The Nebulous Conglomerate Merger: Administrative and Judicial Treatment

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Section 7 of the Clayton Act, which was originally intended to prevent secret acquisitions among competitors, referred by its terms only to stock acquisitions. However, the Supreme Court in strictly interpreting this section distinguished between stock and asset acquisitions and refused to incorporate the latter into the statute. The effectiveness of the statute was thus severely curtailed. In 1950 the Clayton Act was amended so as to expressly embrace asset acquisitions. This amendment also gave rise to four major changes enabling those charged with enforcement to effectively deal with the varied forms of mergers which were affecting competition.

(1) The new amendment required proof of only reasonable probability of a substantial lessening of competition rather than proof of an actual lessening which was previously required.

(2) Any geographic area could now be used to demonstrate a potential lessening of competition, whereas under the former statute, the Government was limited to illustrating this "potentiality" in a particular competitor's community.

(3) The new amendment eliminated any need to prove intent to substantially lessen competition.

(4) The jurisdiction of the act now includes acquisition of any asset of another corporation.

These changes clearly expressed the congressional intent to nip monopolies in the bud, by preventing any potential lessening of competition. However, it was not until 1957 that the vast scope of section 7 was fully explored. In deciding United States v. E.I. du Pont de Nemours & Co., the Supreme Court stated...
that section 7 is applicable to all mergers (horizontal, vertical and conglomerate) provided they may substantially lessen competition or tend to create a monopoly. 11 This blanket application of section 7 caused concern with respect to the validity of all mergers, past, present and future, especially in the nebulous area of conglomerate mergers. 12

The purpose of this paper is to examine recent administrative and judicial treatment of those mergers not typically classified as horizontal or vertical. To aid in our discussion of those newly developed legal principles applicable to conglomerates, frequent reference will be made to the following hypothetical merger.

Lynch Flower Seed Mfg. Co., one of the five leading flower seed producers in America, controls 40% of the market. A total of five firms, including Lynch, control 93% of the market while some twenty other firms share in the remaining 7%. Lynch is negotiating a merger with Silverman Pot Co., the second largest producer of flowerpots in America. Silverman presently controls 11% of the market while the largest firm in the industry controls 29%. The remainder of the industry is controlled by nine other firms which in the aggregate form a symmetrical oligopolistic market structure. 13 An analysis of the legality of such a merger under Section 7 of the Clayton Act will enable us to highlight the trend of interpretation set by the Federal Trade Commission.

In order to determine whether this hypothetical is proscribed by section 7, it must first be classified as one of the three types of mergers (horizontal, vertical or conglomerate) defined by the Supreme Court in Brown Shoe Co. v. United States. 14

Horizontal and Vertical Mergers

The Supreme Court in Brown defined a horizontal merger as "an economic arrangement between companies performing similar functions in the production or sale of comparable goods or services." 15 Thus, any attempt by a firm to eliminate direct competition by acquiring competing firms will fail. Our hypothetical merger will not be invalid, however, since Lynch is not

11 Id. at 590-93.
12 A conglomerate has been termed a merger which does not have the effect of automatically foreclosing to the competitor any market outlay or source of supply (vertical) nor does it automatically eliminate a competitor (horizontal). Procter & Gamble Co., TRADE REG. REP. (1962 Trade Cas.) ¶ 15,245, at 20,257 (FTC Dkt. 6901, Jan. 28, 1962).
14 Supra note 5, at 317.
15 Id. at 334; see United States v. Aluminum Co. of America, 377 U.S. 271 (1964); Union Carbide Corp., TRADE REG. REP. (1961 Trade Cas.), ¶ 15,503 (FTC Dkt. 6826, Sept. 25, 1961).
in direct competition with Silverman, neither performing the same services nor producing similar products.

A vertical merger is the acquisition of either a supplier or a customer of the acquiring firm. A classic example of a vertical merger is found in the du Pont case. Du Pont acquired a substantial stock interest in General Motors Corporation, an extensive purchaser of their products. This parental control gave du Pont a competitive advantage over other suppliers of General Motors and was therefore disallowed. Our hypothetical has neither a retail, wholesale nor customer relationship and, therefore, cannot be held invalid as a vertical merger.

**Conglomerate Mergers**

A conglomerate merger is one involving firms which are neither competitors, potential or actual, as in the horizontal merger, nor customers or suppliers of each other, as in the vertical merger. As such the illegal conglomerate merger does not effect an automatic change in competition, as in the horizontal or vertical, but it does establish a potential for such change. It is this potential that section 7 was enacted to prevent. Since our hypothetical situation is neither horizontal nor vertical, it is necessarily conglomerate.

Having properly classified this merger, we must study its potential effects on competition in order to determine its validity. In order to declare the merger illegal, the court must find that it generates the potential of a substantial anticompetitive effect in a line of commerce. This line of commerce has been defined as any product or group of products which has sufficient peculiar characteristics and uses which make it distinguishable from all other products. Thus, firms are in the same line of commerce if they service a similar product market in an overlapping geographic area.

In determining the geographic market we must consider the particular section of the country where the merger will have an overlapping competitive effect. In our hypothetical, both firms are involved in enterprise throughout the United States; therefore, the geographic market is the entire country.

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It is more difficult, however, to determine the product market. The interchangeability of uses for the product and the elasticity of demand between the product and any of its substitutes are two basic factors which must be considered in making this determination.

However, ascertaining the broad product market may not be sufficient to determine the affected area of competition. The existence of certain factors of demand may establish well-defined sub-markets which may point out either similar or distinct lines of commerce. For example, a five-dollar shoe does not compete with a thirty-dollar shoe, indicating that specific price ranges are termed sub-markets, in that they are aimed at different customers. In our hypothetical, we can see that there is no interchangeability of uses between flowerpots and flower seeds. Likewise, there is no elasticity of demand present since an entirely different demand is generated for each product. Therefore, pots and seeds comprise two separate broad product markets. These broad product markets, however, may be further subdivided by employing practical indicia of demand to determine the actual sub-markets. These practical indicia are: (1) public recognition of the industries as separate industries, (2) uses of the product, (3) price differentiation, (4) similarity of production facilities, and (5) distinct customers.

The reason for examining such practical indicia was best expressed by Mr. Justice White in *United States v. Continental Can* Co.

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21 See, e.g., Brown Shoe Co. v. United States, supra note 5, at 325-26.

22 Id. at 325.

23 In the acquisition by Procter & Gamble of the Clorox Bleach Co., the Government established a single product market by demonstrating that Procter & Gamble was such a well-advertised name that it would have a competitive advantage over the bleach manufacturers by being able to advertise household detergents and bleach at the same time. Since the public would tend to identify the products as one, there would be no sub-markets and therefore the competitive advantage in the single market would argue against the corporate merger. Procter & Gamble Co., supra note 12.

24 In the *Alcoa* merger, the distinction in use between the products was sufficient to establish separate (or sub) markets and did not result in a lessening of competition. United States v. Aluminum Co. of America, supra note 15.

25 Also in the *Alcoa* case, the price differentiation between aluminum and copper conductors was sufficient to contribute to the establishment of separate sub-markets for each product. United States v. Aluminum Co. of America, supra note 15.

26 In the *Ekco* merger, the ability of each firm to manufacture the product of the other was sufficient to place them in the same sub-market, while in actuality the products were entirely different. Ekco Prods. Inc., TRADE REG. REP. (1964 Trade Cas.) ¶ 16,879 (FTC Dkt. 8122, June 30, 1964).

27 In the *Brown Shoe* case, the factor of distinct customers (i.e., for men's, women's and children's shoes) was sufficient to establish separate sub-markets. Brown Shoe Co. v. United States, supra note 5, at 326.
Co., where he reasoned that "since the purpose of delineating a line of commerce is to provide an adequate basis for measuring the effects of a given acquisition, its contours must, as nearly as possible, conform to competitive reality . . . otherwise an adequate determination of the merger's true impact cannot be made." The practical indicia are more a judicial tool in determining the validity of the merger, than an economic reality. This divorce of judicial analysis and economic reality prompted Mr. Justice Harlan, dissenting in Continental Can, to ask whether the potential effect on competition existed other than in the minds of the court.

This problem further raises the question whether the Commission can maneuver the product market to produce any desired result. Since, in all practicality, it is impossible to attack the product market chosen by the Government, the only solution for the firm would appear to be to present another product market which it argues is the one more indicative of the merger's effect. By using this argument, the advantage would appear to be with the defendant since the burden of proof is on the Commission to establish a reasonable product market. For this reason it is important that a careful examination be made into the broad product market and all the practical indicia which could comprise separate sub-markets in order to make a proper determination as to the ultimate line of commerce. In our hypothetical, the practical indicia cannot be employed to establish a separate sub-market. This does not, however, establish that the merger is legal.

There are still several other tests developed by the Commission and the federal courts to determine the validity of conglomerate mergers. But there has been no agreement among the authorities as to the effectiveness of those tests. Rather than following any discernible pattern, tests have been applied both singularly and collectively, so as to reveal any anticompetitive effects of a merger. Thus, the hypothetical merger must be examined in light of each of the tests to determine if it is proscribed by section 7.

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28 Supra note 20, at 457.
29 Id. at 467-77.
30 In a discussion of the newly initiated Trade Regulation Rulings, Commissioner Elman underlined the fact that "both big business and government urgently need ... a better means of determining, in advance, the probable legality of proposed mergers." Elman, Rulemaking Procedures in the FTC's Enforcement of the Merger Law, 78 HARV. L. REV. 385, 391 (1964). See generally Llewlyn & Mann, Some Thoughts on Policy and Enforcement of Section 7 of the Clayton Act, 50 A.B.A.J. 154 (1964).
The Deep Pockets Test

The "deep pockets" test\(^\text{34}\) is essentially an examination into the competitive advantages that arise when a merger results in the acquiring firm having far greater financial resources than its competitors in its new field of endeavor. If the merger results in the entrance of a firm "with a breadth of experience and degree of financial strength beyond anything possessed by the existing members of the industry,"\(^\text{35}\) it is well on its way to illegality.\(^\text{36}\)

This test was further refined to include not only an examination of financial disparity but also any substantial difference in technological or administrative resources, as well as the intangible psychological advantages afforded to a "giant" in a field of "pygmies."\(^\text{37}\)

The acquisition in our hypothetical will result in the entrance of a firm with five times the financial worth of the average firm presently in the industry. However, the disparity is not actually as great as it first appears. The industry leader has an absolute worth of six million dollars. As a result of the merger, the hypothetical would have an absolute worth of twelve million dollars. Compared with the leader, the disparity is not such as will give rise to the "possibility and power to sell at prices approximating cost or below and thus to undercut and ravage the less affluent competition."\(^\text{38}\) Likewise, since Lynch is a single-product firm, administrative and technological "deep pockets" probably will not exist.

However, even if "deep pockets," financial\(^\text{39}\) or otherwise, was found to exist, this would not necessarily result in a finding of illegality.\(^\text{40}\) It must further be shown that the acquisition had the reasonable probability of effecting a substantial lessening of com-

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\(^{34}\) This concept was introduced into the area under consideration by the Commission in Reynolds Metals Co. v. FTC, 309 F.2d 223 (D.C. Cir. 1962). Both the Commission and the circuit court expressly rejected using the vertical aspects of the merger as a basis for a finding of illegality. The "truer picture of anti-competitive effect emerges from even the most cursory consideration of the post acquisition competitive postures of the... [firms in the acquired firm's line of commerce] vis a vis one another." Id. at 229.

\(^{35}\) Procter & Gamble Co., supra note 32, at 21,578.

\(^{36}\) Accord, Reynolds Metals Co. v. FTC, supra note 34.

\(^{37}\) Reynolds Metals Co. v. FTC, supra note 34.

\(^{38}\) Id. at 229-30.

\(^{39}\) All mergers will result, in varying degrees, in financial "deep pockets." Donnem, The Conglomerate Merger and Reciprocity, 8 Antitrust Bull. 283, 284 (1963).

\(^{40}\) The acquisition would be highly suspect, though, if the acquired firm held a monopolistic position in its line of commerce, for it would "entrench the monopoly position of the acquired firm and... strengthen the latter's ability to repulse new competition." Ekco Prods. Inc., supra note 26, at 21,907.
petition. The intra-industry competition may very well be increased—rather than decreased—where, for example, a small firm in a given industry, increased in power by the resources of its merging partner, will be more able to compete with the larger firms in that industry.

Reciprocity

The concept of reciprocity is another aspect in the examination of whether the acquiring firm in any way transfers greater leverage to the acquired firms so as to make it a more formidable competitor. Reciprocity is "the practice whereby firms, overtly or tacitly, make concessions to one another in order to promote their own business interests. Perhaps the most common form of reciprocity is... reciprocal buying. In this context it involves nothing more than the simple idea that 'I will buy from you if you will buy from me,' or the unspoken 'If I will buy from him, he will buy from me.'"

A recent Commission decision rested on the theory that the purchasing power of the acquiring firm will coerce its suppliers to purchase in turn from its acquired firm. The merger therefore takes on a quasi-vertical character. The result of such a practice is to foreclose a portion of the market for intra-industry competition. If this excluded portion is substantial, the merger cannot stand since this "vertical" merger is, therefore, anticompetitive.

Opposition to reciprocal buying is based primarily on the fact that the advantages gained through such practice are not rooted in superior economic performance, but rather, in a species of economic power. The practice "distorts the focus of the trader by interposing between him and the traditional competitive factors of price,

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42 See United States v. Lever Bros., Co., 216 F. Supp. 887, 889 (S.D.N.Y. 1963), where the court said that "by virtue of the... [acquiring firm's] experience, expertise and substantial financial position it was in a much better position to compete in this market than... [the acquired firm] had ever been."

43 One authority distinguishes between psychological and coercive reciprocity. The former involves "the power of a large customer, solely by virtue of the volume of its purchases, to influence the purchases of its suppliers." The latter refers to "overt acts... designed to induce purchases by the supplier." Krash, The Legality of Reciprocity Under Section 7 of the Clayton Act, 9 Antitrust Bull. 93, 98-99 (1964).
44 Consolidated Foods v. FTC, supra note 31, at 20,975.
45 Consolidated Foods v. FTC, supra note 31.
46 Donnem, supra note 39, at 290.
47 In effect, it is "a merger involving the acquisition not of a supplier, but of a supplier's supplier." Procter & Gamble Co., supra note 32, at 21,566.
quality, and service an irrelevant and alien factor which is destructive of fair and free competition on the basis of merit."

The prerequisites for reciprocal buying are not contained in our hypothetical. Lynch does not purchase from firms which in turn purchase from Silverman.

**Potential Competition**

A recent adjunct to these tests is the concept of potential competition. Essentially, this concept "is concerned with specified existing companies that are considered prospective competitors and the effect of their removal by merger is taken into account in determining the changed competitive situation."

Diversification may be achieved through internal or external expansion. If diversification is achieved by acquisition, this necessarily eliminates the possibility of the acquiring firm entering into competition with the acquired firm. Therefore, when diversification is accomplished through acquisition, where the ability to diversify through internal expansion is available, this results in a potential lessening of competition. But there must be evidence that the acquiring firm, in fact, is a potential competitor.

In examining the evidence of potential competition exhibited by the acquiring firm in the hypothetical, the following should be considered:

1. ease of conversion of present facilities,
2. ease of acquiring capital necessary for internal expansion, and,
3. geographic potential.

In our hypothetical, the production facilities of both the acquiring (Lynch) and acquired (Silverman) firms are distinctive and do not lend themselves to conversion. This necessarily results in an increase in the capital outlay that would be required to diversify through internal expansion. Hence, the likelihood of a finding of potential competition is proportionately decreased.

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51 One of the five factors upon which the Commission found Procter & Gamble's acquisition of Clorox to be in violation of §7 was "the elimination, brought about by the merger of Procter as a potential competitor of Clorox . . . ." Procter & Gamble Co., *supra* note 32, at 21,580.
52 "The test cannot be whether one of the parties would like to be in the other party's field but whether, taking into account all economic factors, there is a likelihood that it would have gone into that field apart from the merger." Hale & Hale, *supra* note 50, at 181.
Geographic potential is exhibited by the fact that both firms distribute their products on a national scale and service identical accounts. Therefore, Lynch's present marketing and distribution methods easily adapt themselves to the sale of flowerpots.

The presence of geographical potential must be evaluated in light of prior findings. To date, application of the potential competition theory has been limited to instances giving rise to all three factors. However, the presence of merely one factor may be of such import in certain industries so as to support, on its own, a finding of potential competition.

**Product-Extension Doctrine**

The "product-extension doctrine" is applicable to the "merger of sellers of functionally closely-related products which are not, however, close substitutes." Thus, the acquisition of a liquid bleach company by the manufacturer of a wide range of other consumer items was more appropriately described as "a product-extension merger." A merger involving sellers of functionally closely-related products "may enable significant integration in the production, distribution or marketing activities of the merging firms," thus imparting to the merged firms a considerable competitive advantage.

Many of the aspects inherent in a merger of this type can be found in the hypothetical. Integration at the distribution and marketing levels is readily available since both companies sell their products to the same customers and use the same merchandising methods.

Additional cost advantages accrue to the merged firm because of the close relation of their products from the consumers' view-

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53 Each of these three factors was present in United States v. El Paso Natural Gas Co., supra note 49, where the Court based their finding of a violation of §7 solely on the basis of the fact that the acquired firm was a potential competitor of the acquiring firm.

54 The concept of potential competition is well worth scrutinizing. As recently as 1963 a district court held an acquisition of assets by a firm, which had all the characteristics of a potential competitor, not to be violative of §7. In fact, the factor of potential competition was not even considered. United States v. Lever Bros., Co., supra note 42. Less than a year later the Supreme Court based a finding of contravention of §7 entirely on the concept of potential competition. United States v. El Paso Natural Gas Co., supra note 49. This meteoric rise has not passed unnoticed by the Commission. See note 51 supra.

55 Procter & Gamble, supra note 32, at 21,565. Commissioner Elman views the product-extension merger as a variant of the conventional horizontal merger.

56 Id. at 21,566.

57 Id. at 21,565.
point. The ability to combine advertising budgets will result in a substantial increase in advertising exposure per dollar.58

The third level at which the merger may enable significant integration is that of production. Frequently, acquisitions will be made by firms that can easily integrate the manufacture of acquired products into their present production methods.59 This advantage will obviously not be available to our hypothetical firms because of the physical dissimilarity of their products. However, as demonstrated previously, the merger does give rise to cost savings at the distribution and marketing levels which may impart a competitive advantage to the acquired firm.60 Of course, the question remains as to whether the competitive advantages accruing would substantially lessen competition, or tend to create a monopoly.

Substantiality & Probability

Underlying all of the tests considered is the qualification that even if anticompetitive effects were established, the merger would not fail unless these effects were substantial. "Substantial" has been interpreted to mean "substantiality within the line of commerce involved, not substantiality in any absolute monetary terms."61

The conglomerate merger does not have the automatic effect on competition present in conventional horizontal and vertical mergers. Thus, the determination of "substantiality" rests primarily on reasonable probability. Hence, it need not be proven that the merger did, in fact, have anticompetitive consequences, but merely that the merger creates a reasonable probability of lessening competition.62

Essentially, reasonable probability is determined by an examination of the merger under the previously outlined tests. That outline is by no means intended to be a complete delineation of all tests, but rather, indicative of current and possibly future merger movements.

59 E.g., Brown Shoe Co. v. United States, 370 U.S. 294 (1962); United States v. Lever Bros., supra note 42; Procter & Gamble Co., supra note 58.
60 "[I]f the product markets served by the acquiring and acquired companies are closely tied together, it is possible that substantial competitive advantages may accrue...." United States v. Continental Can Co., 217 F. Supp. 761, 786 (S.D.N.Y. 1963).
61 Ekco Prods., Inc., Trade Reg. Rep. (1964 Trade Cas.) ¶ 16,879, at 21,901 (FTC Dkt. 8122, June 30, 1964); accord, United States v. Aluminum Co. of America, 377 U.S. 271 (1964), where although the decrease in competition was a mere 1.3 per cent, the fact that the acquired company ranked among the top ten producers in both lines of commerce under scrutiny led the Court to conclude that the lessening of competition was substantial. Id. at 281.
62 Reynolds Metal Co. v. FTC, 309 F.2d 223, 229-30 (D.C. Cir. 1962).
Conclusion

These tests have arisen primarily as a result of an attempt by the Commission and the federal courts to deal with modern economic developments. The conglomerate merger is an invention fathered by the need to achieve the diversification necessary for economic growth and often for business survival. In formulating tests applicable to conglomerate mergers, the authorities have repeatedly underlined the fact that they are in no sense establishing per se rules of illegality. Rather, they are attempting to deal with the individual aspects of each merger—separate and distinct from previous decisions. It is all too easy to disregard these disclaimers and regard the tests as establishing per se rules.

It would be economically convenient if definite rules were clearly drawn and uniformly accepted so as to enable the lawyer to more accurately evaluate a proposed conglomerate merger. In their stead, tests have been developed and applied to meet the varied economic arrangements presented. Future proposed mergers must first be examined under each of these tests, and then the individual finding must be compared and evaluated in order to determine the cumulative effect of the merger upon competition.

Access of the Unincorporated Association to the Federal Courts: Venue and Diversity Restrictions

The constitutional grant of diversity jurisdiction to the federal courts extends "to Controversies . . . between Citizens of different States . . . ." ¹ In Strawbridge v. Curtis² the United States Supreme Court declared that in order to satisfy the requirements of diversity it must appear that there is complete diversity, i.e., no plaintiff being of the same citizenship as any defendant. According to common-law principles, an unincorporated association was deemed a citizen of each state wherein a member of the association was domiciled.³ The requirement of complete diversity in a case involving a large unincorporated labor union or a joint stock company may be a practical impossibility since, in most cases, at least one member of the association will be a citizen of the same state as an adverse party. Thus, unless there is a federal question, these associations are excluded from the federal

² 7 U.S. (3 Cranch) 267 (1806).