ANTI-TRUST: COURT OF APPEALS APPLIES *BROWN SHOE* INTERPRETATION OF SECTION 7 OF THE CLAYTON ACT TO PROHIBIT VERTICAL MERGER

SINCE the passage of the Sherman Act[1] in 1890 Congress has repeatedly expressed its faith in a competitive free enterprise economy through its statutory prohibitions of various activities presumed detrimental to competition.[2] The 1950 amendment to section 7 of the Clayton Act[3] sought to provide additional protection to competition by including in its prohibitions the acquisition of the assets of one corporation by another, where the effect of such acquisition may substantially lessen competition or tend to create a monopoly in any line of commerce in any section of the country. In the recent case of *Reynolds Metals Co. v. FTC*[4] a vertical merger of a large affluent corporation into a market composed of substantially smaller enterprises was held to produce sufficient probability of anticompetitive effects in the acquired customer's line of commerce to constitute a violation of the amended section 7.[5]

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[1] 26 Stat. 209 (1890), as amended, 15 U.S.C. § 1 (1958).

[2] *E.g.*, Sherman Act, 26 Stat. 209 (1890), as amended, 15 U.S.C. § 1 (1958); Federal Trade Commission Act, 38 Stat. 717 (1914), as amended, 15 U.S.C. § 1 (1958); Robinson-Patman Act, 49 Stat. 1526 (1936), 15 U.S.C. § 13 (1958).

[3] 38 Stat. 730, 731-32 (1914), as amended, 64 Stat. 1125 (1950), 15 U.S.C. § 18 (1958). "No 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 [to] substantially to lessen competition [between the corporation whose stock is so acquired and the corporation making the acquisition, or to restrain such commerce in any section or community], or to tend to create a monopoly [of any line of commerce]." (Material in italics was added by the amendments; material in brackets was deleted.) In addition to the elimination of the acquiring-acquired test and the additional prohibition of asset acquisitions, other paragraphs of § 7 were also amended in details not here relevant. See Brown Shoe Co. v. United States, 370 U.S. 294, 311-23 (1962) for the Supreme Court's extensive discussion and interpretation of amended § 7.

[4] 309 F.2d 223 (D.C. Cir. 1962).

[5] Section 7 had previously been held applicable to vertical mergers, but such cases based a finding of a violation, at least in part, on the vertical anti-competitive effects between the acquired and the acquiring corporations; whereas the court in the *Reynolds* case refused to rest its decision on the vertical effects of the merger between the acquired and the acquiring corporations and based its decision entirely on the horizontal effects in the acquired customer's line of commerce. See, *e.g.*, Brown Shoe Co. v. United States, 370 U.S. 294, 334-46 (1962).

For a discussion of the distinctions between vertical, horizontal and conglomerate mergers see H.R. REP. No. 1191, 81st Cong., 1st Sess. 11-14 (1949).

On August 1, 1956, Reynolds Metals Company purchased all the stock and assets of one of its customers, Arrow Brands, Inc. Prior to this acquisition Arrow had been engaged in the business of converting and decorating raw aluminum foil, which it purchased from various aluminum manufacturers including Reynolds, for sale to the florist industry throughout the nation. At the time of purchase Arrow's sales accounted for approximately one-third of the total annual sales of floral foil, and approximately five per cent of the total annual sales of all decorative foil. The FTC found that this merger violated section 7 of the Clayton Act,[6] and ordered Reynolds to divest itself of certain property acquired as a result of the purchase. The Court of Appeals for the District of Columbia Circuit affirmed the FTC's findings and order.[7]

This decision, relying heavily on the Supreme Court's recent analysis of the amended section 7 in *Brown Shoe Co. v. United States*,[8] raises several important questions in the application of the provisions of the Clayton Act. The court's determination of the relevant line of commerce, and its evaluation of the effects of the merger in this line of commerce are the most notable aspects of the decision.

The Supreme Court has repeatedly stated that a "product market," a term which is often used synonymously with "line of commerce" by the courts,[9] must be delineated before a violation of the Clayton Act can be found.[10] Prior to the *Brown Shoe* decision the courts devised various tests in an attempt to simplify the identi-

[6] Reynolds Metals Co., TRADE REG. REP. (Complaints, Orders and Stipulations) ¶ 28533, *motion to reopen proceeding denied*, TRADE REG. REP. (Complaints, Orders and Stipulations) ¶ 28666 (1960).

[7] The court excepted from the Commission's divestiture decree a building erected after the merger in which Arrow was housed on the basis that such property was not acquired as a result of the merger, and held that divestiture was unnecessary to restore the competitive situation to its status before the merger. 309 F.2d at 230-31.

[8] 370 U.S. 294 (1962); 31 GEO. WASH. L. REV. 504, *The Supreme Court, 1961 Term*, 76 HARV. L. REV. 54, 183 (1962). See Comment, 4 B.C. IND. & COM. L. REV. 159 (1962).

[9] *E.g.*, Transamerica Corp. v. Board of Governors, 206 F.2d 163 (3d Cir.), *cert. denied*, 346 U.S. 901 (1953); United States v. Columbia Pictures Corp., 189 F. Supp. 153 (S.D.N.Y. 1960); and United States v. Bethlehem Steel Corp., 168 F. Supp. 576 (S.D.N.Y. 1958).

[10] "Determination of the relevant market is a necessary predicate to a finding of a violation of the Clayton Act because the threatened monopoly must be one which will substantially lessen competition 'within the area of effective competition.' Substantiality can be determined only in terms of the market affected." United States v. E.I. du Pont de Nemours & Co., 353 U.S. 586, 593 (1957).

fication of the "product market."[11] These tests apparently proceeded on the basis that a product market could be delineated by a comparison of the competitive characteristics of the defendant's products with like characteristics of various other products.[12] The courts announced that "interchangeability of use" or "cross-elasticity of demand" existed among various products when a substantial similarity was found in their competitive characteristics, and concluded that those products which were interchangeable or cross-elastic constituted a product market, or line of commerce.[13] Thus, it appears that the terms "interchangeability of use" and "cross-elasticity of demand" were applied to various products only after the courts had found, from an analysis of many economic and competitive factors, that effective competition among those products actually existed.[14]

In the *Reynolds* case the court recognized that the physical characteristics of floral foil and other types of decorative foil were not sufficiently different to provide a basis for distinguishing be-

[11] See, *e.g.*, United States v. E.I. du Pont de Nemours & Co., 353 U.S. 586 (1957) (peculiar characteristics); United States v. E.I. du Pont de Nemours & Co., 351 U.S. 377 (1956) (cross-elasticity of demand); American Crystal Sugar Co. v. Cuban-American Sugar Co., 259 F.2d 524 (2d Cir. 1958) (price sensitivity and price differential); United States v. Columbia Pictures Corp., 189 F. Supp. 153 (S.D.N.Y. 1960) (reasonable interchangeability); United States v. Maryland and Va. Milk Producers Ass'n, 167 F. Supp. 799 (D.D.C. 1958) (objective of the merger), *rev'd on other grounds*, 362 U.S. 458 (1960).

[12] In distinguishing between line of commerce and section of the country as used in the amendment to § 7 the Senate Judiciary Committee indicated that line of commerce is intended to mean the line of business in which the defendant is engaged. The Committee used the terms "line of commerce," "relevant market" and "orbit of competition" as possessing the same connotations, and concluded that a line of commerce is to be determined from an evaluation of the defendant's products—what he produces and sells—in its competitive capacities, only one of which is the area in which it is sold. S. REP. No. 1775, 81st Cong., 2d Sess. 6-7 (1950).

[13] See, *e.g.*, cases cited note 11 *supra*.

[14] The comment of Mr. Justice Reed in *United States v. E.I. du Pont de Nemours & Co.* is typical of the broad meaning previously applied by the courts to the terms interchangeability and cross-elasticity: "If a *slight decrease in the price* of cellophane causes a considerable number of customers of other flexible wrappings to switch to cellophane, it would be an indication that a high cross-elasticity of demand exists between them; that the products compete in the same market. . . . The 'market' which one must study to determine when a producer has monopoly power will vary with the part of commerce under consideration. The tests are constant. That market is composed of products that have reasonable interchangeability *for the purposes for which they are produced—price, use and qualities considered.*" 351 U.S. 377 at 400, 404 (1956). (Emphasis added.) However, the tests of "interchangeability" and "cross-elasticity" have been criticized. See, *e.g.*, Crown Zellerbach Corp. v. FTC, 296 F.2d 800 (9th Cir. 1961), *cert. denied*, 370 U.S. 937 (1962); United States v. Bethlehem Steel Corp., 168 F. Supp. 576 (S.D.N.Y. 1958); Comment, 47 VA. L. REV. 1014 (1961).

tween them.[15] Noting, however, that a comparison of physical characteristics alone did not determine a "line of commerce" sufficiently to permit Congress' mandate in the Clayton Act to be effectively carried out, the court proceeded to apply a "submarket" test to the products within this broad market of physically similar goods,[16] and concluded that the florist foil "submarket" was the relevant line of commerce rather than the broader market of decorative foil.[17] The terms "interchangeability" and "cross-elasticity" were used by the court to express its concept of the outer limits of this broad market, and by using these terms in the exclusive sense of physical characteristics of the goods, the court rejected a consideration of other characteristics which, prior to the *Brown Shoe* case,[18] have been included in determining "interchangeability" and "cross-elasticity."[19] Therefore, it appears that the court in the *Reynolds* case intended the term "submarket" to include those products which, having already been separated by their physical characteristics and labelled interchangeable or cross-elastic, had similar competitive characteristics other than physical.[20] The conclusion that physical characteristics were applicable only in determining the broad general market is substantiated by the fact that the court based its decision that floral foil constituted the relevant submarket entirely on the competitive characteristics of (1) public and industrial recognition of

[15] All decorative foil, including florist foil, was gauged at approximately .00065 inches thickness, and the variations and tolerances allowed as to weight apparently provided substantial leeway for overlapping of all types of decorative foil. 309 F.2d at 227.

[16] *Id.* at 226-27.

[17] *Id.* at 229.

[18] Mr. Chief Justice Warren, speaking for the Court, indicated that competitive characteristics of the goods under consideration, such as industry or public recognition of a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors, were valid criteria *only* in determining the boundaries of a submarket. Thus, by implication, these factors were irrelevant in delineating the "outer boundaries of a product market," which he stated were to be determined "by the reasonable interchangeability of use or cross-elasticity of demand" between the defendant's product and substitutes for it. 370 U.S. at 325.

[19] See note 14 *supra.*

[20] The court indicated that practical indicia of economic realities were not to be used in determining the "outer limits" of the hroad market which contains such submarkets, and concluded that the development and qualification of the concept in *Brown Shoe* now made it "clear that mere potential interchangeability or cross-elasticity may be insufficient to mark the legally pertinent limits of a 'relevant line of commerce.' The 'outer limits' of a general market may be thus determined, but sharply distinct submarkets can exist within these outer limits which may henceforth be the focal point of administrative and judicial inquiry under Section 7." 309 F.2d at 226.

florist foil as a separate economic entity, (2) distinct customers and (3) distinct prices.[21] Although the court was here primarily concerned with subdividing the product market below the level of physical identity, its limiting the broad market to physically similar goods fails to provide a basis for analyzing the competitive effects of a merger in a market composed of goods which have dissimilar physical characteristics, but which are recognized and regarded by the industry and the public as constituting a distinct, but unified, economic entity, and, therefore, actually in competition.

The Act itself seems to provide the best criteria for determining what products must be considered as constituting a relevant line of commerce. As the proscribed conduct is the creation of a tendency to lessen competition or create a monopoly,[22] a merger is to be viewed in the light of its probable effect on existing or potential competition.[23] In order to determine whether or not a merger is within the proscribed area, the line of commerce in which the effect of the merger is to be evaluated should be sufficiently broad to include all products which substantially compete with the defendant's product.[24] It is noted, however, that the *Brown Shoe* case recognized that a product may compete in several different ways, and consequently, has provided authority for the courts to define the defendant's product as existing in a multiplicity of markets rather than in a single market.[25] Thus, Arrow's product, floral foil, should

[21] *Id.* at 227. Thus physical characteristics seem to be the basis on which the court rested its decision that decorative foil of all kinds constituted the broad market or the "outer boundaries" of the geueral market, and to this the court applied the terms "interchangeability" and "cross-elasticity." Then, within this broad general market as delineated by physical characteristics the court found relevant submarkets from an evaluation of the other competitive characteristics. *Id.* at 227-29.

[22] See note 29 *infra*.

[23] See, *e.g.*, Aluminum Co. of America v. FTC, 284 Fed. 401 (3d Cir. 1922), *cert. denied*, 261 U.S. 616 (1923); United States v. Bethlehem Steel Corp., 168 F. Supp. 576 (S.D.N.Y. 1958).

[24] "But the boundaries of the relevant market must be drawn with sufficient breadth to iuclude the competing products of each of the merging companies *and to recognize competition where, in fact, competition exists.*" Brown Shoe Co. v. United States, 370 U.S. at 326. (Emphasis added.) See also note 12 *supra*.

[25] "The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the [defendant's] product itself and substitutes for it. However, within this broad market, well-defined submarkets may exist which, in themselves, constitute product markets for antitrust purposes. . . . Because § 7 of the Clayton Act prohibits any merger which may substantially lessen competition 'in any line of commerce,' it is necessary to examine the effects of a merger in each such economically significant submarket to determine if there is a reasonable probability that the merger will substantially lessen competition. If

be considered as existing in several lines of commerce such as aluminum goods in general, decorative foils and wrapping and packaging materials in addition to the floral foil market. Contrary to the approach in the *Reynolds* case, the effect of the merger in *each* of these lines of commerce may be evaluated for anti-competitive effects under the Supreme Court's interpretation of section 7 in the *Brown Shoe* case, and the existence of the proscribed effects in *any* of them should constitute a violation of the Clayton Act.[26]

A second important aspect of the decision in the instant case is the finding of a violation of section 7 in the delineated line of commerce on the basis that the merger of Reynolds and Arrow created a "capacity or potentiality to lessen competition."[27] Assuming the court intended these terms to mean a mere possibility, rather than a probability, of producing the proscribed effects, the decision is a significant departure from prior opinions which have construed the Act,[28] and appears to be in conflict with the intent of Congress.[29] Manifestly the Act does not purport, and was not intended, to prohibit all mergers, but only those which create a reasonable proba-

such a probability is found to exist, the merger is proscribed." 370 U.S. at 325. (Emphasis in original.)

[26] *Ibid.*

[27] "The Commission is not required to establish that the Reynolds' acquisition of Arrow did in fact have anti-competitive consequences. It is sufficient if the Commission shows the acquisition had the *capacity or potentiality* to lessen competition. That such a *potential* emerged from the combination of Reynolds and Arrow was enough to bring it within Section 7. . . . The necessary probability of anti-competitive effect has thus been shown." 309 F.2d at 230. (Emphasis added.)

[28] See, *e.g.*, Brown Shoe Co. v. United States, 370 U.S. 294 (1962) (reasonable probability); United States v. E.I. du Pont de Nemours & Co., 353 U.S. 586 (1957) (reasonable likelihood); International Shoe Co. v. FTC, 29 F.2d 518 (1st Cir. 1928), *rev'd on other grounds*, 280 U.S. 291 (1930) (probable result); United States v. Jerrold Electronics Corp., 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961) (reasonable probability); Pillsbury Mills, Inc., 50 F.T.C. 555 (1953) (probable effect). For a general discussion of the applicable tests see Address by Attorney General Brownell, *The Antitrust Aspects of Mergers*, Meeting of the New York Chapter of the Public Relations Society of America, September 30, 1954, 1 TRADE REG. REP. ¶ 4310.16 (1961).

[29] Congress has clearly indicated that its intent in inserting the words "may be" in the 1950 amendment to the Clayton Act was to establish a reasonable probability test of effect in evaluating mergers under § 7. "The words 'may be' have been in Section 7 of the Clayton Act since 1914. The concept of reasonable probability conveyed by these words is a necessary element in any statute which seeks to arrest restraints of trade in their incipiency and before they develop into full-fledged restraints violative of the Sherman Act. A requirement of certainty and actuality of injury to competition is incompatible with any effort to supplement the Sherman Act by reaching incipient restraints." S. REP. No. 1775, 81st Cong., 2d Sess. 6 (1950). See also 96 CONG. REC. 16453, 16502 (1950); 51 CONG. REC. 14464 (1914).

bility of substantially lessening competition or tending to create a monopoly.[30] A merger, therefore, which threatens to lessen competition in an insignificant or trivial manner, or which creates a possibility, but not a likelihood of lessening competition is not prohibited.[31] On the other hand, there is no requirement that the merger actually produce a lessening of competition in order to violate the Act.[32] Therefore, in order to determine whether an acquisition falls within the proscribed category, the courts have found it necessary to forecast future consequences of the merger,[33] and in so doing have consistently applied the "reasonable probability" test as determinative of future consequences.[34]

In the *Reynolds* case the court concluded that the vertical effect of excluding other manufacturers of raw foil from selling to the one third of the florist foil converting industry represented by Arrow prior to Reynolds' acquisition was insufficient to create a violation of the Act.[35] Therefore, the violation had to occur, if at all, as a result of the horizontal anti-competitive effects created in the florist foil market by Reynolds' entrance as a competing supplier. The only immediate and direct effect which this merger produced was to insert Reynolds into the florist foil market as a replacement for Arrow. Such a substitution of one corporation for another, in the absence of other controlling factors, such as the market structure or history of the industry, would not in itself create the proscribed

[30] The language of § 7 that a merger is proscribed if "the effect of such acquisition *may be* substantially to lessen competition, or *tend to create* a monopoly" seems to indicate that § 7 is restricted to those mergers where a *probable* lessening of competition will occur. (Emphasis added.) The Supreme Court has stated: "Mere acquisition by one corporation of the stock of a competitor, even though it result in some lessening of competition, is not forbidden; the act deals *only* with such acquisitions as probably will result in lessening competition to a substantial degree . . . that is to say, to such a degree as will injuriously affect the public." International Shoe Co. v. FTC, 280 U.S. 291, 298 (1930). (Emphasis added.)

[31] *E.g.*, Transamerica Corp. v. Board of Governors, 206 F.2d 163 (3d Cir.), *cert. denied*, 346 U.S. 901 (1953); United States v. Columbia Pictures Corp., 189 F. Supp. 153 (S.D.N.Y. 1960); United States v. Associated Press, 52 F. Supp. 362 (S.D.N.Y. 1943), *aff'd*, 326 U.S. 1 (1945).

[32] See H.R. REP. No. 1191, 81st Cong., 1st Sess. 14 (1949). See also authorities cited notes 27 and 28 *supra*.

[33] "The test as to whether the merger produced a 'reasonable probability' that it would lessen competition or tend toward monopoly is not an easy one to apply because it obviously involves in a degree the forecasting of the future." Crown Zellerbach Corp. v. FTC, 296 F.2d 800, 824-25 (9th Cir. 1961), *cert. denied*, 370 U.S. 937 (1962).

[34] See authorities cited note 27 *supra*.

[35] 309 F.2d at 229.

anti-competitive effects, but would maintain a status quo in the market.

The court, nevertheless, reasoning that the injection of a large affluent corporation into a market composed of less affluent enterprises produced the proscribed anti-competitive effects, concluded that Reynolds' acquisition of Arrow constituted a violation of the Clayton Act. This decision could have been justified on the previously accepted and well-established test of "reasonable probability" by recognizing the substantial support which the proof of actual anti-competitive effects gives to a finding that the reasonable probability of the merger was to create the proscribed effects.[36] The court, however, stated that there was a violation if the acquisition had the "capacity or potentiality" to lessen competition.[37] This rationale seems to stand for the proposition that, in the absence of economic and social circumstances indicating a desirability for such an acquisition,[38] the entrance into a market by way of a merger of a corporation with sufficient assets to substantially lessen competition by cutting prices will either create a lessening of competition in itself in violation of section 7, or create a reasonable probability that such power will be used to lessen competition. Both of these propositions have the same legal effect since the creation of a reasonable prob-

[36] Proof of actual anti-competitive effects was available and was recognized by the court; however, such proof was regarded as unnecessary to find a violation of the Act as a showing of a capacity or potentiality to lessen competition was regarded by the court as sufficient. *Id.* at 230.

It seems clear that a court is not required to find an intent to lessen competition or an intent to achieve monopoly power or that competition has in fact been lessened in order to find a violation of § 7, but a finding of the existence of any of these factors seems to provide important considerations in forecasting the effects of the merger, and in some instances may be conclusive of a violation. See Aluminum Co. of America v. FTC, 284 Fed. 401 (3d Cir. 1922), *cert. denied,* 261 U.S. 616 (1923); Continental Sec. Co. v. Michigan Cent. R.R., 16 F.2d 378 (6th Cir. 1926), *cert. denied,* 274 U.S. 741 (1927).

[37] 309 F.2d at 230.

[38] Economic situations may arise in which mergers similar to the one in the *Reynolds* case will be necessary to preserve competition, such as the introduction of a large and healthy corporation into a market to preserve a competitive status quo in place of a smaller failing corporation or where the market is already dominated by large affluent companies and only another corporation of similar size and affluence can effectively "hold its own" in the existing competition. The same may be said of situations where the introduction of a large corporation is essential to meet existing consumer demand. In such situations a vertical merger poses no threat to competition and, consequently, would not violate the Clayton Act, but would tend to achieve the same objective of protecting competition. See Brown Shoe Co. v. United States, 370 U.S. 294, 328-34 (1962).

ability to substantially lessen competition will in itself constitute a violation of the Clayton Act.[39]

While the end result of the *Reynolds* case appears to be consonant with the purposes of the Clayton Act, several aspects of the case are worthy of note. First, it appears that economic realities and business practices were openly accepted by the court of appeals as valid criteria for delineating relevant lines of commerce.[40] Second, the court, while attempting to follow the *Brown Shoe* case, apparently overlooked a significant aspect of that decision by unnecessarily attempting to exclude the decorative foil market as a relevant line of commerce in order to isolate the floral foil market as the relevant line of commerce. If economic realities revealed that both markets were lines of commerce in which Reynolds was engaged, then, under the multiple market doctrine of the *Brown Shoe* case, both markets were relevant, and a finding of the proscribed effects in either of them should have been sufficient to find a violation of section 7.[41] Third, the multiple market concept facilitates the finding of a violation of section 7 by eliminating the necessity of excluding all but one line of commerce, but collaterally increases the necessity of a "reasonable probability" test of effect in order to avoid prohibiting mergers that were not intended by Congress to be proscribed. The test apparently applied by the court in the *Reynolds* case that a finding of a possibility, capacity or potentiality to create the proscribed effects is sufficient to establish a violation of the Clayton Act is misleading as a precedent and is likely to lead to unwarranted and undesirable results if followed. Unless clarified to insure adherence to the reasonable probability test, this decision may create a substantial restraint to diversification by vertical or conglomerate mergers of large corporations into fields not already inhabited by competitors of similar size and affluence.

[39] The net effect of this rationale approaches the mechanical per se type rule applied to some cases under § 1 of the Sherman Act. Such mechanical tests, however, have been rejected as not applicable to § 7 of the Clayton Act. See, *e.g.*, American Crystal Sugar Co. v. Cuban-American Sugar Co., 259 F.2d 524 (2d Cir. 1958); Transamerica Corp. v. Board of Governors, 206 F.2d 163 (3d Cir.), *cert. denied*, 346 U.S. 901 (1953).

[40] The court considered only four factors in determining floral foil to be a relevant line of commerce: (1) physical characteristics, (2) existence as a separate economic entity, (3) customers and (4) prices. 309 F.2d at 227-29.

[41] 370 U.S. at 325.