Law360

Antitrust Law And The Digital Economy

Law360, New York (November 30, 2011, 12:00 AM ET) -- As the Internet revolutionizes the world, courts are playing catch-up, grappling with how to apply old norms to the brave new world. The antitrust world is not exempt. The Internet has created new products and new methods of distribution, broken down geographic boundaries and other barriers to entry, and generally enhanced competition. But has the Internet created a separate market, where purveyors of new technology no longer compete with their old world counterparts? That was the question posed — and answered in the affirmative — by the U.S. district court in U.S. v. H&R Block Inc, -- F.3d -- (D.D.C. 2011).

In blocking a merger between H&R Block and TaxACT — two providers of online tax services — the court rejected many modern defense-oriented schools of thought, potentially portending a return to a world where, as Justice Potter Stewart observed over forty years ago, “the Government always wins.”

Of course, the government does not always win. And it is not clear that it should have won here. But whether the court reached the right result or not, the case will be instructive to those seeking to merge because of the ground that it breaks, the paths it chose to retread in reaching its conclusions, and the bold steps it took bringing the digital world back to the future.

The Facts

H&R Block operates hundreds of retail tax stores. This case is not about that. Rather, this case is about Block’s decision to acquire TaxACT and merge it with its own online service.

The government alleged that Block and TaxACT were two of the three largest online providers. They would have a combined market share of 30 percent; Intuit — the maker of TurboTax — would continue to be dominant, with over 60 percent market share; and a fringe of 18 other competitors would make up the remainder. The DOJ argued that the merger would create an effective duopoly, and take TaxACT — an historically aggressive competitor that emphasized offering free services to gain market share — out of the market.

Block argued that the combined firm would better compete against Intuit, the 800-pound gorilla, and that the government created an artificial distinction by separating online and offline alternatives. In Block’s view, online offerings simply fell in the middle of the broad continuum of alternatives, with accountants and retail tax stores offering high levels of assistance at relatively higher prices; self-filers using “pen-and-paper” with low levels of assistance, and online services filling out the middle, as the “Goldilocks” offering. All of these alternatives are one-for-one substitutes.

The court acknowledged that all are one-for-one substitutes, which “provide taxpayers with a means to perform the task of completing a tax return.” Nevertheless, the court sided with the government. That it ultimately defined an online market may not be too surprising. But how it got there is telling.

The District Court’s Analysis

The court started its analysis with market definition, which was — as it frequently is — the dispositive issue. Once the court defined an online market, it triggered a presumption of illegality that ultimately proved impossible to rebut.

Market Definition: Brown Shoe and the Three Great Lies — Statistics, Statistics, Statistics

So how did the court define an online market and exclude its offline brethren?

It was not an easy task. Block showed that over 70 percent of consumers use offline alternatives, not online services. The court acknowledged this: “It is beyond debate,” the court stated, “that all methods of tax preparation are, to some degree, in competition.” But this was not enough: “The mere fact that a firm may be termed a competitor in the overall marketplace does not necessarily require that it be included in the relevant market for antitrust purposes.”

In excluding offline alternatives from the digital market, the court ironically turned to the Supreme Court’s 1962 decision in Brown Shoe Co. v. United States, 370 U.S. 294 (1962). That decision — which predates the economic revolution that has since swept through the world of antitrust law — introduced the much-maligned concept of “submarkets.” Because this concept focuses on soft factors or “practical indicia,” such as industry “perception,” it can lead to markets defined by subjective beliefs rather than economic analysis.

In this case, there certainly were differences between the faceless offerings of online tax services and the more personal approach historically dominating the tax preparation market. In such circumstances — especially where (as here) the economic data was admittedly ambiguous and “imprecise” — the Brown Shoe indicia almost inevitably lead to defining distinct markets for online and offline services, even though there may be substantial competition between the two.

Fortunately, with criticism of Brown Shoe so widespread, the court did not rest entirely on that case. Instead, it supplemented its analysis with a more economics-oriented approach: the “hypothetical monopolist” test. Unfortunately, the court misapplied that test, and did so in a way that goes to the core of the issue of whether online and offline products compete.

Under the hypothetical monopolist test, an online market exists if a hypothetical monopolist could profitably raise prices for online services. If any such attempt would cause a “critical loss” of customers to switch to offline alternatives, the market cannot be limited to online providers. In this case, the court determined that the magical “critical loss” number was 16.7 percent, meaning that a ten percent price increase would be profitable “if the resulting lost sales did not surpass 16.7 percent.”

Block argued that the test supported its view of a broad market, since there was substantial evidence of switching, both to professional assistance and to pen-and-paper. The court disagreed.

With respect to professional assistance, the court found that Block’s litigation-driven consumer survey data was biased. The survey, the court noted, was prepared by defendants, who phrased the question in a way that “leads respondents to think about the market … in the same terms that defendants do.” Thus, in the court’s view, the survey lacked “credibility.”

Instead, the court relied on pre-existing IRS data, which would be fine if it actually answered the relevant question and purported to support the government’s case. But it did not; thus, confirming the old adage that the three greatest lies are statistics, statistics, statistics.

In finding that the magic critical loss threshold would be exceeded the court pointed to data showing that a majority (53 percent) of online consumers who switched providers from one year to the next switched to other online providers rather than to offline alternatives. The court said 53 percent is bigger than 16.7 percent. So case closed.

But that is not the right analysis, for two reasons. First, the statistic does not answer the relevant question, which is how many customers switch in response to a price increase. It just answers the question of what happens after they have decided to switch. Whether 10 customers or 10 million customers would switch in response to a price increase — which is the only relevant question — is unanswered by the data.

Second, even accepting the data, it shows that almost a majority (47 percent) of the customers switch to offline products. That too is far above the 16.7 percent threshold, and would suggest that the market needs to include those alternatives. The court never answered why such evidence was irrelevant.

The court also appeared to make a third statistical mistake later in its analysis. Block argued that there was no segment of the population uniquely suited to online services, and that “assisted” preparation is the “most popular method across all complexity levels.” In support, Block produced evidence that many taxpayers — over 44 percent — who file “simple” returns used accountants and retail tax stores. The fact that such a high proportion of online providers’ core target audience actually use offline professional assistance shows that online and offline alternatives compete.

The court did not see it that way. The statistics, the court held, supported the view that there was “a partially different consumer profile” for online and offline consumers because filers of complex returns are more likely to seek out the assistance of professional accounts. But why is that relevant? This may be a reason for defining a market for professional assistance. But it does not undercut the fact that professional assistance may also be a significant — and indeed the most common — competitive alternative for filers of simple tax returns.

Not only did the court exclude professional assistance from the market, it also excluded pen-and-paper alternatives. In doing so, the court not only relied on the same flawed statistics, it compounded these errors by committing three more. First, the court relied on the fact that “the share of returns prepared via pen-and-paper has dwindled” as the online services have grown. But this shows high levels of competition, not the absence of it.

Second, the court held that pen-and-paper, or “self-supply,” is not a legally cognizable substitute. In the court’s view, the “rationale for including ‘self-supply’ in a relevant product market does not appear to apply to [a] market in which consumers are individuals and not also potential traders or producers.” This is a puzzling conclusion, since the court acknowledged that self-supply can constrain prices when corporations engage in the same activity through vertical integration.

The assertion that self-supply by consumers cannot have a similar impact defies economic logic. Online providers often create new ways for individuals to interact with their environment. Kindle Fire, for example is priced at $199, not because the iPad is priced at $499, but because, by pricing it at that level, it causes consumers who were not in the tablet market to enter it. The district court's view here — that simply not buying a service has at best a limited role in merger analysis — ignores what may, in fact, be the driving force in constraining prices.

The district court's view is also without legal support. To be sure, the court cited a few cases where consumer self-supply was ultimately excluded from the relevant market. But none of these cases stand for the proposition that consumer self-supply is not legally cognizable.

Third, the court rejected the notion that pen-and-paper could even logically be part of the market because it already excluded professional assistance, which it subjectively believed to be a closer substitute than pen-and-paper. The court's analysis, however, both misapplies the hypothetical monopolist test, and inappropriately shifts the burden of proof to the defendants.

How so? It is the government's burden to show that an online market exists. Under the hypothetical monopolist test, the only question is whether a critical loss of customers would switch to offline alternatives — in technical terms, it depends on the "own elasticity" of demand for online products. In analyzing this, it matters not what those alternatives are or how close or far away they are, just whether they take share away from online services. The court, however, did not see it this way. Instead, the court required the defendants to prove that pen-and-paper was in the market, and to do so by showing that it was a closer alternative than professional assistance. The law does not place the burden on the defendant to do either.

Competitive Effects: Has the Presumption of Adverse Competitive Effects Become Irrebuttable?

Having limited the market to online services, the case was essentially over. The defendants' primary argument — that they could further expand the online marketplace by continuing to erode the hegemony of expensive professional accountants — was no longer relevant. More importantly, they were now faced with the almost insurmountable task of disproving a negative: that the merger would not reduce competition between H&R Block and Intuit.

This task was made almost impossible by Inuit's own documents. Intuit had apparently conducted "war games" to determine the impact of the proposed merger. While these documents showed Intuit's fear of increased competition, they also noted that Block's incentive "would be not to escalate [the] free war: making free the starting and ending point for customers." This put the nail in the coffin, convincing the court that Intuit and Block would prefer détente to nuclear war.

The court also rejected Block's attempt to show that it lacked the power unilaterally to raise prices. Factually, the court noted "one immediate effect" — conceded by the defendants — would have been "the removal of TaxACT from the IRS-sponsored … website," which is an important distribution channel for free e-filing services.

Legally, the court rejected Block's insistence that unilateral effects can only arise if two conditions are met: (i) the merging parties are each others' closest competitors, and (ii) the combined firm will have more than 35 percent market share.

The government conceded that it could meet neither of these requirements. But it claimed it did not need to. Both requirements were recently omitted from the 2010 revisions of the government's Horizontal Merger Guidelines. Because these revisions were largely viewed by the defense bar as a transparent effort to improve the government's litigation position (and not necessarily based on any new economic learning), there were serious doubts about whether courts would follow the new guidelines.

The district court's decision applying the new guidelines, thus, represents a significant victory for the Division. As the head of the Antitrust Division, Sharis Pozen, announced just days after the court's ruling, the decision "validates" the Division's decision to amend the guidelines. See H&R Block Ruling Validates Merger Revisions, Says Pozen, The Deal (Nov. 17, 2011).

Entry and Expansion: Is It Too Little, Too Late For New Internet Competitors?

Unable to rebut the presumption of anti-competitive effects, the defendants had virtually nowhere left to turn. And the court quickly dispensed with their remaining arguments. With respect to entry and expansion, Block argued that there were eighteen other online providers already in the market, and with no barriers to their expansion, Block would be unable to raise prices. The court rejected this argument.

In doing so, the court limited its analysis to the top two fringe competitors, since those were the only two to testify at trial and defendants' admitted they were the ones "most poised to replicate the scale and strength of TaxACT." Of course, given the rapidity with which Internet firms' fortunes rise and fall, and the difficulty in predicting who the winners and losers will be, the wisdom of constraining the analysis to just two existing competitors can be debated.

But even accepting this approach, the court took a novel approach in minimizing the competitive significance of the existing competitors. With respect to the first competitor, TaxHawk, the court essentially held that its management was too lazy to take advantage of any potential profit opportunities that might arise if Block attempted to raise prices above competitive levels.

As the court noted, "[w]hile TaxHawk's decision to prioritize a relaxed lifestyle over robust competition and innovation is certainly a valid one, expansion from TaxHawk that would it allow it to compete "on the same" playing field as the merged company appears unlikely."

Whether factually true or not (and the evidence was fairly compelling that it was true), what is interesting about this finding is that it is based on the belief that firms are not economically rational actors — and would choose to leave profit opportunities on the table, even where they are capable of taking advantage of them. Such an approach elevates subjective intent over objective economic criteria, and violates the core maxim of profit maximization underlying all of economics and modern antitrust law.

With respect to the next largest online provider, TaxSlayer, the court took a more traditional, but no less sweeping, approach. It simply held that "reputational" barriers and "stickiness" prevent growth by other online providers. Defendants' pointed out that such supposed barriers did not get in the way of TaxACT's own meteoric growth, just a few years prior. The court responded by positing that TaxACT must have enjoyed a significant first mover advantage, and that all of the "low-hanging fruit" from consumers who were inclined to switch from pen-and-paper to online products has already been picked.

Such arguments, of course, have superficial appeal. But the evidence cited in the decision — which shows substantial switching among online providers and between offline and online providers — suggests that another competitor would find no shortage of potential customers. It also does not address whether the market for online services is "mature," or whether it is still in the early adopter stage, with significant room for growth. The court's view of a static market place simply does not account for the dynamism of the Internet, where firms quickly fall in and out of favor, depending on how well they keep pace with consumer demands and the value proposition they offer.

Efficiencies: What Is the Value of Management Estimates, Forecasts, and Commitments?

Having rejected defendants' entry/expansion arguments, the court then rejected defendants' efficiencies arguments. As an initial matter, the court rejected as a ploy defendants' offer to make a binding commitment not to raise future prices. "This type of guarantee," the court held, "cannot rebut a likelihood of anti-competitive effects."

The court also rejected the defendants' more traditional efficiencies arguments, as unsupported by hard evidence. As future efficiency estimates often are, Block's claims were largely based on management's estimates. But as the court noted, "[w]hile reliance on the estimation and judgment of experienced executives about costs may be perfectly sensible as a business matter, the lack of a verifiable method of factual analysis … renders them not cognizable by the court."

This, of course, puts the merging parties in a classic, though potentially avoidable, catch-22. On the one hand, the Merger Guidelines state that "projections of efficiencies may be viewed with skepticism … when generated outside of the usual business planning process." But when such estimates are prepared as part of the "usual business panning process," — which typically depends heavily on management estimates — they lack a "verifiable method of factual analysis that renders them not cognizable."

Implications

So what are the implications of H&R Block? On the one hand, the mode of analysis is fairly traditional — some may argue too traditional for today's economy — and the outcome it reached is not totally surprising.

At its core, the decision reaffirms the paramount importance of market definition, thus rejecting the attempt in the recently revised merger guidelines to de-emphasize market definition.

But the decision also tells us something else, which also should not be surprising. In trials — before a judge or a jury — it is not always about who is right or wrong. It is just as often about who the judge views as more credible.

The government won in part because the court viewed the government’s expert as “generally more credible” that the defendants’ expert. Although the government expert’s statistics were riddled with flaws, and his analysis was — in the court’s words — “an imprecise tool,” the court nevertheless found that his testimony had “probative value” and the court adopted virtually all of his ultimate conclusions.

This, of course, demonstrates the need for merging parties to undercut the government expert’s credibility by engaging in economic analysis that appeals to the judge as equally credible early in the process, where the flaws of the government’s analysis can be exposed, and alternatives — without such flaws — can be presented.

Beyond that, there is a more fundamental question: Does H&R Block portend a return to a world where the “government always wins?” Most likely not. The government’s track record remains mixed, especially in high-tech markets. And while the H&R Block decision will certainly embolden the Antitrust Division, it is by no means the final chapter on the issue of how the antitrust laws will apply to the digital economy.

--By Colin R. Kass and Keith L. Butler, Proskauer Rose LLP

Colin Kass is a partner with Proskauer in the firm's Washington, D.C., office. Keith Butler is an associate with the firm in the Los Angeles office.