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The 2010 Horizontal Merger Guidelines and Restraints on Innovation

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The 2010 Horizontal Merger Guidelines give increased treatment to a topic that was not well developed in previous Guidelines – namely, mergers that threaten to restrain innovation. The 1968 Guidelines had contained a statement on innovation to the effect that:

the Department has used Section 7 to prevent mergers which may diminish long-run possibilities of enhanced competition resulting from technological developments that may increase inter-product competition between industries whose products are presently relatively imperfect substitutes.

1968 Merger Guidelines, III, 20.

The 1984 Guidelines noted briefly that market share figures might overstate a firm's competitive significant if rivals had access to a technology that it did not. (1984 Guidelines, § 3.21) The 1992 guidelines treatment of innovation was limited to a single footnote in its opening statement on market power, to the effect that "[s]ellers with market power also may lessen competition on dimensions other than price, such as product quality, service, or innovation." 1992 Horizontal Merger Guidelines, §0.1, n.6. They never returned to the subject. However, the Guidelines for the Licensing of Intellectual Property, which were issued in1995, focused a great deal of attention on licensing practices in innovation intensive markets and occasionally referenced situations where the nature of a license or joint venture entailed that the transaction should be treated more like a merger than a contract. (Antitrust Guidelines for the Licensing of Intellectual Property, §3.2.3) The licensing Guidelines also developed the idea of an "innovation market," a concept that the 2010 Horizontal Merger Guidelines do not repeat. The 2006 Commentary on the 1992 Merger Guidelines also speak in several places about the relevance of innovation, although they also do not return to the subject of innovation markets.

Restraints on innovation are addressed in the 2010 Horizontal Merger Guidelines mainly in the category of unilateral effects. The Guidelines have a separate section on mergers limiting "innovation and product variety" which is concerned with "unilateral effects arising from diminished innovation or reduced product variety." (2010 Horizontal Merger Guidelines, §6.4.). As the Guidelines state:

The Agencies may consider whether a merger is likely to diminish innovation competition by encouraging the merged firm to curtail its innovative efforts below the level that would prevail in the absence of the merger. That curtailment of innovation could take the form of reduced incentive *to continue with an existing product-development effort or reduced incentive to initiate development of new products.*

The first of these effects is most likely to occur if at least one of the merging firms is engaging in efforts to introduce new products that would capture substantial revenues from the other merging firm. The second, longer-run effect is most likely to occur if at least one of the merging firms has capabilities that are likely to lead it to develop new products in the future that would capture substantial revenues from the other merging firm. The Agencies therefore also consider whether a merger will diminish innovation competition by combining two of a very small number of firms with the strongest capabilities to successfully innovate in a specific direction.

The Agencies evaluate the extent to which successful innovation by one merging firm is likely to take sales from the other, and the extent to which post-merger incentives for future innovation will be lower than those that would prevail in the absence of the merger.

The story closely resembles that of diverted sales on the demand side, except that in this case the emphasis is on diversion of supply through innovation. The concern is hardly fanciful and some version of it has been known in antitrust since the beginning of the twentieth century. For example, in *Continental Paper Bag Co. v. Eastern Paper Bag Co.*, 210 U.S. 405, 429 (1908), the dominant firm had acquired a patent in a technology that competed with technology it was already using. It did not use the patent at all, preferring to stick with its existing technology, but also refused to license it to others and filed a successful infringement action against a rival firm that developed technology that infringed the acquired patent.

A similar concern is also expressed in the Antitrust Law treatise, which argues that an appropriate remedy in most such cases is to permit dominant firms to acquire nonexclusive licenses in patents that lie at the heart of their power, but not exclusive licenses (3 Antitrust Law ¶707g) Prohibiting such acquisitions altogether often precludes firms from keeping their own technology up to date. In order to accomplish this, however, they do not need the patent's power to exclude; they only need access to patented technology developed by others. As a result, permitting the acquisition of nonexclusive licenses strikes about the right balance between denying a dominant firm access to essential technology and permitting it to exclude others from its market.

Both the acquisition and the nonuse of a patent are lawful acts in and of themselves. However, the combination of acquisition and nonuse represents a different concern – a practice that is not authorized by the Patent Act and that can result in the suppression of competition. Indeed, the acquisition and nonuse of patent can be far more threatening to competition than the acquisition of a production facility, whether or not it is shut down. When an acquired plant or other productive facility is taken off the market or out of production by a merger others can build a rival plant depending on the height of entry barriers and other market factors. But a patent forecloses all technologies covered by its claims whether or not it is actually being practiced. For example, if a dominant firm with Alpha technology sees a close rival with incipient Beta technology that threatens to compete with Alpha, acquisition of the firm with the Beta technology eliminates not only that firm as a competitive threat but also takes the Beta technology and any technology covered by the Beta patent claims off the market altogether. In the Paper Bag decision the patentee acquired the competing technology and did not practice the patent at all. Further, the rival was guilty of infringement under the doctrine of equivalents, which in that case meant that his technology did not literally infringe the acquired patent at all but merely reached the same result.

Patents are unquestionably "assets" reachable by §7. At the time a patent is acquired neither the government nor anyone else may know whether the acquiring firm intends to practice it. But the exclusive or nonexclusive nature of the assignment is knowable, and exclusive assignments in areas subject to dominance should be regarded as highly suspicious. Further, exclusivity is almost never essential to protect any legitimate interest of the acquiring firm. Its legitimate interest is to be able to practice the best technology itself, but not to prevent others from using technology that it did not develop itself.

Of course, a nonexclusive license may be worth less to the acquirer than an exclusive license, and this may injure the inventor/assignor of the patent. Indeed, an exclusive right to the patent in the hands of the dominant firm who does not intend to use it could be worth more than a nonexclusive right held by that firm or others. But patents do not create entitlements to market monopolies any more than ownership of a production plant entitles one to a monopoly in its product market, or to sell it subject to a an anticompetitive noncompetition agreement. That is, the general rule that assets can be freely transferred to the highest bidder clearly applies to patents, but it is just as clearly subject to the constraint that anticompetitive transactions can be enjoined when they fall within the prohibitions of the antitrust laws.

This entry was posted on Tuesday, November 16th, 2010 at 7:47 pm and is filed under Mergers and Acquisitions
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