad market, well-defined submarkets exist which, in themselves, constitute product markets for antitrust purposes.\textsuperscript{31}

Thus in a later decision a can manufacturer was prohibited from acquiring a bottle manufacturer because their products were in competition in certain "end use" markets, such as the beer container industry.\textsuperscript{32}

The objective of the Government in a section 7 case is therefore to define the relevant product and geographic markets sufficiently broad to include the products of both acquiring and acquired firms, yet not so broad as to reduce their respective market percentages to an insignificant figure. By mastering this feat of economic legerdemain the Government has been able to compile an impressive record of section 7 victories.\textsuperscript{33}

\textit{The Effect May Be Substantially to Lessen Competition}

As is plain from the language of this clause, the thrust of section 7 is preventive and not remedial. Its purpose is to reverse potential restraints of trade in their incipience, and thereby avert the often disastrous consequences of dismantling a fully-integrated acquisition. Accordingly, it has been held that the Government need not establish the certainty that a restraint of trade will result from a given acquisition, but only a "reasonable probability" that such will be the effect.\textsuperscript{34}

Perhaps the most troublesome element of the statute has been the requirement of a "substantial" lessening of competition. Initially, the test for measuring the degree of anticompetitive effect depends upon the type of merger involved. Thus the legality of a horizontal merger will hinge on the resultant increase in market power of the merged firm, whereas in the case of a vertical merger, the standard criterion is the degree of foreclosure to competitors of the market of the acquired firm. Most conglomerate mergers have horizontal or vertical components, and to that extent are treated as horizontal or vertical mergers.

\textsuperscript{31} Id. at 325.
\textsuperscript{33} See United States v. Von's Grocery Co., 384 U.S. 270 at 301 (1966) (Stewart, J. dissenting): "The sole consistency that I can find is that in litigation under § 7 the Government always wins."
when measuring their anticompetitive effects. The pure conglomerate or diversification merger cannot be indexed on a straight market percentage basis—the standards for determining its legality are discussed in detail in the following section.

Within these indices of measurement, the term “substantially” has been variously interpreted. Several decisions illustrate the extreme limits of its definition. As respects horizontal mergers, the Supreme Court has intimated in *United States v. Pabst Brewing Co.* that a merger of two breweries supplying an aggregated 4.49 percent of the national beer market would result in a substantial lessening of competition in that market. A trend toward increased concentration was detected, rendering the market more sensitive to further horizontal amalgamation.

The Court has held that a vertical merger which would foreclose one percent of the acquired firm’s market would substantially lessen competition in a market characterized by vertical integration.

A strict interpretation of the term “to lessen” would require proof of probable diminution of existing competition in order to establish a section 7 violation. Nevertheless, a joint venture between a non-producer and an existing seller in the southeastern sodium chlorate market was invalidated on the basis that the non-producer was a “potential entrant” into the market via internal growth. Apparently a merger is vulnerable to section 7 attack whenever a commensurate market entry through internal expansion was contemplated and would have increased competition in that market. Accordingly, “to lessen” should be read as “to prevent from increasing” competition.

It should be noted that certain stock acquisitions by their nature have no effect whatsoever upon competition, and these acquisitions are expressly allowed. An example of this type of acquisition is the purchase of non-voting preferred stock in another corporation for capital investment purposes. Since the acquiring firm gains no control over the management of the corporation in which it has acquired the stock, it is obvious that no anticompetitive effect can result.

Finally, section 7 proscribes not only those acquisitions which may substantially lessen competition, but also those tending to create a

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36. Id.
37. Id.
It would appear that tendency to create a monopoly would be subsumed under the broader probability of lessening of competition, but there may arise certain cases, particularly with regard to vertical mergers or patent acquisitions, where problems of proof may favor the allegation of a tendency toward monopoly.

APPLICATION OF SECTION 7 TO THE CONGLOMERATE MERGER

Soon after the enactment of section 7 in 1914, it became evident that any major horizontal merger would be blocked due to the resulting increase in market dominance. In 1957, the *du Pont-GM* decision foreshadowed a similar crackdown on sizable vertical mergers. In an attempt to evade section 7 application, firms bent on acquisition began to diversify, resulting in a significant increase in the number of conglomerate mergers during the 1960-69 decade. However the statute again proved sufficiently ductile to adapt to the task, as the Government was able to establish several various means whereby a conglomerate merger could lessen competition.

Before exploring these potential restraints, it is necessary to isolate and define the diverse types of acquisition encompassed by the term "conglomerate merger." In its broad sense the term denotes a residuary category—viz., all mergers that are neither horizontal nor vertical. Three distinct classes of merger fall within this category. The product extension merger involves the acquisition of a firm producing a product related to, but not in competition with, a product of the acquiring firm. Bases for the desirability of this type of merger may include similarities in production or marketing methods of the two products, or product complement.

A market extension merger results from the acquisition of a firm selling the same product as that of the acquiring firm, but in another geographic market, so that the two firms are not in competition. The advantages are obvious—the acquiring firm is experienced in handling the product; personnel and positions may be readily interlocked; inventory, credit, and accounting loads can be pooled, etc.

The third class is the pure conglomerate, or diversification merger, wherein a corporation acquires another firm producing a product totally unrelated in all aspects to that produced by the acquiring firm. An example of such a merger is the acquisition by a steel producer of

41. *Id.*

42. *Mergers and Acquisitions*, vol. 6/3 at 15, table 5 (Fall 1971).
a retail clothing chain. About the only conceivable advantage to be obtained by this type of merger, aside from its relative safety from section 7 attack, is the distribution of risk of capital loss. The former can hardly be classed as a positive advantage, however, since many corporate activities, such as divisional spin-off, debt reorganization, internal expansion, or liquidation of assets, similarly involve a negligible risk of section 7 interference.

These three classes of conglomerate merger are susceptible in varying degrees to section 7 regulation under a number of theories, each of which purports to describe a type of trade restraint. A discussion of each of these theories follows, with an analysis of its validity and application in relation to its particular economic matrix.

Redefinition of Product Line

*Continental Can* demonstrated that by manipulating the lines of distinction between related products, a product extension merger could be suffused with a sufficiently horizontal taint to construe a lessening of competition. Thus it was found that metal and glass containers were substitute products in certain industries, and that “interindustry competition between glass and metal containers is sufficient to warrant treating as a relevant product market the combined glass and metal container industries and all end uses for which they compete.”

The extent to which this rule of product interchangeability will be projected is as yet problematic. Many diverse products have potentially interrelated uses. Carrying this line of reasoning to its *reductio ad absurdum*, a drastic increase in the price of hammers could conceivably lead to the use of baseball bats to drive nails. This hypothetical conjunction of end uses, however, should obviously not prevent a forging company from acquiring a manufacturer of baseball bats. It is safe to conclude that a high degree of cross-elasticity of demand between the two products will probably lead to the finding of a hybrid market. The difficulty will arise in determining the point at which the degree of product interchangeability is no longer sufficiently high to place the products of the two firms in a competing market.


44. 378 U.S. at 457.
Potential Entrant

In *United States v. El Paso Natural Gas Co.* an acquisition by a firm outside the acquired firm’s market was found violative of section 7 where the acquiring firm would probably have otherwise entered the market by internal expansion. Two justifications are advanced for this rule: 1) the acquisition removes the threat of a new market entrant, which is an effective stimulant to competition, particularly in an oligopolistic market, and 2) it lessens future competition, *i.e.* prevents an *increase* in competition, as previously noted, by eliminating the potential entrant as a future competitor in its own right through internal expansion.

The primary utility of the potential entrant rule is obviously in blocking a market extension merger, such as was contemplated in *El Paso Natural Gas Co.* Nonetheless the rule could easily be extrapolated to bar a pure conglomerate merger where the requisite intent of the acquiring firm to enter the market of the acquired firm by any means could be established; a non-producer planning to enter the market is as viable a force on existing competition as an outside producer considering entry.

It should be emphasized that the validity of the potential entrant rule demands a showing that the acquiring firm was, but for the acquisition, a *probable* entrant via internal growth. Otherwise virtually all conglomerate mergers could be blocked by the rule, since an acquisition in itself indicates an interest in the market of the acquired firm. Apropos of this requirement, a district court has recently held that minutes of the board of directors of an acquiring firm in a market extension merger, which minutes stated that the firm would enter the New England beer market only if it could acquire an established producer in the market, constituted a sufficient showing of lack of probable independent entry. This finding is perhaps a bit too credulous to be practical; if the decision survives appeal, the potential entrant rule could be effectively negated by the simple procedure of drafting the minutes against future antitrust litigation.

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45. 376 U.S. 651 (1964).
46. *Id.*
Reciprocal Trading and Related Problems

There is some argument that section 7 should operate to prevent conglomerate acquisition where there is a danger that the resulting firm may exploit its diversity to promote reciprocal trade, tying arrangements, or some other form of exclusive dealing agreement with other firms which deal with one of its divisions. This danger is most prevalent in the case of a "broken" vertical merger, i.e. a conglomerate acquisition wherein one firm acquires another firm one step removed in the production chain, so that firms in the middle are in a position to buy from one division of the conglomerate and sell to another. Such an arrangement is obviously fertile ground for reciprocal dealings, and was the basis, in Federal Trade Commission v. Consolidated Foods Corp., for invalidation of the acquisition by a food retailer of an onion-garlic producer.

In Consolidated Foods, however, there was evidence of actual reciprocal trade agreements, wherein food processors who sold to Consolidated agreed to buy from its newly-acquired onion-garlic division. Since such agreements have been held illegal under the Sherman Act, there is no logical necessity for section 7 application. It is doubtful that the statute was intended to be employed as a panacea to prevent all mergers which enable a substantive antitrust violation. Such a broad construction of section 7 is analogous to construing the hiring of an adolescent cashier as "contributing to the delinquency of a minor," since the minor is thereby placed in a position to defalcate.

Furthermore, the same net result could be accomplished by internal expansion, i.e. the firm could construct a production unit which would enable it to buy from and sell to the same party. It appears somewhat ludicrous to prohibit an acquisition on the basis of an effect which could lawfully be accomplished by internal growth.

In summary, it seems that the possibility of reciprocal trade or similar agreements is a defensible bar to a conglomerate acquisition only where it is proved that such is a probable consequence. The proof could include past behavior of the firms, market exigencies, etc.

50. E.g., Whitney, supra note 47.
52. Id.
55. Turner, supra note 48.
The "Deep Pocket" Doctrine

This theory generally holds that a conglomerate is in a position to offset losses in one division with profits from another. It is thereby able to sell below cost for sustained periods of time, and by so doing drive out the small single-line competitors.66

The deep pocket doctrine suffers from the same logical defects inherent in the reciprocal trade theory. Such predatory pricing as the doctrine anticipates is an unfair trade practice, and hence subject to control under section 5 of the Federal Trade Commission Act.57 Moreover, again the firm could enter the market through internal expansion and present the same "deep pocket" threats. In short, section 7 appears to be an improper instrument for concluding the possibility of predatory pricing.58

Entrenchment of Market Power

In Federal Trade Commission v. The Procter & Gamble Co.,59 a product extension merger between Procter & Gamble, a large soap manufacturer, and Clorox, the largest producer of liquid household bleach, was prohibited on the basis that Procter's enormous marketing and advertising power would solidify Clorox's already dominant position in the household bleach market.60 Thus a new facet was added to the array of section 7—the acquisition by an inordinately large corporation of a firm in an oligopolistic market could be blocked as a potential trade restraint.

Reasons advanced for this rule are that the resultant market power of the merged firm, particularly in a concentrated industry, would discourage new entry, and possibly intimidate smaller competitors from engaging in price competition for fear of retaliatory price cuts.61 Such reasons appear valid, but as with reciprocal trade dangers, it would seem that the Government should be held to the burden of proving the probability of the aforementioned restrictive effects in order to defeat a proposed acquisition.

60. Id.
61. Turner, supra note 48; Whitney, supra note 47.
Economies of Scale

Finally, it has been claimed that the sheer size of a large conglomerate operation provides certain economies of advertising, marketing, distribution, and accounting costs not shared by smaller competitors. Most commentators agree, however, that these economies of scale should not in themselves invalidate an otherwise lawful merger, for to allow such a result would be tantamount to subsidizing inefficiency. Furthermore, any unfair price or service advantage obtained through size alone would constitute an illegal price discrimination under the Robinson-Patman Act, obviating the necessity for the more stringent section 7 remedy.

The Department of Justice Merger Guidelines

In May, 1968 the Department of Justice promulgated a set of guidelines for the avowed purpose of informing the interested public as to the types of mergers which would be challenged. Such information should be of critical interest to corporate management, since the Department has insufficient personnel and funding to challenge all mergers, and since the majority of those challenged are never consummated, the guidelines, if adhered to by the Department, have the practical effect of statutory law.

The espoused general policy of the Department in enforcing section 7 is the preservation and promotion of "market structures conducive to competition." Hence the main thrust of the Government's enforcement program is directed not at isolated incidents or anticompetitive intent, but at acquisitions which alter the elemental composition of the market. Since there is as yet insufficient evidence to determine the market effect of the majority of conglomerate mergers, the guidelines focus on three specific anticompetitive results—mergers involving a potential entrant, those creating a danger of reciprocal trade; and those tending to entrench market power in the acquired firm.

Simply stated, the Department will challenge an acquisition by a potential entrant of one of the large firms in a highly concentrated industry. Thus a "toehold" acquisition, i.e. an acquisition, by a poten-

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64. 1 CCH TRADE REG. REP. § 4430 (1968).
65. Id.
66. Id.
tial entrant, of an insignificant firm for the purpose of establishing an initial market outpost, is not disfavored. Regarding reciprocal trade, a merger will be challenged where market conditions in the respective markets of the two firms would tend to engender the practice, or where either of the firms have engaged in such conduct in the past. Moreover, the Department will generally challenge a merger which would give the merged firm an inordinate absolute size advantage over the other firms in the acquired corporation's market, or which would otherwise tend to provide the merged firm with undue market leverage.

Discretion is reserved in the Department to challenge other conglomerate mergers as evidence of their anticompetitive effects is accumulated. The traditional "failing company" doctrine may divert the Department from challenging an otherwise unlawful acquisition, but it is clearly provided that this doctrine will apply only where the target firm is hopelessly insolvent, and hence of no competitive consequence in its market. For the most part, the merger guidelines are a restatement of section 7 decisional law, and as such contribute only nominally to its clarification.

CONCLUSION

In the vast majority of section 7 controversies, the central question is the meaning of a "substantial lessening of competition." Unfortunately, the courts and counsel alike have not always been sufficiently versed in economic principles to apply the statutory criteria to the facts involved. As a result, the statute has often been used as a blunt instrument with which to bludgeon to death a merger believed to be "not in the public interest." This heavy-handed approach to the statute has rendered section 7 anathema to corporate growth.

Although the Government and the courts have demonstrated a fear of industrial concentration, there is no evidence that competition is less vigorous between the four or five behemoths in a highly concentrated industry than between the myriads of independent firms in a fragmented industry. Moreover a concentrated industry is generally a more efficient consumer of resources, owing to centralization of shipping, manufacturing, and storage facilities, as well as capital savings.

67. Id.
68. Id.
69. Id.
70. Id.
As respects the conglomerate merger, there is as yet an insufficient return of data to predict its effect on competition. It appears that such isolated dangers to competition as possible reciprocal trade agreements or predatory pricing can best be handled by resort to more specific statutes. Until more information is available concerning the market effects of the conglomerate merger, the strictures of a section 7 remedy demand that it be applied against a conglomerate only where there is no other means of averting a probable anticompetitive result.

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