THE THRESHOLD

The Newsletter Of
The Mergers &
Acquisitions Committee

Volume IX
Number 2
Spring 2009

CONTENTS

Going South: Procedural and Stubstantive Aspects of Acquiring Troubled Firms
Mark J. Botti and David T. Blonder 3

Behaviorial Economics and Merger Enforcement: A Speculative Guide
Timothy J. Brennan 21

Needed Revisions of the Non-Horizontal Merger Guidelines
James Langenfeld 30

Should the Agencies Issue New Non-Horizontal Merger Guidelines?
Gregory J. Werden 40

Delta-Northwest: Lessons and Comments from Navigating an Extensive DOJ Merger Review Process
Ian Conner and Haidee Schwartz 42

Brown Bag Summary: The Use of Price Effects Evidence
David E. Altschuler 56

Post Close Caution: Antitrust Agencies Challenge Two Consummated Mergers
Scott A. Sher and Valentina V. Rucker 63

Trends in FTC Merger Enforcement: Assessing the Most Recent Data
Michael L. Keeley, Russell M. Steinthal and Irina C. Rodríguez 71

Important Changes to Canada's Competition and Investment Laws: More Certainty or Less?
Peter Franklyn and Shuli Rodal 83

About the Mergers and Acquisitions Committee and The Threshold 91

From the Chair

To All Committee Members:

Welcome to Spring! If you are reading this before or during the Spring Meeting, be sure to check out our two great programs at the Meeting which are sure to further elucidate merger matters. First, on Thursday morning at 8:15 (coffee is available), our own Paul Hewitt will moderate a panel entitled, "Has Whole Foods Transformed Merger Enforcement?" Contemplating this question will be panelists Paul Friedman of Dechert, Jan McDavid of Hogan & Hartson, Robbie Robertson of the FTC, and Bob Kramer of DOJ. At 1:30 on Thursday, former Antitrust Section Chair Kathy Fenton will moderate a panel entitled, "Revisiting the 1992 Merger Guidelines: Is it Time to Open Pandora's Box?" The panelists for that question will be Ilene Gotts of Wachtell Lipton, Joe Krauss of Hogan & Hartson, Carl Shapiro of the Haas Business School at Berkeley, and Gary Zanfagna of Honeywell. We expect the programs to be compelling and hope they will provide at least some answers to the intriguing questions their titles pose.

In the pages that follow, our editors have brought to us topics ripped from today's antitrust headlines. Mark Botti and David Blonder discuss the issues surrounding acquisitions of financially troubled firms. Eerily anticipating the Ticketmaster/Live Nation transaction, we have two

COPYRIGHT NOTICE
Copyright 2008 American Bar Association. The contents of this publication may not be reproduced, in whole or in part, without written permission of the ABA. All requests for reprint should be sent to: Director, Copyrights and Contracts, American Bar Association, 321 N. Clark, Chicago, IL 60654-7598, FAX: 312-988-6030, e-mail: copyright@abanet.org mailto:copyright@abanet.org.

articles on the possibility of revising the non-horizontal merger guidelines that were issued in 1984. Jim Langenfeld of LECG discusses changes he thinks need to be made to those guidelines, while Greg Werden of DOJ explains why he thinks the existing guidelines provide sufficient business guidance, particularly given the paucity of non-horizontal merger enforcement. Ian Connor of Hunton & Williams and Haidee Schwartz of O'Melveny provide us an insiders' view of the review of the Delta/Northwest transaction.

Equally timely, Scott Sher and Valentina Rucker of Wilson Sonsini provide an update on the recent set of post-closing merger challenges by the agencies, and explain why certain post-closing activities attract agency attention. Michael Keeley, Russell Steinthal, and Irina Rodríguez of Axinn Veltrop analyze the recently released merger enforcement data from the FTC, and Peter Franklin and Shuli Rodal of Oslers provide an explanation of proposed sweeping revisions to Canada's competition and investment laws. Tim Brennan of the University of Maryland, Baltimore County, provides insight as to how the growing field of behavioral economics could impact merger review. We also have a report on one recent brown bag sponsored by the Committee.

We hope you enjoy this issue. Thanks to our editors Beau Buffier, Mary Lehner and Steve Smith, and to Vice Chair Paul Hewitt who oversees all the Committee's publication efforts.

See you at the Marriott!

Jim Lowe

Chair, Mergers & Acquisitions Committee

[top]

Going South: Procedural and Substantive Aspects of Acquiring Troubled Firms

Mark J. Botti and David T. Blonder

The economic downturn that started in the sub prime mortgage industry has cascaded into the biggest global economic crisis since the 1930s. Each day seems to bring more bad news — another industry or company bailout, massive layoffs, quarterly loss announcements, or impending economic failure.

Governments are under tremendous pressure to respond quickly to this synchronized global economic meltdown by taking action to restore liquidity and confidence in global financial markets, and by pursuing spending programs to stimulate the economy. Many governments have adopted extraordinary measures to prevent further deterioration and financial ruin of numerous sectors of the economy, particularly banking. However, the crisis is far from over and may still be spreading.

One potential ally of governments in this financial crisis may be companies with healthy balance sheets that are able to engage in strategic mergers or acquisitions that reinvigorate otherwise destabilized businesses. Some commentators are predicting an upsurge in acquisitions by strong firms of troubled companies and distressed assets.[1]

How will the antitrust authorities respond to such deals? Although it is doubtless still early in the economic crisis, there have already been a number of small and large distressed company mergers and acquisitions (M&A) requiring antitrust regulatory approval. These deals have obviously not been reviewed in a public policy vacuum, and the preliminary indications are that the antitrust enforcement agencies have sufficient flexibility to clear certain acquisitions of failed or distressed companies very quickly.

Mark J. Botti and David T. Blonder *are partner and counsel, respectively, in the Washington, DC office of Akin, Gump, Strauss, Hauer & Feld LLP*

This article first provides an overview of the evolving government policy environment, highlights the bailout initiatives taken in both the US and the EU to address the economic crisis, and discusses how government ownership of acquisition targets and the overall economic crisis may influence prospective antitrust enforcement.

The article then examines both antitrust law and strategy and addresses the following key questions: What legal defenses are potentially available for

---

[1] See Kenneth Klee and Suzanne Stevens, Distressed Deals: Here Come the Strategics, The Deal, March 8, 2009, at 30 (noting that acquisitions of distressed and bankrupt targets have gone mainstream, with increasing involvement by strategic buyers).

otherwise presumptively anticompetitive acquisitions of distressed companies? How have these defenses fared in recent transactions? What strategies should be considered by antitrust counsel in approaching and handling acquisitions involving distressed companies?

I. Overall Considerations: Government Ownership and General Economic Distress

A. United States

In the United States, the government's efforts to deal with the financial crisis began with the Troubled Assets Relief Program ("TARP"), created by the Emergency Economic Stabilization Act of 2008. This law authorized the Treasury Department to spend up to $700 billion to purchase distressed assets, especially mortgage-backed securities, and to inject additional capital into banks.[2] Subsequently, in February 2009, President Obama signed into law the American Reinvestment and Recovery Act, which authorizes even more spending to stimulate the economy in the wake of the economic downturn.[3] In conjunction with these measures, the federal government has engaged in "de facto nationalization" of large financial institutions such as Citigroup, by acquiring significant, and in some instances, controlling equity stakes. More such nationalization may be on the horizon, with other large institutions deemed "too big to fail" on the government watch list for possible intervention.

As an overall matter, how might the economic crisis and bailout actions of the federal government affect antitrust enforcement? At one level bailouts are "antitrust neutral." Voting securities acquisitions by the Treasury Department are clearly exempt from HSR Act reporting requirements.[4] However, these acquisitions could have significant future antitrust implications.

1. Implications of Government Ownership of Acquisition Targets

An interesting question arises whether government controlled or partially controlled entities, such as Citigroup, cease to be "persons" within the meaning of the Sherman Act, thereby rendering them immune from antitrust liability. Case law often refers to this as the "federal instrumentality doctrine." It is clear that the United States, its agencies and officials are absolutely immune from antitrust liability under the doctrine of sovereign immunity.[5] This immunity may also

---

[2] See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008), available at http://frwebgate.access.gpo.gov/cgibin/getdoc.cgi?dbname=110_ cong_public_laws&docid =f:publ343.110.

[3] See http://www.recovery.gov.

[4] See Post of Manfred Gabriel, Antitrust Review, http://www.antitrustreview.com/ archives/1574 (discussing applicability of HSR exemptions).

[5] See Sea-Land Serv. Inc. v. Alaska R.R., 659 F.2d 243, 246 (D.C. Cir. 1981).

apply to private entities, depending "on the extent to which the federal government or its agencies directly own and/or exercise plenary control over the entity in question."[6] The government has taken equity stakes in companies, and there are significant restrictions being placed on bailout recipients. On the other hand, treasury officials have repeatedly stressed that they have no intention of nationalizing U.S. banks. The courts have not yet addressed any government ownership/control antitrust defenses in the current crisis, but the broader the TARP bailouts extend, the more likely such issues will arise.

2. General Economic Distress: *Appalachian Coals* Redux?

Historical precedent demonstrates that the financial crisis in and of itself is not a green light to an anticompetitive merger. Antitrust regulators had to confront the weakened financial condition of individual firms in the context of a merger in the depression-era *Appalachian Coals*[7] case, which involved the coal industry at a time of severe economic distress. Competing coal producers formed a new corporation as their selling agent with the authority to set prices for almost 73% of the commercial production in the immediate region where they mined.[8] The Government challenged the deal, alleging that the corporation eliminated competition among coal producers and controlled bituminous coal prices in many interstate markets.[9] Despite the government's objections, the court found no Sherman Act violation, and no injunction was issued.[10] While the Court was very solicitous regarding the national economic crisis, it also found that most of the defendants' coal was marketed in another, highly competitive region, and that given the vast volume of coal reserves potentially available to the market, there was no basis to conclude that competition anywhere would be negatively impacted by the operation of their plan.[11]

In the end, *Appalachian Coals* provides little comfort to merging parties who are seeking expedited merger approval rather than success after a lengthy court battle. Instead, a careful reading of the opinion serves as a reminder that in the current financial crisis merging parties need to do something more than simply refer generally to the crisis to obtain antitrust clearance.

---

[6] See Name.Space, Inc. v Network Solutions, Inc. 202 F.3d 573, 581 (2d Cir. 2000).

[7] Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933). Important to the court's decision was an analysis of the severe financial distress facing the industry as a whole, with capacity far outstripping demand, and the consolidating producers facing substantial competition for a large volume of their sales.

[8] Id. at 357.

[9] Id. at 358.

[10] Id. at 378.

[11] Id.

Since *Appalachian Coals*, U.S. courts and antitrust agencies have developed a number of specific doctrines (discussed below) to evaluate the relevance of economic distress to merger antitrust review. Similar doctrines have been adopted either formally or through informal practice in other jurisdictions.[12] In the past, these potential antitrust defenses have typically been narrowly interpreted in the context of specific mergers, and the defenses have been unsuccessful more often than not. Will the antitrust enforcement agencies be more open to such defenses in the current global economic crisis? Will the agencies show some antitrust enforcement flexibility in light of competing broader public policy concerns or initiatives outside of the realm of competition? As the economic news seems to worsen each day, it is not inconceivable that the crisis will color the perceptions of antitrust regulators regarding the potential viability of these defenses in particular cases.

In a recent speech before the New York Bar Association, Commissioner Rosch seemed to acknowledge that this was occurring. He observed:

> The Commission has already been faced with not just a failing firm argument, but an actual failing firm in one industry in the last month and a half. The most the agency could do was explain to the bankruptcy court which of the two bidders for the failed firms' assets appeared to be the least anticompetitive (though both appeared anticompetitive). As almost always happens in these situations, the more anticompetitive firm offered more money for the assets to the bankruptcy court, and the court approved that buyer. The result will probably be reduced output, higher prices, less innovation and fewer jobs, but there is *nothing the antitrust enforcement agencies can do about it.* (emphasis added). This is not a good result, and underscores the need to closely analyze the financial conditions of all firms involved when we review mergers—the resulting merged entity as well as remaining competitors.[13]

It is safe to assume that these remarks do not mean that the FTC is throwing in the towel. Rather, given the increasing relevance of failing firm defenses, agency staff will likely be even more careful and rigorous in evaluating whether the requirements of the defenses are met.

---

[12] See, e.g. What are the Criteria that Need to be Satisfied for the Failing Firm Defence to Apply? http://www.concurrences.com/rubrique.php3?id_rubrique=626&lang=en (providing an overview of jurisdictions that have failing firm defenses).

[13] See J. Thomas Rosch, Implications of the Financial Meltdown for the FTC, Remarks before the New York State Bar Association (Jan. 29, 2009), available at http://www.ftc.gov/speeches/rosch/090129financialcrisisny barspeech.pdf [hereinafter Rosch Speech].

Commissioner Rosch made an important point regarding proving ease of entry, which typically assumes ready availability of capital. With constriction of credit markets, he commented that such proof may be more difficult.[14] Commissioner Rosch also mentioned that constricted credit availability may make it more difficult for merging parties to find acceptable divestiture buyers, potentially resulting in more consent decrees contingent on identification of up-front acceptable buyers, and thus, ultimately, more blocked mergers due to "lack of an effective fix."

At the Antitrust Division, more aggressive merger enforcement is almost certain under new Assistant Attorney General Christine Varney. At her confirmation hearing before the Senate Judiciary Committee on March 10, 2009, she was warmly welcomed by Committee members eager to reverse the prior administration's "record of passivity and at times even hostility towards antitrust enforcement." Senator Kohl asked the AAG-designate about the severe economic recession, the substantial pressures it has put on many industries to consolidate, the appropriate approach to mergers and acquisitions in the banking or other troubled industries using TARP funds,[15] and what the Assistant Attorney General should do to ensure that antitrust policy would play a role in the Obama administration's economic restructuring efforts. Ms Varney replied by questioning some of the previous administration's merger enforcement decisions, commenting that "from the outside those looked like mergers in horizontal markets that one wonders why they were not challenged. I can assure you, that if I am confirmed to the Department of Justice Antitrust Division, the law will be vigorously enforced. Horizontal mergers will be thoroughly examined and, where they lead to impermissible consolidation and concentration, they will be blocked."[16]

It obviously remains to be seen whether President Obama's campaign promise to "step up review of merger activity and take effective action to stop or restructure those mergers that are likely to harm consumer welfare"[17] will be

---

[14] See Rosch Speech at 10.

[15] Antitrust commentators have also raised policy concerns about TARP funds being used for acquisitions resulting in industry consolidation. See Memorandum on the Proposed Acquisition By Pfizer of Wyeth, American Antitrust Institute (Feb 11, 2009) (noting that $22.5 billion of loans would be granted by four banks who have received TARP injections of at least $95 billion plus credit guarantees (as of January 28) of $345 billion), available at http://www.antitrustinstitute.org/archives/files/PfizerWyeth%20AAI%20memo.2.11.09_02142009 0933.pdf.

[16] See Executive Nominations: Hearing before the S. Judiciary Comm., 112th Cong. (2009) (Testimony of Christine A. Varney) available at http://judiciary.senate.gov/hearings/ testimony.cfm?id=3700&wit_id=7670.

[17] See Statement of Barack Obama for the American Antitrust Institute, available at http://www.antitrustinstitute.org/archives/files/aai-%20Presidential%20campaign%20- %20Obama%209-07_092720071759.pdf.

affected by the financial crisis.[18] It is simply too early to tell, for example, whether the lightning fast tracking and clearance of mergers that occurred in the banking industry might spill over into other industries. Experts predict the economy will remain weak through 2009 and possibly longer.[19] The persistent, economic crisis will surely give the antitrust agencies multiple opportunities to consider whether and how to integrate considerations relating to the economic crisis into merger enforcement decisions.

B. Europe

In September and October of 2008 as the credit crisis in the banking markets intensified, EU member states implemented unprecedented bailouts of financial sector businesses, often on a country-wide basis. In November 2008 the European Commission adopted a European Recovery Plan to help pull Europe, and particularly its banks, out of the financial crisis. The various measures and support schemes of support that have been developed and implemented are subject to continuing strict oversight from the European Commission.[20]

The European Commission has the authority to intercede in individual country bailout efforts through its State aid notification policy (a mechanism that does not exist in the U.S.). The Commission has applied that authority in a flexible manner and, for example, granted approval to EU member states to help ensure the long term viability of the European banking sector.[21] State aid is also currently being expanded to aid the automotive sector.[22] The Commission has further published a variety of communications to guide member states, to ensure

---

[18] See Michael Orey, Obama Appoints Antitrust Chief, BusinessWeek, Jan. 22, 2009, available at http://www.businessweek.com/bwdaily/dnflash/content/jan2009/db20090122_987212.htm?chan=top+news_top+news+index+-+temp_news+%2B+analysis (commenting on potential tougher enforcement stance and noting the economic crisis “may require a recalibration of those plans. With so many businesses financially hobbled, regulators may feel pressure to approve deals they would ordinarily oppose.”); see also Andrew Ross Sorkin, Why Obama Must Say ‘Yes’ to Deals, N.Y. Times, Nov. 11, 2008, available at http://dealbook.blogs.nytimes.com /2008/11/11/why-obama-may-say-yes-to-deals.

[19] Jeannine Versa, Forecasters: Economy Worse in '09, better in '10, Associated Press, Feb. 23, 2009 available at http://news.yahoo.com/s/ap/troubled_economy; _ylt=AqIoArTLjigHRYxjMMukkHYDW7oF.

[20] The details of European bailout efforts are quite complex. Only a brief overview is provided herein, in order to discuss potential impact on near term merger control decisions.

[21] See Press Release, Brussels European Council, State Aid: Overview of National Measures Adopted as a Response to the Financial and Economic Crisis (Feb. 16, 2009), available at http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/67&format=HTML&aged=0&language=EN&guiLanguage=en.

[22] See Press Release, Brussels European Council, EU Support to Fight the Crisis in the Automotive Sector, (Feb, 25, 2009), available at http://europa.eu/rapid/ pressReleasesAction.do?reference=IP/09/318&format=HTML&aged=0&language=EN&guiLanguage=en.

that proposed programs comport with EU competition law. They cover the application of State aid rules to measures taken in relation to financial institutions,[23] recapitalization,[24] and access to finance,[25] and many have since been amended to adapt to the evolving crisis. As a result, the State aid rules have reemerged to a role of prominence in EU competition policy.

The overall policy objective of State aid control is to ensure that government interventions do not distort competition and intra-community trade within the European Union. The rules are designed to maintain a level playing field for European businesses by controlling the manner in which state resources are made available. In the face of mounting pressure surrounding the massive bailouts, EC Commissioner Neelie Kroes has remained firm and stated her resolve that the Commission's primary objective is to ensure that competition does not suffer. In the context of the banking bailouts, she stated:

> I prefer that we take structural measures that clear balance sheets, restructure or wind down banks and allow the survivors to resume lending without looking back. This is the clearest path to both financial stability of the sector and viability of its major players. This is much better than contemplating mergers between troubled banks.[26]

On another occasion, she said:

> We need to be flexible on procedures — yes — but not on principle. The temporary and targeted aid measures in the EU address the new market failures in the provision of

---

[23] Communication from the Commission — The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis, 2008 O.J. (C270/02), available at http://eur-lex.europa.eu/LexUriServ/ LexUriServ.do?uri=OJ:C:2008:270:0008: 0014:EN:PDF.

[24] Communication from the Commission — The Recapitalisation of Financial Institutions in the Current Financial Crisis: Limitation of Aid to the Minimum Necessary and Safeguards Against Undue Distortions of Competition, 2008 O.J. (C10/03), available at http://eur-lex.europa.eu/LexUriServ/ LexUriServ.do?uri=OJ:C:2009:010:0002:0010:EN:PDF.

[25] Communication from the Commission — Temporary Framework for State Aid Measures to Support Access to Finance in the Current Financial and Economic Crisis 2008 O.J. (C16/01), available at http://eur-lex.europa.eu/LexUriServ/ LexUriServ.do?uri=OJ:C:2009:016:0001:0009:EN:PDF.

[26] See Neelie Kroes, Address at Kangaroo Group Breakfast Debate, European Parliament, (Feb. 19, 2009) available at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/ 09/68&format=HTML&aged= 0&language=EN&guiLanguage=en.

> credit using our existing principles. Flexibility does not mean throwing out the rules.[27]

Although these statements come in the context of the EU's State aid reforms, it seems unlikely the Commission would compartmentalize this analysis and limit it only to State aid, when faced with the prospect of a potential onslaught of distressed firm arguments in mergers. In the EU, the failing firm buzzword is in the air and member state political pressure may be mounting in Brussels as industries are failing. In fact, Neelie Kroes spoke of the possibility of increased merger activity as a result of the fallout and restated the Commission's long-standing position on the use of the failing firm defenses. She stated that the Commission would take into account economic conditions in determining the applicability of the failing firm defense, permit takeovers to be implemented without having to wait for the Commission's approval in cases where there is urgency and where there were no "a priori" competition concerns, and grant derogations from waiting period standstill obligations in appropriate cases, pending an ultimate determination of the proceedings. [28] While she believes that "two turkeys do not make an eagle," her statements suggest that distressed firm defenses will be asserted and carefully considered in European merger control proceedings.[29]

II. Antitrust Enforcement Process and Substance

A. The Importance of Timing in Distressed Transactions

In circumstances where a failing firm type argument is going to be advanced, parties in a hurry are generally well advised to come fully prepared to frame the issues and address them directly with agencies, even prior to the agency clearance process if in the US, or through pre-notification contacts in the EU or other member states. As part of this process, before filing and approaching the agencies, companies need to marshal detailed information necessary to educate antitrust agency staff regarding key issues and to communicate specific reasons underlying the need for expeditious review and approval. At a minimum, parties should furnish key deal documents, strategic plans, market studies and other

---

[27] See Neelie Kroes, The Road to Recovery, Address at 105th Meeting of the OECD Competition Committee, (Feb. 17, 2009), available at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH%2F09%2F63&format=HTML&aged=0&language=EN&guiLanguage=en.

[28] See Neelie Kroes, Dealing with the Current Financial Crisis, Remarks before the Economic and Monetary Affairs Committee, European Parliament, (Oct. 6, 2008), available at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/498&format=HTML&aged=0&language=EN&guiLanguage=en.

[29] See Neelie Kroes, Address at Kangaroo Group Breakfast Debate, European Parliament, (Feb. 19, 2009) available at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/68&format=HTML&aged= 0&language=EN&guiLanguage=en.

competitive data, historical financial information, and lists of significant customers. They should also strongly consider offering up strategic business personnel to make presentations and respond to staff questions. A sure prescription for delay is simply to file the necessary documents and wait for the agencies to respond.

United States antitrust agencies have historically attempted to respond to legitimate needs for expedition in merger review (e.g., hostile tender offers or where financing is at risk), and they regularly grant early termination of the Hart-Scott waiting period where antitrust problems are absent or can be resolved with minimal investigation. For small transactions that are not antitrust-sensitive, early termination is routinely granted in two to three weeks. However, for large and complex transactions, even if early termination is granted because no antitrust problems are present, termination often does not occur until very late in the 30-day period, or may even not occur until late in a *second* 30-day period following a "withdrawal and refile" procedure to avoid a second request.[30]

Fortunately, the agencies' track record thus far in the current crisis indicates that they have been diligent in clearing even extremely large mergers involving distressed firms on an expedited, and sometimes extremely expedited, basis. Recent illustrative examples include Wells Fargo & Company's $12.7 billion acquisition of Wachovia Corporation, which was cleared by antitrust regulators *one day* after it was announced, and the grant of early termination within *four days* of filing for Mitsubishi UFJ Financial Group's $9 billion equity investment in Morgan Stanley for a 21% interest in the company.

Similarly, in the EU, the European Commission cleared the UK government's bailout package for mortgage lender Bradford & Bingley in less than a day, and granted a derogation from the waiting period in the follow-on transaction involving clearance of Banco Santander's acquisition of Bradford and Bingley's UK retail account deposits.[31] In most cases, however, the Commission has been very conservative in its approach and fairly reluctant to grant derogations. Merging parties generally need to have no, or only minor, competitive horizontal overlaps. However, where the target is in immediate danger of insolvency (e.g., within a few weeks), a strong case for derogation can be made. Fortunately, the Commission has flexibility in this process and has the discretion to grant a partial derogation, customizing it to permit the purchaser to take management control of the failing or failed business without acquiring ownership of the shares or otherwise exercising strategic control.

---

[30] See generally 16 C.F.R. 803 (2006).

[31] The only area of overlap between the parties was in mortgage lending. However, the market shares of the merged entity on the UK mortgage market would remain below 20%, with a relatively small increment resulting from the merger and the Commission assumed that Abbey would reinvest in the business and return the business to premerger levels. Moreover, Abbey would continue to face a number of competitors.

A word of caution: the well-publicized instances of rapid merger clearance do not signal that antitrust agencies are turning a blind eye to anticompetitive mergers or that the ordinary rules are going out the window. Rather, the lesson is that the financial crisis is an important factor driving the agencies to take a quick look at certain deals. Merging parties still need to rapidly marshal facts and arguments demonstrating that an acquisition of a distressed competitor is not anticompetitive.

B. Distressed Firm Defenses in the Antitrust Review Process

1. United States

U.S. courts and antitrust enforcement agencies have developed three related sets of principles under which the troubled nature of a target firm could serve as a partial or complete merger antitrust defense: (1) the failing firm defense, (2) the *General Dynamics* defense, and (3) the flailing firm defense.

a. Failing Firm Defense

The Supreme Court's decision in *Citizen Publishing Co. v. United States*[32] is a leading case discussing the elements of the failing firm defense. In 1940, the city of Tucson, Arizona had only two vigorously competitive daily newspapers: the Citizen, an evening paper, and the Star, both a daily and Sunday paper. The Citizen had sustained repeated annual losses.[33] After new owners purchased the Citizen and tried unsuccessfully to reinvigorate the newspaper, they subsequently negotiated a 25-year joint operating agreement with the Star, forming Tucson Newspapers, Inc. ("TNI"),[34] the effective purpose which was to end any commercial competition between the newspapers. To that end, three types of controls were imposed: (1) price fixing via the joint establishment of subscription and commercial advertising rates; (2) profit pooling among and distribution to TNI's principals pursuant to an agreed-upon ratio; and (3) the foreclosure of competing publishing operations within the Tucson metropolitan area pursuant to an agreement not to compete between stockholders, officers and executives of the companies forming TNI.[35]

At trial, the parties asserted a failing company defense but it was rejected because at the time the parties entered the joint selling arrangement, the owners of the Citizen were not contemplating a liquidation, never sought to sell the

---

[32] 394 U.S. 131 (1969).

[33] Id. at 133.

[34] Id.

[35] Id. at 134.

newspaper, and there was no evidence that entering into the joint agreement was Citizen's only viable alternative.[36]

The Supreme Court affirmed,[37] but in doing so held that a merger between the two newspapers would not have been unlawful if one of the companies was "failing," and satisfied the following criteria: (1) the company was in imminent danger of failure, (2) the failing company had no realistic prospect for a successful reorganization and (3) there was no viable alternative purchaser that posed a less anticompetitive risk. It sustained the district court's factual findings, noting that at the time of the arrangement, the Citizen was not on the verge of going out of business, nor was there a serious probability at that time that it would terminate its business and liquidate its assets, but for entering into the agreement.[38] The agreement was not the "last straw at which the Citizen grasped."[39]

The failing firm defense is recognized by many (but not all) antitrust authorities, including those in the United States, the European Commission, and many EU Member States.[40] The central element of the defense is that, if a company's assets would exit the market but for the acquisition, stopping the acquisition will not protect any future competition. In assessing whether failure is truly imminent, the agencies will consider the company's finances and working capital at the time of the transaction, business and cash flow on a historical basis, as well as access to available capital from financial institutions.

b. *General Dynamics* Defense

Where a target firm is struggling but cannot meet the strict requirements of the "failing firm" defense, parties may have a *General Dynamics* defense.[41] In that case, the Supreme Court concluded that, even if a company was not going to exit the market, if it completely lacked the resources to engage in new competition in the future (as opposed to merely fulfilling existing contractual commitments), acquisition of that company would not be unlawful despite its high historic market shares.

---

[36] Id. at 137.

[37] Id.

[38] Id.

[39] Id. Although now the Citizen may be about to take that last grasp. *See* Sale Deadline Passes, 'Tucson Citizen' Likely to Quit in March, Associated Press, Feb 20, 2009, available at http://www.azcentral.com/news/ articles/2009/02/20/20090220tucson-citizen0220-ON.html.

[40] See, e.g., U.S. Dept. of Justice and Federal Trade Commission, Horizontal Merger Guidelines ¶ 5-5.2 (1997 rev.) [hereinafter Guidelines]; Restatement of OFT's Position Regarding Acquisitions of 'Failing Firms'; available at http://www.oft.gov.uk/shared_oft/business_leaflets/general/ oft1047.pdf.

[41] United States v. Gen. Dynamics Corp., 415 U.S. 486 (1974).

In *General Dynamics*, a case involving the production and sale of coal, much of the government's evidence challenging the acquisition consisted of past production statistics showing that in certain geographic markets, the coal industry was concentrated among a small number of large producers, that market concentration was increasing, and that the acquisition would materially enlarge the acquiring company's market share and contribute to the trend toward concentration.[42] The district court rejected these claims, finding that coal had become increasingly noneconomic relative to other sources of energy (e.g., oil and natural gas) and had lost share as a result.[43] The presence of long-term, fixed price requirements contracts under which the coal was sold also was compelling to the court,[44] because "such sales do not represent the exercise of competitive power, but rather the obligation to fulfill previously negotiated contracts at a previously fixed price."[45]

The Supreme Court agreed that the acquired firm had no future competitive significance because it had previously committed all its coal reserves under long term contracts and had no further coal reserves to sell, and thus it had no ability to compete for new customers.[46] The Court observed that although an acquired firm's previous annual sales were normally a relevant predictor of future competitive strength, past sales did not "as a matter of logic give a proper picture of a company's future ability to compete."[47] Other factors, such as the "structure, history and probable future of the relevant product market" should be considered.[48] The better measure of the acquired coal company's ability to compete for future contracts, said the Court, was measured by the size of its uncommitted reserves, rather than its past production.[49]

c. Flailing Firm Defense

Lastly, there is the so-called "flailing firm" defense, which is often invoked as a *General Dynamics* "variant," where a merging company is in financial distress, but it is not actually exiting the market and would likely have *some* competitive influence going forward (unlike the factual situation in *General Dynamics*). The argument is that the company is in such a weakened state that its competitive influence is reduced to the point that its elimination from the market will not have a significant impact.

---

[42] Id. at 494.

[43] Id. at 499.

[44] Id.

[45] Id. at 501.

[46] Id. at 507-509.

[47] Id. at 501.

[48] Id. at 498.

[49] Id. at 501.

The defense has met with some degree of formal skepticism and resistance from the antitrust enforcement agencies and is not incorporated explicitly into the *Merger Guidelines*. Some courts, moreover, have failed to recognize the flailing firm defense as an appropriate expansion of the failing firm defense. A recent example of this occurred in *United States v. UPM-Kymmene Oyj*[50] a merger between Raflatac, Inc. ("Raflatac"), a subsidiary of UPM-Kymmene Oyj ("UPM"), and Morgan Adhesive Company ("MACtac"), two competing manufacturers of labelstock products. The court distinguished the "weakened competitor" argument from the failing firm and failing division defenses. UPM and MACtac were the second and third largest North American producers of bulk labelstock, each possessing approximately between 8% to 12% share in the sales of different types of bulk paper labelstock.[51] However, the transaction would have left Rafalatac, and fellow labelstock manufacturer Avery Dennison, with about 70% of the sales of certain kinds of labelstock, with only fringe competitors remaining. This would result in changed and aligned incentives among the various labelstock manufacturers, resulting in harm to competition.

The parties urged the court to consider the "weakened" and "declining" competitiveness of MACtac,[52] arguing that MACtac was an ineffective competitor, and its sales had declined consistently and this trend had reversed itself only very recently.[53] MACtac's parent was also not satisfied with its returns, was limiting its investment, and had previously received a much higher price offer than was being sought in the current deal.[54] The government asserted that while these weakened firm factors could be considered by the court, it could not be the primary justification for permitting a merger and "should not vitiate the standards for the failing firm or failing division defense."[55]

The court agreed and found that the company's failure or ineffectiveness was rooted more in generalized "economic conditions or management errors that were made in a good faith attempt to perform well."[56] MACtac, while viable, was non-competitive simply because its parent company had decided not to compete.[57] To allow such conduct to be used to justify an otherwise anti-competitive merger appeared to be bad policy and the court concluded that the MACtac's "declining

---

[50] U.S. v. UPM-Kymmene Oyj, No. 03 C2528, 2003 U.S. Dist. LEXIS 12820 (ND Ill., July 25, 2003)

[51] See Complaint at *22-23, UPM-Kymmene OYJ, No. 03-C2528, 2003 WL 21781902 (N.D. Ill. July 25, 2003).

[52] Id. at *29-30.

[53] Id.

[54] Id.

[55] Id. at *29.

[56] Id. at *30.

[57] Id.

condition will either be reversed or its slack will be taken up by other producers—the existing price competition will be diminished little or not at all."[58]

However, in *FTC v. Arch Coal, Inc.,*[59] where the government sought to enjoin an acquisition in the coal industry, the weakened financial condition of the target played a more significant role, even where it was not a complete defense. The merging parties argued that Triton Coal, the acquired company, was essentially a failing firm, and that Triton's high market share overstated its true competitive significance. The court rejected the failing firm defense, but found that Triton was still a weakened competitor with no meaningful prospects for improvement because of its high production costs, low coal reserves, and the uncertainty surrounding its ability to acquire additional reserves or attract another purchaser.[60] The court therefore denied the FTC's request for a preliminary injunction, finding that Triton's competitive significance was far less than its existing market share might have otherwise indicated.[61]

2. European Union

Since the onset of the financial crisis, no published European Commission decisions have referenced any significant assertions of distressed firm defenses. Moreover, the failing firm defense is not explicitly recognized in the European Merger Control Regulation.[62] Distressed firm defenses have nonetheless been employed in some earlier cases, albeit sparingly, and some Commission statements have been supportive.[63] The Commission has indicated, for example, that a merger would not be deemed anticompetitive where the acquirer could show that it would likely capture the target's market share in any event, absent the merger. Further, in *BASF/Eurodiol Pantochim,*[64] although the Commission noted that the market share of the financially troubled target company would probably be distributed among competitors if the target were allowed to fail, it observed that certain production capacity would be lost permanently if the merger did not take place. Although BASF would have a 70 percent market share post-transaction the Commission cleared the merger on the basis that it would have less of a harmful impact than if the companies completely exited.

3. United Kingdom

---

[58] Id. at *36.

[59] 329 F. Supp. 2d 109, 146-47 (D.D.C. 2004).

[60] Id. at 155-157.

[61] Id. at 157-59.

[62] See Monti/Russeva, *Failing Firms in the Framework of the EC Merger Control Regulation*, 1999-4 Eur. L. Rev. 38.

[63] See, e.g., SCPA/Kali + Salz-MdK, 1998 ECR I-1375.

[64] Case COMP/M.2314, 2002 O.J. (L132/45).

Recent events in the UK provide some interesting additional data points that may serve as a bellwether indicator of possible re-emergence of distressed firm arguments in the EU.

On December 18, 2008, the UK Office of Fair Trading (OFT) restated its policy regarding the failing firm defense, presumably in response to increased confidential informal inquiries and in anticipation of its increased use. Paralleling the classic failing firm defense in the United States, the OFT said it would clear a merger based on "failing firm" claims where compelling evidence demonstrates that (1) the business in question would inevitably have exited the market with no serious prospect of being reorganized, and (2) there is no realistic and substantially less anti-competitive alternative to the merger.

The OFT will take account of prevailing economic and market conditions when assessing evidence put forward by merging parties. In particular, those conditions will be relevant to an evaluation of evidence on the inevitability of a business exiting the market (for example, because of cash flow difficulties or an inability to raise capital), and the realistic availability of alternative purchasers for an exiting business.

The Stilton Merger

The most recent UK case involving the failing firm defense was the Competition Commission's ("Commission") January 14, 2009 clearance of the merger between Stilton cheese producers Long Clawson and Millway.[65] The OFT found that the merger combined two of the only three mainstream suppliers responsible for the vast majority of sales, and gave Long Clawson more than 50 per cent of the total UK market.[66] It referred the completed acquisition to the Competition Commission for further investigation on the basis of unilateral and coordinated theories of harm.[67]

The Commission found a loss of competition post-merger, but did not consider it substantial when compared with the situation absent the merger, finding that Millway would have exited the market after Christmas 2008, the peak

---

[65] The OFT considered that although Millway had been struggling, it was not necessarily "a spent force." Millway still maintained its UK and supermarket contracts, and the OFT believed that Long Clawson, Milway's largest competitor, was not the only conceivable purchaser of the assets. The OFT concluded that Long Clawson's purchase of Millway would result in the most highly concentrated market outcome possible and that any purchaser apart from Long Clawson (and T&T, another substantial producer) would not raise such competition concerns.

[66] See Completed acquisition by Long Clawson Dairy Limited of Millway Limited (Oct. 8, 2008), available at http://www.oft.gov.uk/advice_and_resources/resource_base/Mergers_home/decisions/2008/Long-clawson2.

[67] Id.

season.[68] However, Millway incurred years of financial and customer losses due to various production problems. It had depended on parent company support for years and could not restructure itself to become economically viable or find a less anti-competitive buyer. For these reasons, the Commission approved the deal.

The Lloyds HBOS Merger

The even more remarkable (and arguably anomalous) indicator of a more lenient, if not panicked, approach to merger control, is the UK clearance of the Lloyds TSB Group plc ("Lloyds") acquisition of HBOS plc ("HBOS"), which occurred in the fall of 2008. In October 2008, the UK Enterprise Act was amended to add new public interest intervention grounds regarding the stability of the UK financial system. The revised legislation permitted the Secretary of State in exceptional circumstances to circumvent the usual competition review by issuing an "intervention notice," whereby the OFT would report directly to the Secretary of State on competition issues in lieu of referral to the UK Competition Commission. This provision was employed to fast track and clear the Lloyds/HBOS deal over which the OFT had exhibited clear competition concerns.

On October 24, 2008, the OFT published its report to the Secretary of State finding a substantial lessening of competition in relation to personal current accounts (PCAs), banking services for small and medium sized enterprises (SMEs) and mortgages. The OFT's analysis of the merged company indicated that the combined banks would have 30% of PCAs, the same share in mortgages, and 40-50% of small business services in Scotland.[69]

The Secretary of State bypassed the OFT and did not refer the acquisition to the Competition Commission,[70] stating he was "satisfied that on balance the public interest is best served by allowing this merger to proceed without a reference to the Competition Commission."[71]

From a competition enforcement standpoint, the means used to effect the result in the Lloyds/HBOS deal appears to be an outlier in terms of the representative types of responses that we can expect going forward. If the Lloyds deal had been subject to EC merger control, the UK government would have been unable to intervene, and public interest considerations would not have trumped

---

[68] See Long Clawson Dairy Limited/Millway Merger Inquiry (Jan. 14, 2009) available at http://www.competition-commission.org.uk/rep_pub/reports/2009/fulltext/541.pdf.

[69] See Anticipated acquisition by Lloyds TSB plc of HBOS plc, Report to the Secretary of State for Business Enterprise and Regulatory Reform (Oct. 24,. 2008) available at http://www.oft.gov.uk/ shared_oft/press_release_attachments/LLloydstsb.pdf.

[70] See Peter Mandelson Gives Regulatory Clearance to Lloyds TSB Merger with HBOS (Oct. 31, 2008) available at http://nds.coi.gov.uk/environment/ fullDetail.asp?ReleaseID=382908&NewsAreaID= 2&NavigatedFromDepartment=True.

[71] Id.

the competition assessment. In the US, where such a framework doesn't exist, it seems unlikely that similar measures will be taken in an attempt to displace the antitrust agencies' role in conducting a competitive assessment in distressed transactions. At least that is the hope publicly expressed by some in the enforcement community.[72]

III. Proving Distress

Despite the firm, but fairly noncommittal, tone taken by the enforcement agencies in public statements with respect to the effect of the economic crisis on merger enforcement, the various failing company defenses remain an important, if not formal, aspect of agency merger investigations. For example, the U.S. Merger Guidelines provide that changing market conditions should be considered in evaluating a firm's future competitive significance.[73] Nonetheless, merging parties have to recognize that to be successful, something more than mere recitation that one of the merging firms is "flailing" is required. The parties must bring forward real, independently verifiable facts to show that the "flailing" firm is not a significant competitive factor in the market.

Failing firm arguments are "easily the subject of self serving speculation—relatively easily alleged, but difficult given the information asymmetries, to verify independently."[74] Disparities often exist between parties and antitrust enforcement agencies with regard to accessing credible information necessary to proving up this defense. Given the potential skepticism of agency staff evaluating these claims, it is important for parties to produce contemporaneous data and ordinary course documents so an independent determination can be made whether the thresholds of the defenses may be met. Regardless of the jurisdiction, candor with agency staff and transparency in the process is essential.

We believe that, while the global antitrust agencies might adhere to the letter of their policy views, the current worldwide economic crisis will cause them to be more receptive to the factual proposition that a merging company is flailing or failing and thus has little true competitive significance. Moreover, global antitrust agencies will undoubtedly be sensitive to any effects of the merger on the broader economy.

---

[72] See Rosch Speech at 12-13 (commenting that antitrust agencies taking into account financial consideration of the merged entity will help to solve the current crisis).

[73] See, e.g., Guidelines at ¶1.521 ("The Agency will consider reasonably predictable effects of recent or ongoing changes in market conditions in interpreting market concentration and market share data.").

[74] See U.K. Office of Fair Trading, Restatement of OFT's Position Regarding Acquisitions of 'Failing Firms,' OFT1047 (2008) at 3, available at http://www.oft.gov.uk/shared_oft/business_leaflets/general/oft1047.pdf.

Merger control rules will likely continue to be applied in a more flexible manner to account for the difficult and extraordinary circumstances that companies are facing during these troubling economic times. The existence of the economic crisis is not something global antitrust authorities are likely to question, and its very real impact on the financial viability of many companies is not open to debate. Thus, while the credit crunch and financial crisis will not radically change competition policy, merging parties who have well-grounded factual arguments that one of them is failing or distressed should encounter an open-minded and sympathetic audience in the antitrust agencies.

[top]

Behavioral Economics and Merger Enforcement: A Speculative Guide

Timothy J. Brennan

The ability of economics to frame questions, identify anomalies, and make predictions very much rests on the foundations that people and firms have identifiable goals revealed by their actions and their behavior is understood as means to those ends. Absent identifiable failures, markets produce prices that allow individuals to choose what makes them as well off as they can be, subject to "supply equals demand." It is the ability to rely on those premises, and the experience developing inferences and intuitions based on those premises, that have given economics its power in providing plausible guides for private actions as well as public policies in any number of areas, including antitrust.

The growing field of behavioral economics (BE) proffers a challenge to the presumptions that have given economists confidence in those judgments. The consequences of that challenge are not restricted to the ivory tower. To the degree that economic principles guide public policies, these challenges could affect how those public policies are designed and implemented. Over the last three decades, antitrust has become one area guided in large measure by economics, hence those interested in antitrust need to be aware of BE's challenges.

The source and nature of the guidance remains a matter of debate, whether one comes at antitrust with "Chicago school" expectations that market forces will overcome most nominally structural impediments to efficiency, or "post-Chicago" strategic models that illustrate how imperfect information can lead to a wider variety of possible outcomes. While the Chicago school's characteristic faith in the market may be undercut if firms and consumers don't always make decisions that minimize costs or maximize profits, the post-Chicago game theoretic models rely on an expectation of rational decision-making, backwards induction, and probabilistic inferences that may be beyond the practical capabilities of most individuals and perhaps firms.

***Timothy J. Brennan** is a Professor of Public Policy and Economics at the University of Maryland Baltimore County, and a Senior Fellow at Resources for the Future*

This article offers a short sketch of what BE might suggest about merger analysis. A brief description of behavioral economics and its differences from orthodox economics is followed by a general characterization of how we assess the competitive effects of mergers. That characterization suggests two places where BE might matter: market delineation—how consumers might react, —and competitive effects—how the merger affects firm conduct and performance given that expected reaction. At this junction, because the process of identifying how consumers might react—market delineation—is already empirical, it does not appear that BE is likely to change that aspect of merger evaluation very much.

With regard to competitive effects, however, BE may lend credence to expectations of post-merger collusion that standard economic models might not support. Since BE is relatively new and, to my knowledge, not yet employed in litigated merger cases,[1] this and any other such assessment is necessarily speculative. The article concludes with some short observations on whether BE should play a role in merger analysis.

What Is Behavioral Economics?

The fundamental claim of BE is that, empirically, people do not act as the standard economic model predicts. To those who have not been around the economics block more than a few times, this seems trivially obvious, because people and firms are not always narrow, self-interested money grubbers. But for those who have been around that block, the BE challenge is more difficult because the standard economic model is amazingly malleable, almost to the point of tautology. People can have tastes or desires for whatever one can imagine, whether or not it has anything to do with self interest or wealth.[2] Puzzled when people donate to charities, or vote even when doing so has no effect on the outcome? Just posit a preference for altruism or civic duty. The only restriction the standard model puts on choices is that they be internally consistent. If someone prefers two broken legs to one, and one broken leg to none, they must prefer two broken legs to none. This may be a ludicrous preference, but perfectly consistent with the standard model and with its fundamental prediction: if you make any activity a person wants more expensive, he'll do less of it.

Coming up with empirical exceptions that fall outside such an elastic conception of behavior is thus no small task. With apologies to experts in BE, we can impressionistically divide its exceptions into three categories, recognizing that the boundaries among them are somewhat permeable.[3] After introducing these categories, we then examine how they would apply in antitrust, specifically to mergers.

The first category we might call contrary to preference, or, to put it more colloquially, "weakness of will." This refers to settings when someone makes a choice that they will simultaneously and consciously acknowledge that they did not want to make it. Smoking when one wants to quit or eating when one is

---

[1] Maurice Stucke, Behavioral Economists at the Gate: Antitrust in the Twenty-First Century, 38 Loyola U. Chicago L. J. 513, 514-15 (2007).

[2] Id. at 520 argues that non-self interested behavior is inconsistent with the standard paradigm. Whatever the flaws of that paradigm, this is not one of them. Self-interest may improve predictability in some contexts, but that is an empirical restriction akin to presuming a particular elasticity of demand. It may or may not be empirically validated, but whether it holds is not a test of the standard theory.

[3] Id. at 527-28 provides a useful list of behaviors often regarded as inconsistent with the assumptions of the standard economic model.

trying to stick to a diet are paradigmatic examples. Modeling such behavior, or even finding ways to talk sensibly about people making choices they don't want to make, is not easy for philosophers or economists.[4] One way of viewing the challenge is that people are not unified selves but distinct ones, and the problem of self control is how we allow our preferences at one time to overrule our preferences at subsequent times.[5] A second is to posit that people have, along with the ordinary preferences over goods and services one sees in any economics textbook, preferences over those preferences, e.g., they prefer cigarettes but would prefer that they preferred not to smoke.[6]

A second category is inconsistency. The idea here is that people act in self contradictory ways based upon variations in circumstances that ought to have nothing to with the choices. Behavioral economics got off the ground through a series of laboratory experiments in which different people were randomly given differently framed choices between two options.[7] The outcomes were mathematically identical, but one group would typically choose a first option while the other would choose the second, when they should generally all have chosen one or the other. A related observation is that people make choices based upon how questions are framed, such as which alternative is presented first, when such considerations make no difference as to outcomes under any of the available options. A recently prominent example is that people are much more likely to choose a workplace savings plan if they have to opt out of one that is provided by default rather than have to choose one when the default option is none.[8] This led to the formulation of psychological hypotheses that properties unrelated to outcomes or what one knows about them affects choices, such as endowment effects (valuing something more if one has it than if one would have to buy it),[9] salience (placing excessive statistical weight on proximate events),[10] and

---

[4] Harry G. Frankfurt, Freedom of the Will and the Concept of a Person, 68(1) J. Phil. 5 (1971).

[5] Thomas Schelling, The Intimate Contest for Self-Command, 60(3) The Public Interest, 94 (1980); Jon Elster, Ulysses and the Sirens: Studies in Rationality and Irrationality (1984); Jon Elster, Weakness of the Will and the Free-Rider Problem, 1 Econ. & Phil. 231 (1985).

[6] David George, Preference Pollution: How Markets Create the Desires We Dislike (2001).

[7] Daniel Kahneman & Amos Tversky, Prospect Theory: An Analysis of Decision Under Risk, 47 Econometrica 263 (1979). Kahneman was awarded the 2002 Nobel Prize in economics for his work in this area.

[8] Richard H.Thaler & Cass Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness 103-17 (2008).

[9] Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias, 5 J. Econ. Perspectives 193 (1991).

[10] George A. Akerlof, Procrastination and Obedience, 81 Amer. Econ. Rev. Papers & Proceedings 1 (1991).

preference reversals (people say they prefer gamble A to gamble B but would pay more for gamble B than gamble A).[11]

A third aspect of behavioral economics isn't that choices are necessarily inconsistent, but that they exhibit implausibility. An example of implausible behavior currently playing a role in policy debate is the argument that some practices to reduce energy use and greenhouse gas emissions have "negative costs," because the consumers do not take certain measures even though they would save more by implementing these measures than they cost.[12] Sometimes the evidence for implausibility involves a kind of inconsistency. A longstanding example familiar to economists is that there are persons who both gamble (indicating a preference for risk) and purchase insurance (indicating aversion to risk.)[13] Another would be the observation that people's willingness to search for a lower price is proportional to the price of the object, when it should be based on the cost of the search itself. People might be willing to go to a number of department stores to save $5 on a $50 pair of shoes but not go to a number of electronic stores to save $20 on a $1000 television, when the savings from the search are greater in the latter case.[14]

Application To Mergers

We can consider how BE might affect merger cases by looking at how they are generally analyzed at present. The central question in merger cases is whether allowing a merger will lead to a materially less competitive outcome, generally understood as an increase in prices over what they would have been absent the merger. This depends on two factors—how does the merger affect the ability of firms to institute a price increase, and how would consumers react to a price increase. These two factors may be inter-related, in that the profitability of a post-merger firm that increases price depends on the degree to which buyers would turn to the products of others.

However, under the standard procedure for analyzing mergers as described in the U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, these two factors are bifurcated.[15] Characterizing the

---

[11] Amos Tversky & Richard H. Thaler, Preference Reversals, 4(2) J. Econ. Perspectives 201 (1990).

[12] McKinsey & Company, Reducing U.S. Greenhouse Gas Emissions: How Much At What Cost? xii-xiii (2007), available at http://www.mckinsey.com/clientservice/ccsi/pdf/US_ghg_final_report.pdf, (last visited Feb. 5, 2009).

[13] Milton Friedman & Leonard Savage, The Utility Analysis of Choices Involving Risk, 56 J. Political Econ. 279 (1948).

[14] Richard H. Thaler, Mental Accounting Matters, 12 J. Behav. Dec. Making 183, 186 (1999).

[15] U.S. Department of Justice & Federal Trade Commission, Horizontal Merger Guidelines (1992, rev. 1997) (hereinafter Horizontal Merger Guidelines). The utility of this standard framework has been questioned. Lawrence White, Horizontal Merger Antitrust Enforcement: Some Historical

response of consumers to price increases is the purpose of delineating a relevant market. The "hypothetical monopolist" test for a relevant market—finding the smallest set of products and sales area over which a single firm would have to operate to be able to institute a significant, non-transitory price increase—is there to tell us whether consumer response to attempts to raise price would be sufficiently great to render a merger essentially harmless. The ability of the firm to exploit this consumer resistance is covered by "competitive effects." This inquiry is further divided into two categories, whether the merger facilitates collusion across the relevant market ("coordinated effects") or whether by bringing the two firms under unified control would lead to a higher price, taking the strategic reactions of other firms into account ("unilateral effects").[16]

The Consumer Side: Market Delineation

The strongest evidence for behavioral economics comes from looking at the actions of persons, sometimes in the "real world," often in controlled laboratory experiments. Consequently, one might expect that the strongest influence of BE on merger assessment would be on the consumer side. This would concern what consumers regard as substitutes and how they would react to price changes, i.e., market delineation.

In practice, however, BE is unlikely to change much of how markets are identified. Market delineation is designed to be already a largely empirical exercise. Whether consumers regard the products from a seller as a sufficiently close substitute to those offered by the merging parties to be included in the market, and perhaps render price increases unprofitable, is for the data and other evidence to decide. To take a recent example, whether buyers regard shopping at a Giant or Safeway as a substitute for shopping at Whole Foods is an empirical question. Any consumer behavior BE might identify will be embedded in this data and related evidence of consumer switching patterns. As far as I know, BE representations of conduct are generally consistent with the standard model insofar as that increasing the price of something reduces consumption of it, whether or not that consumption is contrary to preference, inconsistent with other purchasing patterns, or otherwise implausible.

Perspectives, Some Current Observations, Prepared for the Antitrust Modernization Commission's "Economist's Roundtable on Merger Enforcement" (rev. Mar. 16, 2006), available at http://govinfo.library.unt.edu/amc/commission_hearings/pdf/White_Statement_final.pdf (last visited Feb. 6, 2009). Farrell, Joseph and Carl Shapiro, Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition (2008), available at http://ssrn.com/abstract=1313782, (last visited Feb. 6, 2009). Nevertheless, dividing the antitrust analysis of mergers into the buyers' side and the firms' side is a useful way to examine how introducing behavioral economics into the analysis might change how we assess whether a merger should be blocked

[16] Horizontal Merger Guidelines at §§2.1, 2.2.

In short, to the extent that consumer resistance to price increases is an empirical question, our methods for defining markets already take behavioral economics into account. But some potential if not necessarily likely ramifications are worth noting. First, in some cases a market definition might appeal to standard economic rationality rather than data. An argument that X must be a substitute for Y because it would be "irrational" to expect consumers to regard them as distinct or vice versa might be plausible using standard economic thinking, but perhaps not treated as such by a behavioral economist. Second, BE might suggest that a conclusion regarding whether X and Y are substitutes based upon surveys might give different answers depending on how the questions were framed. Third, interpretations of econometric results are properly influenced by prior theoretical expectation. BE might be invoked to suggest that results found implausible may nevertheless reflect actual consumer behavior. As far as I can determine, incorporating BE need not imply a stronger or weaker enforcement stance. BE considerations could make it more or less plausible that two goods are substitutes, and that finding could make a merger more or less problematic.

The Seller's Side: Competitive Effects

Behavioral economics is likely to play a larger role on the sellers' side, affecting arguments regarding a merger's potential competitive effects. The potential influence of BE differs between settings where unilateral effects and coordinated effects form the basis for concern. Unilateral effects cases are less likely to come out differently if BE becomes a part of the analysis. This is because unilateral effects cases depend first on how one would predict a merged firm would react to the reduction in competition. For the merged firms, call them A and B, it seems unlikely that BE would usurp profit maximization, in that the marginal effect of internalizing the impact of A's prices on B's profits and *vice versa* are probably similar whether or not BE is incorporated.

A second aspect of unilateral effects cases—how the strategic outcome is affected by the predicted reactions of other firms in the relevant market to the actions of the merged firm—may be slightly more fertile ground for BE. Predicting the outcome relies more on models requiring calculation of Nash equilibrium and, with simultaneous price or quantity decisions, assuming that the relevant market will arrive at such an outcome. Because these calculations can often require complex inferences in the face of imperfect information regarding the costs and sometimes dispositions of one's rivals—the post-Chicago analysis of predatory pricing being an excellent example—BE raises questions about the applicability of such models to the "real world."[17] As with market delineation, however, the direction of the effect incorporating BE into unilateral effects cases is not obvious.

---

[17] The specific model referred to here is found in David Kreps & Robert Wilson, Reputation and Imperfect Information, 27 J. Econ. Theory 253 (1982). For a vast collection of such models, the standard reference is Jean Tirole, The Theory of Industrial Organization (1980).

BE's most significant effect on merger analysis is likely to involve coordinated effects. In the standard model, collusive outcomes are problematic because it is generally in the individual interest of each party to cheat. The ascendance of unilateral effects models in merger analysis in the last twenty years has likely been brought about at least in part by the increasing influence of this realization.

However, as we all know, collusion happens. The standard model allows for this through repeated games, but that explanation is not without considerable difficulties.[18] BE may offer some alternative explanations. For example, instead of assuming firms decide what price to charge on the basis of predictions relying on ascertaining the rational strategic choices made by rivals in a multistage or complex game, one might find that they set prices using simple heuristic guides, like "see what my competitor down the street is charging, and match it." Such equilibria may be stabilized by loss aversion, i.e., firms are more concerned with averting potential losses if the cartel were to break down than lured by the prospect of gains from cheating. Such considerations could support tacit collusion and agreements lacking explicit mechanisms to punish cheaters.

Suggesting that BE may reinvigorate coordinated effects as a basis for merger enforcement is not enough to suggest that it will. First, the strongest case for BE in general is laboratory evidence. Before BE justifies a concern with collusion, one needs experimental evidence that it applies, and that suggests when it is more or less likely.[19] A second consideration is whether the merger affects the outcome. One needs not only strong evidence to support post-merger collusion, but that pre-merger collusion is unlikely. These considerations suggest BE may apply with more force to mergers that involve the acquisition of "mavericks" that set their own prices and do not go along with the "normal" business practices that would otherwise support pre-merger collusion.[20]

Third, and most important, is to keep in mind that the cognitive foibles leading to reliance on heuristics, loss aversion, or other implausible or inconsistent outcomes, appear most likely for individuals. They appear less likely

---

[18] One difficulty, known as the "Folk Theorem" is that the models that support collusion as an equilibrium outcome support almost every other potential outcome as well. See JeanTirole, The Theory of Industrial Organization 246-47 (1989). A second, often referred to as the "renegotiation problem," is that after a firm cheats, nothing stops the parties from starting over rather than inflicting the punishment that is supposed to deter cheating. Id. at 253. I think of the latter as suggesting that the repeated game reliance on punishment contradicts the fundamental standard economic principle that "sunk costs don't matter." Once someone has cheated, that is in the past, not the future. Absent new information being conveyed by that cheating, the circumstances that made a collusive outcome plausible at the outset are just as plausible after the cheating takes place.

[19] For a survey of oligopoly experiments indicating factors that may lead to collusive outcomes, see Christoph Engel, How Much Collusion? A Meta-Analysis on Oligopoly Experiments (2006), available at http://ssrn.com/abstract=951160 (last visited Feb. 6, 2009).

[20] Horizontal Merger Guidelines at §2.12.

when one is considering their applicability to the actions of multi-million or billion dollar enterprises that one might presume are willing and able to acquire information to predict profit-maximizing outcomes. I would have been more comfortable presupposing the rationality of large institutions prior to the fall and in some cases demise of the nation's largest investment houses.[21] Such a fall is not necessarily irrational, if the circumstances leading to the credit crunch were genuinely very low probability events, but one does have to wonder.

The Policy Side: Should We Care?

The discussion so far has been descriptive, concerning what might happen were behavioral economics to become a factor in merger analysis. That leaves open the question of whether BE should play a larger role in merger analysis, beyond how it is already implicitly incorporated in market definition.

On that I am somewhat skeptical. BE's advocates can be excused for characterizing such skepticism as the byproduct of a career invested in the standard paradigm, but there may be a little more to it. A first consideration is normative. The justification for merger policy, and antitrust more generally, is (or at least incorporates) consumer welfare.[22] The standard model offers a means of assessing consumer welfare, roughly using the "area under the demand curve," but fundamentally and more importantly, based on how much consumers reveal they are willing to pay for goods and services. If persons' revealed preferences cannot be trusted because they reflect cognitive limitations, the justification for judging industry conduct or structure on the basis of how well they satisfy those preferences is undercut. We should be reluctant to invite BE into the debate unless we know how it defines when interventions are beneficial.

A second source of reluctance is on the positive side. Over the decades, many forms of behavior have seemed inexplicable within the standard economic model. However, rather than being relegated to the dustbin, the standard model has proven to be intellectually progressive because its practitioners have expanded its reach by achieving new understandings incorporating considerations such as transaction costs, strategic behavior, and asymmetric information. Vertical restraints are a familiar and perfect example. Seemingly inexplicable, the initial view was that they must reflect the exercise of market power by default. It was only after recognizing difficulties in contracting for the provision of information

---

[21] Joe Nocero, Risk Management, New York Times Sunday Magazine, Jan. 2, 2009, at 24.

[22] There is, of course, a continuing debate about whether total or consumer welfare is the appropriate standard. Alan Fisher & Robert Lande, Efficiency Considerations in Merger Enforcement, 71 Cal. L.Rev. 1580 (1983); Thomas Ross & Ralph Winter, The Efficiency Defense in Merger Law: Economic Foundations and Recent Canadian Experience, 72 Antitrust L. J. 471 (2005); Kenneth Heyer, Welfare Standards and Merger Analysis: Why Not the Best? 2(2) Competition Policy Int. 29 (2006); Russell Pittman, Consumer Surplus as the Appropriate Standard for Antitrust Enforcement, 3(2) Competition Policy Int. 205 (2007).

that these practices came to be adequately explained and, in most if not all cases, regarded as presumptively benign. The appropriate response to BE may not be to discard the standard model, but to continue to engage in theoretical work to refine and extend it to cover the phenomena it currently may not be able to explain.

This is not to deny that behavioral economics is both an important development and relevant for policy. On the positive side, it may come to be viewed as a complement to rather than substitute for the standard model, because it incorporates the non-monetary cost that individuals and firms would bear in figuring out which course of action would be ideal. This is inherently no more descriptively threatening to the standard model than is the presence of goods and services that reduce costs in other ways, such as saving time or reducing physical effort. On the policy side, however, one does need to be careful, as BE can invite paternalistic interventions, based on presumptions such as "those who don't agree with me must just have high 'thinking costs' and would be better off if led to do what I think they should do." Where high "thinking costs" are plausible, BE can justify policy, and in fact already has done so. Much of the argument for consumer protection policy, apart from that relating directly to promoting and protecting competition, is that in some circumstances individuals can be profitably exploited by being led to make mistakes through clever framing or selected withholding of information.

But such considerations need not affect competition policy per se. We do not typically allow market failures outside the competitive realm to affect antitrust; we would not, for example, condone a beer merger that raised price because reduced alcohol consumption would reduce harms from drunk driving. Just as we leave the competition in beer markets to antitrust and prevention of drunk driving to traffic laws, we can generally keep the antitrust eye on the competition ball using the standard model and leave BE-based considerations to agencies empowered to deal with consumer protection.[23]

---

[23] An issue this invites for another day is whether consumer protection and competition enforcement should be in the same agency or should be covered by the same law. It may be better to leave consumer protection to those comfortable with the idea the consumers are exploitable due to being inherently error-prone and leave competition enforcement to develop legal guidance to businesses premised on the belief that buyers and sellers are presumptively rational.

[top]

Needed Revisions of the Non-Horizontal Merger Guidelines

James Langenfeld

Merger guidelines are intended to provide transparency in merger policy and enforcement, which is extremely important both in ensuring that businesses understand the ground rules and in providing self discipline for the agencies. To this end, the European Commission (E.C.) recently issued detailed non-horizontal merger guidelines covering vertical and conglomerate mergers.[1] The U.S. antitrust agencies, in contrast, have not updated their Non-Horizontal Merger Guidelines[2] for 25 years even though (1) the competition agencies in the U.S. have challenged mergers between firms that do not compete with one another, and (2) economic analysis has progressed in identifying when non-horizontal mergers can reduce competition. The limitations of the existing Non-Horizontal Merger Guidelines have been highlighted by many government officials, and there have been calls to update the sections that deal with vertical mergers.

It has been argued that the Non-Horizontal Merger Guidelines should not be updated because there is not a sufficient consensus about how to analyze them and because a public statement about merger enforcement would encourage more active enforcement than merited. These arguments correctly caution against overly aggressive enforcement, but are not arguments against revising clearly outdated Guidelines. Now is the time to start the process of revising them.

***James Langenfeld** is a Director at LECG, an Adjunct Professor at Loyola University Law School Chicago, and the former Director for Antitrust, Bureau of Economics, Federal Trade Commission*

Antitrust Guidelines

The stated purpose of antitrust guidelines is embodied in the current U.S. Horizontal Merger Guidelines: "The Guidelines are designed primarily to articulate the analytical framework the Agency applies in determining whether a merger is likely substantially to lessen competition . . ."[3] In attempting to accomplish this goal, the Department of Justice (DOJ) and the Federal Trade

---

[1] European Commission, Guidelines On The Assessment Of Non-Horizontal Mergers Under The Council Regulation On The Control Of Concentrations Between Undertakings (adopted by the european commission on Nov. 28, 2007 and published on Oct.18, 2008) available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:265:0006:0025:EN:PDF [hereinafter E.C. Guidelines].

[2] U.S. Department of Justice, 1984 Merger Guidelines (Jun.14, 1984), available at http://www.usdoj.gov/atr/hmerger/11249.pdf [hereinafter the Non-Horizontal Merger Guidelines].

[3] U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (Apr. 2, 1992, rev. Apr. 8, 1997).

Commission (FTC) have issued and revised Merger Guidelines entirely or in part 5 times over the last 40 years, but the agencies have not addressed non-horizontal merger analysis in the Merger Guidelines since 1984.

The U.S. Guidelines obviously do not reflect advances in the economic literature in the field of non-horizontal mergers since 1984. Other jurisdictions have issues guidelines that reflect the new learning: the E.C. issued non-horizontal merger guidelines in 2007, and the Australian Competition & Consumer Commission issued Merger Guidelines in November of 2008 that address non-horizontal mergers.[4] The primary focus of non-coordinated effects in the E.C. Guidelines, for example, is on the potential for foreclosure.[5] In contrast, the Non-Horizontal Merger Guidelines' presentation of non-coordinated competitive problems from vertical mergers is centered on the creation of barriers to entry,[6] and does not mention foreclosure.

The Non-Horizontal Merger Guidelines also do not accurately reflect the agencies' enforcement policies regarding vertical mergers. In 2005, Former Chairman Pitofsky stated that under the Non-Horizontal Merger Guidelines none of five recent vertical challenges at that time would have been regarded as violations and "could not have been brought if the vertical guidelines were controlling."[7] In contrast to the Horizontal Merger Guidelines that are so influential, the "vertical guidelines have been widely ignored."[8] It is not surprising that the Antitrust Modernization Commission recommended updating the Non-Horizontal Merger Guidelines to incorporate the new thinking about

---

[4] See Australian Competition and Consumer Commission, Merger Guidelines §§ 5-6 (Nov. 21, 2008), available at http://www.accc.gov.au/content/item.phtml?itemId=809866&nodeId=7cfe08f3df2fe6090df7b6239c47d063&fn=Merger%20guidelines%202008.pdf [hereinafter ACCC Guidelines]. The ACCC Guidelines do not have an independent section on the coordinated effects of conglomerate and vertical merger (while the E.C. Guidelines do), however, in Section 6, the ACCC Guidelines recognize that vertical and conglomerate mergers may give rise to coordinated effects. They also discuss generally how a merger (of any type) can facilitate coordinated conduct. The ACCC Guidelines are in many ways similar to the E.C. Guidelines in recognizing foreclosure and other anticompetitive theories that are absent from the 1984 U.S. Non-Horizontal Merger Guidelines.

[5] See E.C. Guidelines at ¶¶ 33-39, 40-46; Jeffrey Church, Vertical Mergers, 2 Issues in Competition Law and Policy 1455 (ABA Section of Antitrust Law 2008).

[6] Non-Horizontal Merger Guidelines at ¶ 4.21.

[7] Robert Pitofsky, Antitrust: Past, Present, and Future of Antitrust Enforcement at the Federal Trade Commission, 72 U. Chi. L. Rev. 209, 221 (2005).

[8] Id. at 220. See Thomas B. Leary, The Essential Stability of Merger Policy in the United States, 70 Antitrust L. J. 105, 120 (2002-03); Timothy J. Muris, Principles for a Successful Competition Agency, 72 U. Chi. L. Rev. 165, 184 (2005).

vertical mergers and to provide transparency in how the agencies analyze these non-horizontal mergers.[9]

The Non-Horizontal Merger Guidelines also discuss the theory of potential competition, and set enforcement standards in which the agencies would likely challenge a merger. The potential competition cases the U.S. agencies have pursued, unlike the vertical merger cases, have generally followed the Non-Horizontal Merger Guidelines. Even if the new administration should decide to pursue more challenges of mergers of potential competitors,[10] there seems to be no need to revise this portion of the Non-Horizontal Merger Guidelines.

Neither of the U.S. antitrust agencies has pursued pure conglomerate cases (i.e., not horizontal, vertical, or potential competition) since 1984. The E.C. has used conglomerate theories to challenge mergers,[11] but these attempts have been controversial and often opposed by U.S. antitrust officials in both the Clinton and Bush administrations.[12] Absent a sea change in thinking about conglomerate mergers in the U.S., extending the Non-Horizontal Merger Guidelines to cover pure conglomerate mergers would not be useful.

Economics of Vertical Mergers and Recent Enforcement History

There has been a great deal of new economic thinking about the competitive implications of vertical mergers since the dominance of "Chicago School" economics in 1984, and there have been a number of enforcement actions in the U.S. based at least in part on this newer research.[13] The "Chicago School" literature on vertical mergers in general argues against challenging vertical

---

[9] Antitrust Modernization Commission, Report and Recommendations 68 (2007), available at http://www.amc.gov/report_recommendations/amc_final_report.pdf.

[10] Some commentators have argued that new thinking about barriers to entry reflected in the Horizontal Merger Guidelines should applied to potential competition cases, which would result in more challenges. See John Kwoka, Eliminating Potential Competition, 2 Issues in Competition Law and Policy 1437 (ABA Section of Antitrust Law 2008); John Kwoka, Non-Incumbent Competition: Mergers Involving Constraining and Prospective Competitors, 52 Case W. Res. L. Rev. 173 (2001).

[11] See, e.g., Case COMP/M.2220, General Electric v. Honeywell, 2004 O.J. (L 048) 1-85; Case IV/M.877, Boeing v. McDonnell Douglas, 1997 O. J. (L 372) 8-18; Case COMP/M. 2416, Tetra Laval v. Sidel, 2004 O. J. (L 038) 1-17 and 13-87; Case IV/M.833, Coca Cola Co. v. Carlsberg A/S, 1998 O. J. (L 145) 41-62; Case IV/M.938, Guinness v. Grand Metropolitan, 1998 O. J. (L 288) 24-54.

[12] See, e.g., U.S. Department of justice, Range Effects: The United States Perspective, (Oct. 12, 2001), available at http://www.usdoj.gov/atr/public/international/9550.pdf; W. J. Kolasky, Deputy Assistant Attorney General, Antitrust Division, U.S. Department of Justice, Remarks Before George Mason University Symposium (Nov. 9, 2001) available at http://www.usdoj.gov/atr/public/speeches/9536.pdf; Paul Yde, Non-Horizontal Merger Guidelines: A Solution in Search of a Problem? 22 Antitrust 74, 74-83 (2007).

[13] See Church, Vertical Mergers, supra note 6.

mergers. Central to much of the Chicago School's argument is the successive monopoly model, where there is only one maximum monopoly profit. [14] In this model, additional monopolies in the manufacturing and distribution chain lead to a world of "double marginalization," in which an upstream monopolist increases price and restricts output compared to the competitive level, and the downstream monopolist then further raises prices and restricts output because of higher input costs. Vertical integration enhances economic efficiency by allowing the upstream firm to supply inputs to the downstream firm at marginal cost without adding a supracompetitive profit margin upstream.[15] However, the elimination of double marginalization depends on the assumptions of successive monopolies, linear pricing,[16] and the input being used in fixed proportion to other inputs. Absent these assumptions there is the potential for anticompetitive effects from a vertical merger.

Under "Post-Chicago" theories of vertical mergers, a vertically integrated firm could foreclose its rivals if there is "imperfect competition" in the pre-merger and post-merger environment. The literature identifies two types of foreclosure: input foreclosure (where the integrated firm seeks to raise rivals' costs) and customer foreclosure (where the integrated firm seeks to reduce rivals' revenues).

Research shows that input foreclosure can follow from a vertical merger when the upstream division of the integrated firm either stops supplying inputs to competitors of its downstream division, or continues to sell at a substantially increased price.[17] Research also shows that an acquiring downstream firm may actually have the incentive to foreclose its rivals--a result which the Chicago School in effect treats as implausible--and provides the conditions under which increased intermediate prices increase final goods prices. [18]

---

[14] The single profit result states that there is only one monopoly rent to be captured between two firms in a vertical relationship. As a consequence, integration will not add anything to the market power the acquiring firm. See Robert H. Bork, The Antitrust Paradox (1978); Richard A. Posner, Antitrust Law (1976).

[15] Other efficiencies from vertical mergers can include the realization of economies of scope, supply assurance, improved information flow and coordination compared to contracting, elimination of free riding on promotional activities, and internalization of R&D benefits. For a general discussion of potential efficiencies from vertical and conglomerate mergers, see Simon Bishop, et al, The Efficiency-Enhancing Effects of Non-Horizontal Mergers, Report for European Commission (Enterprise and Industry Directorate-General 2005).

[16] That is unit pricing, without non-linear discounting such as rebates.

[17] Michael Salinger, Vertical Mergers and Market Foreclosure, 103 Q. J. Econ. 345, (1988) provides a model of input foreclosure assuming oligopoly in both the upstream and downstream markets.

[18] See Janusz A. Ordover, Garth Saloner & Steven C. Salop, Equilibrium Veritcal Foreclosure, 80 Am. Econ, Rev. 127, (1990); see also Gerard Gaudet & Ngo V. Long, Veritcal Integration, Foreclosure, and Profits in the Presence of Double Marginalization, 5 J. Econ, & Mgmt. Strategy 409 (1996); Richard S. Higgins, Competitive Vertical Foreclosure, 20 Managerial & Decision

The 1984 Merger Guidelines do not acknowledge the possibility of input foreclosure as the basis for a merger challenge. However, the FTC and the DOJ have used input foreclosure arguments in challenging vertical merger cases. [19]

For example, in 1995 the FTC challenged a merger between workstation manufacturer Silicon Graphics and graphics software firms Alias Research Inc. and Wavefront Technologies Inc. Both Alias and Wavefront used workstation manufacturers as platforms on which to sell their software, thereby placing them upstream of Silicon Graphics.[20] The FTC argued that among other factors, the merger would foreclose "access by other workstation producers to significant, independent sources of entertainment graphics software thereby giving Silicon graphics access to sensitive information about other workstation producers."[21] Furthermore, foreclosure of this nature would increase costs to rivals of Alias and Wavefront, who sought to develop software for Silicon Graphics workstations. The FTC obtained a consent that required Silicon Graphics to (1) offer open architecture and programming interfaces to competitor software developers, (2) offer independent entertainment graphics software companies participation in its software development programs on no less favorable terms than other software developers, and (3) have an FTC approved "porting agreement" so that two major entertainment software programs can be run on the porting partner's competing system.[22]

In 1999, the FTC staff raised input foreclosure concerns regarding book retailer Barnes & Noble's later abandoned acquisition of book wholesaler Ingram.[23] Richard Parker of the FTC stated "raising rivals costs theory ha[d] been developed in the economic literature of the last decade or so, and focuse[d] on the actual impact on competition from foreclosure. The issue is whether the integrated firm after the vertical merger has both the incentive and the ability to increase its rivals' costs by denying access to essential inputs upstream or to essential outlets for production downstream." [24]

Econ. 229 (1999); Yongmin Chen, On Vertical Mergers and Their Competitive Effects, 32 Rand J. Econ. 667 (2001).

[19] Church, Vertical Mergers, supra note 6, provides a list of 23 merger consents or abandoned mergers that involve vertical anticompetitive theories during the 1990s at 1460. He lists 3 cases since 2000.

[20] See FTC Press Release on consent to the merger (Nov. 16, 1995) available at http://www.ftc.gov/opa/1995/11/ sil2g.shtm.

[21] Id.

[22] Id.

[23] Richard G. Parker, Senior Deputy Director, Bureau of Competition, Federal Trade Commission, Address at the International Bar Association (Sep. 28, 1999) available at http://www.ftc.gov/ speeches/other/barcelona.shtm.

[24] Id. Parker cited this theory back to Ordover, Saloner, and Salop, *supra* note 28.

The DOJ challenged AT&T's acquisition of McCaw in the 1990s based on the potential for input foreclosure. The DOJ reasoned that the merger would reduce other cellular operators' access to essential infrastructure equipment supplied by AT&T, and thereby harm competition. The DOJ found that there was "was little elimination of double marginalization, reduction of transaction costs, and opportunity for improved coordination since McCaw did not purchase AT&T equipment and is unlikely to do so in the future because it is also 'locked in' to its current equipment supplier." As a remedy the DOJ required that other operators be able to obtain equipment from AT&T and use alternative suppliers.[25]

Although there have been fewer vertical mergers challenged since the 1990s, there still have been investigations and some challenges. For example, Cytyc Corp.'s acquisition of Digene Corp. was challenged in 2003 on grounds that included an input foreclosure theory.[26] The FTC argued that if the merger were to take place, Cytyc's rivals would have difficulty accessing Digene's HPV test and gaining much needed FDA approval, thereby increasing costs to consumers.

Customer foreclosure can follow from a vertical merger when the downstream division of a merged firm stops purchasing inputs from competitors of the upstream division and increases the competitors' cost structures. However, for this form of customer foreclosure to be credible, it must be profit maximizing for the downstream division to forgo obtaining inputs from an external supplier.[27]

Despite the absence of any discussion of customer foreclosure in the 1984 Guidelines, it has also been used by the FTC in analyzing mergers. Customer foreclosure arguments were used, among others, in the 1997 merger of Cadence Design Systems (an operator of integrated circuit layout environments) and Cooper & Chyan Technology (a producer of integrated circuit routing tool software).[28] The FTC negotiated a consent agreement in which developers of integrated circuit routing tools would be able to participate in the merged firm's independent software interface programs at rates no less favorable than the terms applicable to any other participants (i.e., other participants that did not compete with the merging firms' products). The FTC investigated the merger between

---

[25] Steven C. Sunshine, Deputy Assistant Attorney General, Antitrust Division, U.S. Department of Justice, Remarks Before the American Bar Association Section of Antitrust Law (Apr. 5, 1995) available at http://www.usdoj.gov/atr/public/speeches/2215.pdf at 8-11.

[26] See FTC Press Release, FTC Seeks to Block Cytyc Corp.'s Acquisition of Digene Corp. (June 24, 2002) available at http://www.ftc.gov/opa/2002/06/cytyc_digene.shtm.

[27] See Michael A. Salinger, Vertical Mergers in Multi-Product Industries and Edgeworth's Paradox of Taxation, 39 J. Indus. Econ. (1991).

[28] See Complaint, In the Matter of Cadence Design Sysytems, Inc. (F.T.C. 1997) (File No. 971-0033) available at http://www.ftc.gov/os/1997/05/cadence.pdf; see Statement of Commissioners Pitofsky, Steiger, and Varney, available at http://www.ftc.gov/os/1997/05/state01.htm. Consent was subsequently given on this merger.

Synopsys Inc. (a producer of front end tools for chip design) and Avant! Corp. (a producer of back end tools for chip design) in 2002 on similar grounds. Essentially, the question was whether the merger amounted to customer foreclosure on the part of Synopsys. While the FTC decided to close its investigation of the merger, Commissioner Leary cited the use of customer foreclosure theories in understanding the anticompetitive effects of the merger.[29]

Costs and Benefits to Revising U.S. Non-Horizontal Merger Guidelines

There are obviously costs and benefits associated with revising any policy statement, even one as out of date as the 1984 Guidelines. Both Paul Yde[30] and Greg Werden[31] present several arguments against updating the Non-Horizontal Merger Guidelines that should be considered before undertaking any revisions. All of these criticisms argue for caution in challenging vertical mergers, but none of them support leaving outdated guidelines on the books. Moreover, Yde and Werden do not give adequate weight to the consensus that the 1984 Guidelines do not reflect the economic thinking that underlies the most recent U.S. or E.U. enforcement actions against non-horizontal mergers.

First, all agree there are differences between horizontal and vertical anticompetitive theories. Horizontal mergers can lead to an immediate reduction in output and increased prices. In contrast, anticompetitive theories relating to vertical mergers involve the merged firm expanding its output at the expense of its competitors, raising these rivals' costs, and in the longer run reducing the sales of its competitors by more than any expansion of the merged firm's output.

Second, the current economic models describe possible anticompetitive effects from vertical mergers, but Yde and Werden argue the theories lack generality. It is true that new economic models depend on a variety of conditions, many of which are not easily observed. However, even horizontal mergers of firms in an oligopoly may lead to a variety of changes in the market, depending on assumptions about the ways in which competitors behave that can be difficult to observe. In part, this is why the Horizontal Merger Guidelines devote a great deal of analysis to competitive effects.

Third, many of the new economic models do not address all of the potential pro-competitive effects of vertical integration, and in particular the benefits of eliminating double marginalization in vertical cases. Moreover, elimination of double marginalization can occur when the merging firms have

[29] Id.

[30] Paul Yde, Non-Horizontal Merger Guidelines: A Solution in Search of a Problem?, 22 Antitrust 1, 74 (2007).

[31] Gregory Werden, Forthcoming in George Mason Law Review (2009).

market power in the upstream and downstream markets. However, the elimination of double marginalization depends on several observable assumptions. An inquiry into the likelihood of the elimination of double-marginalization or other efficiencies can be done, and the agencies have done so in the past.

Fourth, vertical and conglomerate theories are said to lack any systematic empirical basis. It is true that economic research on vertical restraints has yielded some mixed results,[32] and there is relatively little recent research specifically devoted to the impact of non-horizontal mergers. There is also empirical research questioning whether horizontal merger enforcement has demonstrably improved welfare, but there still is a consensus that some horizontal mergers should challenged.

Yde and Werden raise additional concerns that revised Non-Horizontal Merger Guidelines would not provide more transparency to U.S. enforcement policy or explain past challenges.[33] Few vertical mergers were challenged under over the last eight years under the Bush administration, but there were several notable vertical merger challenges under the last Democratic administration. To the extent the incoming Obama administration's non-horizontal merger policy is more like the policy that prevailed under President Clinton than President Bush, there are enough cases that follow the new economic literature to provide guidance for revising the vertical portions of the 1984 Guidelines. It is highly unlikely that economic thinking about non-horizontal mergers will change substantially in the near future, and it is equally unlikely that the types of vertical cases will be radically different than the ones brought in the 1990s.

Yde also argues the U.S. vertical merger cases typically involve negotiated consents, where the merging parties have incentives to agree to close the merger promptly and thus may not accurately reflect antitrust jurisprudence in this area.[34] But a stated purpose of the Guidelines is to make more transparent the agencies' analyses and concerns; the fact that some merging parties may have been willing to sign consents rather than test the agencies' theories in court in no way undercuts the usefulness of new Guidelines.

---

[32] For example, James Cooper, Luke Froeb, Dan O'Brien & Michael Vita, Vertical Antitrust Policy as a Problem of Inference, 23 Int. J. of Ind. Organ. 639 (2005) argue that the recent economic models only show the possibility of anticompetitive effects, and that procompetitive outcomes are much more likely to result from a vertical merger based on existing research. Others have disagreed with their interpretation of the existing empirical work. See William Comanor, F. M. Scherer, and Robert Steiner, Vertical Antitrust Policy as a Problem of Inference: The Response of the American Antitrust Institute (AAI Working Paper No. 05-04, 2005).

[33] Yde, supra note 31, at 77.

[34] Id.

Yde expresses concerns that revised guidelines would lead to too much enforcement.[35] Agency staffs, however, would likely limit their investigations to the vertical theories discussed in the revised guidelines, which presumably would not result in over-enforcement.

Yde also argues that vertical cases can be complex, and that it will be costly to investigate them.[36] Vertical cases are likely to be more costly to investigate, but the investigations will take place regardless of what the guidelines state. If anything, costs are likely to be higher if parties are relying on outdated guidelines that do not identify the types of theories that may be pursued; this also argues for revising the 1984 Guidelines.

Finally, Yde has expressed concerns about the agencies' attempts to explain their non-horizontal merger enforcement policy.

> "Despite occasional attempts by the antitrust agencies to explain their vertical merger enforcement decisions, these decisions have been decidedly ad hoc and cannot be interpreted to express any coherent or predictable policy. Arguably this ad hoc approach demonstrates that the current vertical merger guidelines are sufficiently flexible that . . . the existing guidelines' framework is competent to accommodate the particular matter under review."[37]

If, as Yde contends, existing policy statements "cannot be interpreted to express any coherent or predictable policy,"[38] then this strongly argues in favor of creating a clearer statement through a revision of the Non-Horizontal Merger Guidelines. Moreover, if recent U.S. vertical merger cases have not been brought based on the theories articulated in the 1984 Guidelines, this does not suggest the Guidelines are "flexible" – it suggests they are outdated.

The Time to Act

The new leaders of U.S. antitrust agencies will have to weigh the benefits and costs associated with policy changes, such as revising the 1984 Non-Horizontal Merger Guidelines. The benefits of updating the vertical portions of those Guidelines include informing businesses about when a merger is likely to be investigated, and giving the agencies' staffs clearer guidance about the nature and scope of such investigations.

---

[35] Id. at 78.

[36] Id.

[37] Id. at 77.

[38] Id.

The most immediate cost of revising the guidelines is that the agencies must devote scarce resources to the task.[39] But merger activity is down due to the economic slowdown in most industries. The reduction in the number of mergers should lead to a lower workload at the agencies, so there should be a relatively low opportunity cost of revising the Guidelines now. The new administration also presents an opportunity for the DOJ and FTC to work together to develop a common understanding of this area of antitrust enforcement.

Werden believes that a revision could be useful if there is change in policy, but that the new administration should wait until it has sufficient experience to formulate policy, announce the policy, and then, after some time, revise the Non-Horizontal Merger Guidelines. I disagree. Calls for revisions of these Guidelines have existed since at least 2000 and there is no reason to think that further delay will yield any benefits, especially since any guidelines revisions need to be started now if they are to be accomplished in the next year or two. Unless there is a substantial change in policy from the 1990s or in economic thinking, we can expect more non-horizontal merger challenges to take place under the new administration that follow the reasoning of past vertical cases and recent economic analysis. Moreover, to the extent that revised Non-Horizontal Merger Guidelines prove to be incomplete in some way, they can be revised relatively quickly as various U.S. antitrust guidelines have been in the past.

The U.S. Non-Horizontal Merger Guidelines are now ripe for revision. The format can be similar to that found in the 1984 U.S. and 2007 E.C. Guidelines.[40] That is, the revision should describe a set of theories of anticompetitive effect and the factual circumstances in which those theories may apply. The E.C. Guidelines follow this approach in a structured analysis that applies market power screens, identifies a coherent theory of anticompetitive harm that has factual relevance, and assesses the nature and magnitudes of merger-related efficiencies.[41] In effect, the E.C. has already done much of the difficult work here. The U.S. agencies should be able to build on that platform and prepare a revised set of guidelines that reflect current economic thinking and agency policy.

---

[39] It took about two years to create the 1992 Horizontal Merger Guidelines, even though there was a consensus on many of the important issues. The author was involved in that process, and it was a major undertaking.

[40] Yde, supra note 31, at 80.

[41] I also agree with Yde that any revised Guidelines should not be written in a way that gives the agencies too much room to discard efficiency claims. Id. at 81.

[top]

Should the Agencies Issue New Non-Horizontal Merger Guidelines?

Gregory J. Werden*

In the mid-1960s, the legality of all corporate mergers was called into doubt by a series of Supreme Court decisions. On May 30, 1968, Assistant Attorney General Donald F. Turner's Merger Guidelines provided a measured response to the prevailing climate of uncertainty.

By clarifying enforcement policy, the guidelines held out the prospect of two beneficial effects—enhanced deterrence of the anticompetitive mergers subject to challenge, and reduced chilling of the other mergers not subject to challenge. In this way, Turner's guidelines were a model for future antitrust guidelines relating to business practices sometimes anticompetitive but other times competitively neutral or even procompetitive.

When I arrived at the Antitrust Division, less than a decade after their release, Turner's guidelines were almost forgotten. In the early 1980s, the Division was challenging many mergers, but the Merger Guidelines said nothing useful about which mergers would be challenged. Assistant Attorney General William F. Baxter sought to remedy that with the Merger Guidelines issued on June 14, 1982.

A decade later, the Division was basing many merger challenges on unilateral effects theories not articulated in the Merger Guidelines. The Horizontal Merger Guidelines issued on April 2, 1992 codified a significant policy change that had been announced and implemented by the Division several years earlier. Critically, the Horizontal Merger Guidelines stated the enforcement policies of not just the U.S. Department of Justice but also the Federal Trade Commission.

Gregory J. Werden
is a Senior Economic Counsel, Antitrust Division, U.S. Department of Justice

Non-horizontal mergers were addressed in the 1968 and 1982 guidelines, as well as in the 1984 minor revision of the guidelines, but as the title indicates, they are not addressed by the Horizontal Merger Guidelines. The only statement of enforcement policy for such mergers now in force is a section of the 1984 Merger Guidelines, which states the policy of the Justice Department alone. Thinking on the competitive effects of non-horizontal mergers has evolved substantially since 1984, so one must doubt whether the 1984 Merger Guidelines

* The views expressed herein are not purported to reflect those of the U.S. Department of Justice. A longer version of this essay will appear in issue 4 of volume 16 of the George Mason Law Review.

are of use to the business community when contemplating non-horizontal mergers or to merger practitioners when offering advice.

Jim Langenfeld forcefully argues that issuing new guidelines for non-horizontal mergers should be a high priority for the federal enforcement agencies. I question whether issuing such guidelines should even be on the agencies' initial agendas.

First, as Langenfeld recognizes, a substantial commitment of resources would be required to produce new guidelines for non-horizontal mergers. My experience from past guidelines projects suggests that the effort would occupy many of the agencies' best people for thousands of hours in total. That time might be better devoted to other policy projects.

Second, antitrust guidelines are potentially worth the effort required to produce them only if there is significant legal uncertainty to address. That seems unlikely, however, in view of the infrequency of challenges to non-horizontal mergers in recent years. Langenfeld cites no evidence that the business community or merger practitioners are anxious about enforcement policy toward non-horizontal mergers.

Third, guidelines are useful only if they articulate enforcement policy in a manner that mitigates business uncertainty. Guidelines merely outlining the teachings of the economic literature on non-horizontal mergers are unlikely to accomplish that objective. Only a minute fraction of proposed non-horizontal mergers raise competitive concerns sufficient to warrant a challenge, and I doubt that guidelines can characterize usefully what sets apart those few cases.

Fourth, antitrust guidelines send the right message to the business community only if they have the proper tone. Important in this regard are the relative proportions of text devoted to positive and negative statements, and it is especially difficult to achieve the right balance with non-horizontal mergers. Describing the theories of competitive harm requires vastly more words than describing theories of efficiency gains, yet the latter theories have much more widespread applicability.

Finally, Langenfeld argues that new guidelines for non-horizontal mergers should be issued quickly then promptly revised if application experience reveals problems. However, recent history suggests that prompt revision of merger guidelines is unlikely. And my work on numerous antitrust guidelines has taught that actual enforcement experience often is what allows the agencies to go beyond abstractions and offer practical guidance. Changes in enforcement policy should be announced in speeches and codified into guidelines only after accumulating enforcement experience.

[top]

Delta-Northwest: Lessons and Comments from Navigating an Extensive DOJ Merger Review Process

Ian Conner and Haidee Schwartz

Following the U.S. Department of Justice ("DOJ") staff's recommendation, the DOJ formally closed its investigation of the merger of Delta Air Lines and Northwest Airlines on October 29, 2008.[1] The European Commission closed its investigation of the merger on August 6, 2008. Combining the number one airline for U.S. travel to Europe with the number one airline for U.S. travel to Asia, the merger created the world's largest airline. The combined airline is also the only U.S. carrier that operates on a truly global scale, with hubs in the United States and Asia and joint venture partner hubs in Europe. The transaction was the first successful merger of two healthy U.S. legacy carriers in 21 years, and is expected to generate annual efficiencies and synergies of more than $2 billion.

Delta and Northwest announced their plans to merge on April 14, 2008 and made their Hart-Scott-Rodino filing on April 21, 2008. The DOJ's antitrust investigation lasted just short of seven months, a relatively brief period for a merger of this scale and complexity. The relatively short investigation was the result of several factors. First, the Department's Transportation Energy & Agriculture section's institutional knowledge of the industry, coupled with the staff's immediate launching of a detailed review, allowed the investigation to focus on core issues early in the process. In addition, the parties' antitrust counsel and economists worked closely together and stayed in communication with, and responded quickly to, Division staff throughout the extensive review.

Ian Conner *is an associate with Hunton & Williams LLP and an Adjunct Professor at William & Mary Law School*

Haidee Schwartz *is an associate with O'Melveny & Myers LLP.*

The antitrust review of the merger generated many interesting and challenging issues. This article considers several points that we believe will be of interest to practitioners.

Events Leading Up to the Merger

In 2007, U.S. Airways launched a hostile and unsuccessful bid to acquire Delta while Delta was still in bankruptcy. Several months later, Delta emerged

[1] O'Melveny & Myers represented Northwest before the DOJ, as well as before competition authorities in the European Union and China. Hunton & Williams served as lead regulatory counsel for Delta before DOJ and the European Commission, assisted by K&L Gates and Boies Schiller & Flexner. Economists from CompassLexecon represented both Delta and Northwest. Robert Willig served as principal economic expert for Delta and Daniel Rubinfeld served as principal economic expert for Northwest.

from bankruptcy, and soon thereafter Northwest emerged from bankruptcy. By the fall of 2007, articles speculating on likely consolidation in the airline industry began appearing in the press. Much of this speculation centered on Delta merging with United or Northwest, as well as a potential combination between United and Continental. This speculation dramatically increased when Pardus, a private equity group with ownership interests in Delta and United, publicly urged Delta and United to merge.

Following Pardus's public advocacy, Delta announced that its board had established a special committee to review and analyze strategic options for the airline. Delta's discussions with potential merger partners came at a time when the airline industry faced a very difficult economic environment. Airlines faced an unprecedented rise in the cost of fuel as the price of oil soared from $70 to more than $140 a barrel in a single year. Average jet fuel prices shot up 55 percent during the first two months of 2008 and rose another 20 percent in March. Thus, at $100 a barrel at the time of the merger announcement, oil was nearly double what it had been in January 2007. By the parties' first meeting with the DOJ in late April 2008, oil had reached $120 per barrel. This made it almost impossible for airlines to turn a profit, as 34 percent of a ticket's price went toward covering the fuel cost, compared to 15 percent in 2000. Fuel prices continued to rise after the merger announcement, touching $147 a barrel in July before declining to around $65 a barrel at the time the merger closed.

Despite these challenges, Delta and Northwest remained committed to the merger. From late January through February 2008, the media reported continuing negotiations between the two carriers and their pilot groups, as the airlines sought to achieve unprecedented agreement from the Air Line Pilots Association, Intl.[2] (ALPA) and their respective pilot groups on a new combined contract and integration plan. In mid- to late-February, the media reported that merger talks had broken down as the pilot groups at the respective airlines failed to reach agreement. In March these talks revived, and on April 14, when Delta and Northwest announced their merger plans, they did so with the support of the Delta pilots' union. The Northwest pilots' union announced its support of the merger during the DOJ's investigation, and unanimously approved a tentative Delta-Northwest pilot labor agreement on June 27, 2008, following a similar move by Delta's pilot leadership just two days earlier. Prior to closing, the airlines completed an unprecedented agreement with the Delta and Northwest units of ALPA on a joint contract unifying both pilot groups under one pilot working agreement.

The Delta/Northwest merger, for the first time since Delta's acquisition of Western in 1987, united two U.S. legacy carriers not facing failure or liquidation. In fact, both carriers had emerged from bankruptcy the year before — Delta in April 2007 and Northwest in May 2007 — as two of the most efficient U.S.

[2] ALPA represented the pilots' groups at both Delta and Northwest.

airlines. Like America West's merger with U.S. Airways, the merger of Delta and Northwest was an end-to-end merger. It combined Delta's geographic strength in the east and trans-Atlantic markets with Northwest's strength in the Midwest and trans-Pacific markets.

The Antitrust Division of the Department of Justice investigated the merger, with 15 states and the District of Columbia conducting their own parallel merger investigation in loose coordination with the DOJ. The European Commission and antitrust authorities in Brazil, Canada, China, Mexico, South Africa, and South Korea also reviewed the merger.

Section I: The Timing Agreement — the Benefits and Challenges of Setting and Following an Aggressive Timeline

From the outset, counsel recognized that they had to follow an aggressive timeline for what was expected to be, and was, a very significant and thorough Second Request investigation. To meet the parties' tight timetable for concluding the antitrust review and closing the merger before the end of 2008, the parties and counsel began planning for the antitrust review well before the merger announcement. Pre-announcement preparations included collecting 4(c) documents at regular intervals so they only needed to be refreshed for the HSR filing; creating a detailed target timeline to complete merger review before the end of 2008; and lining up document vendors and other outside consultants.

Shortly after filing the Hart-Scott-Rodino merger notification, the parties began negotiations with the DOJ staff regarding a potential timing agreement. Concluding that the standard DOJ Process & Timing Agreement was not a viable option for this merger, the parties focused on negotiating different terms. In light of the aggressive deadline for closing, counsel worked backwards from the deadline to create a reasonable timing agreement that would allow the parties to complete their Second Request response, while also providing the DOJ staff with what counsel believed to be adequate time to review the Second Request production and complete their investigation. The ultimate result was a timing agreement that provided the staff 75 days to review the production and complete their factual investigation, and then provided an additional two weeks for negotiations and meetings with the Front Office. That set the Second Request compliance date at mid-July 2008, less than 60 days from issuance of the Second Request.

Recognizing that once the parties received the Second Request, they would have very little time to complete the review, the parties identified likely custodians and commenced pulling documents for these custodians by late April. By the time the Second Request actually issued, the parties already had pulled and electronically loaded documents for a substantial number of custodians for whom the DOJ requested documents. This made the remaining document pulls considerably less time consuming, with many simply involving updated pulls. This also enabled the parties to ensure that all systems were tested and working

smoothly, as well as to set personnel in place to rapidly review the very substantial volume of documents involved.

Upon issuance of the Second Request on May 21, 2008, the parties began to exchange draft timing agreements with the DOJ staff. The negotiations over the timing agreement lasted four weeks. The draft timing agreements under consideration, however, stated that the parties would begin a rolling production of materials on June 9, 2008, slightly less than three weeks after the issuance of the Second Request and before the parties and the DOJ signed the timing agreement. Despite not having a signed timing agreement, the parties began their rolling production on June 9, 2008 (and dealt with their first technical issue on June 10). During this same time period, counsel also negotiated modifications to the Second Request.

The parties and the DOJ signed the timing agreement ten days later, on June 19, 2008. The key provisions of the timing agreement included:

- A list of custodians from whom files would be pulled in order to comply with the second request (approximately 50 custodians for Northwest and 60 custodians for Delta);

- A schedule for producing, on a rolling basis, the Second Request response beginning three weeks after issuance of the Second Request;

- A requirement that 50 percent of the document production be completed ten days or more prior to certification of compliance;

- A provision permitting the DOJ to select five custodians from each company whose documents would be produced ten or more days prior to certification of compliance with the Second Request;

- An agreement by the parties to certify compliance no earlier than July 14, 2008;

- An agreement that, by early August, staff would provide the parties with a preliminary assessment of whether the parties were in substantial compliance, and that the parties would use best efforts to resolve any deficiencies identified within 10 business days; any deficiencies discovered after this date would be resolved by the parties and staff in good faith, but with no effect on the timing agreement dates;

- A truncated timetable for submission by the parties of white papers on identified topics subsequent to certifying substantial compliance (with simultaneous submission of all materials and data upon which the studies were based); and

- The parties' agreement not to close the merger before a set date, and to provide the DOJ with at least 21 days prior notice.

The agreement further stated that if the parties certified compliance after July 14, all other dates would move back on a day-for-day basis from the date the parties certified compliance. If the parties failed to meet any of the requirements related to producing documents for specified custodians or producing the percentage of documents required by the rolling dates, all dates would be moved back ten days.

If the parties met all requirements of the timing agreement, the DOJ committed to both a set date by which the DOJ would inform the parties of TEA's recommendation, and a meeting a few days later in which staff and section management, including the section chief, would discuss the factual and legal bases for the recommendation. Additionally, the agreement provided that if TEA recommended challenging the merger, the parties would have the opportunity to meet with the Deputy Assistant Attorney General and then the Assistant Attorney General within a set period.

The agreement established the time frame under which all counsel and economists worked for six months. As noted, without the pre-Second Request and pre-timing agreement collection of materials from expected custodians and other detailed preparations, the parties could not have met their tight schedule, which included both responding to the Second Request and preparing a series of white papers within weeks and sometimes within days of each other. The parties used simultaneous work streams and dedicated teams working on multiple economic and legal analyses concurrently. For the entire review period, the parties also made executives available who assisted in responding to DOJ requests and interrogatories on a nearly constant basis.

While a mechanism for interim feedback from staff was not incorporated in the timing agreement, to ensure no slippage in the calendar, counsel also stayed in regular contact with DOJ staff and tried to ascertain concerns or questions in order to respond quickly. The parties and the DOJ only modified the timing agreement once. At the end of the review period, the parties extended the agreement to provide the DOJ a small amount of additional time, consequently moving back all subsequent dates by the same set period. No other elements of the timing agreement changed.

From our perspective, the timing agreement benefited both the parties and the DOJ. It served the critical function of providing the DOJ with time to engage in an extensive and thorough review of the merger, in large part by accelerating the dates on which it would receive data, documents, and economic studies, as well as assurance that the parties would not close without providing significant advance notice to the Division. For the parties, it provided a date certain (within a

few weeks) by which they would know the DOJ's decision and, if favorable, would be able to move forward with closing and operating as a combined airline.

Section II: When Attorneys are "NA" — Generating Privilege Logs to Avoid Challenges

Both companies' Second Request privilege logs included thousands of documents. Delta and Northwest had been in bankruptcy for much of the period covered by the Second Request. Delta also had fended off a hostile takeover bid by U.S. Airways the prior year and Northwest had participated as a non-voting minority partner in the acquisition of Midwest Airlines (and had received a Second Request) during the covered period. Finally, both parties, as members of the SkyTeam Alliance, applied for antitrust immunity from the Department of Transportation during the year preceding the merger filing. All of these events generated significant amounts of privileged material, which the parties listed in their respective privilege logs as part of their Second Request response. In total, the two privilege logs included approximately 33,000 documents (out of a total production exceeding 20 million documents).

Given the time pressures and size of the privilege logs, the DOJ used a computer program to review the logs. This resulted in unexpected complications for the parties and the DOJ. The program identified objections to the great majority of the privilege designations. Specifically, the DOJ challenged 94 percent of the 23,770 entries on Delta's privilege log and 56 percent of the 9,410 entries on Northwest's privilege log. The DOJ's letter covering the issues in Delta's privilege log arrived more than a month after its submission. The letter challenging Northwest's privilege log arrived approximately a week after Delta received its privilege log letter. Both letters arrived after the period in the timing agreement during which deficiencies alleged by the DOJ could cause slippage in the timing agreement. The timing agreement provided that the parties would address subsequent challenges, but these would not affect the timing of the review.

DOJ letters indicated that the privilege challenges resulted from its use of an automated program to identify "deficient" privilege log entries. This program, which looked for very specific phrasing of privilege claims, had apparently rejected many of the parties' claims due to the phrasing used by the parties in their logs. A review of the types of challenges illustrates this point and the potential issue it poses for parties in future mergers.

The DOJ's letter included several categories of challenges identified by the program:

- documents on which the parties failed to make a privilege claim (classified by the DOJ as "NC");

- documents withheld under work product privilege that were allegedly created in anticipation of the DOJ's investigation or other purpose, rather than in anticipation of litigation ("WP-NL");

- documents where the log asserted attorney-client privilege, but purportedly failed to indicate attorney involvement, consisted of legal advice but was not sent by an attorney, or requested legal advice but was not sent to an attorney ("NA");

- documents where the circumstances purportedly indicated that the document primarily concerned business matters ("BUS");

- documents withheld completely rather than being redacted where the document apparently did not consist wholly of legal advice ("RED");

- documents the DOJ believed were disclosed to third parties ("W3D");

- documents disclosed to a third party and the claim of privilege rested on a joint defense agreement, but that supposedly were not supported by an "an actual joint defense or anticipation of specific litigation" ("WIE");

- claims it felt were insufficient to support a privilege determination ("INSUF");

- errors in the log names appendix that apparently failed to identify an author, recipient, or copyee ("UAR"); and

- documents sent to an email distribution list where the appendix failed to identify all of the individuals in the list ("LST").

For Delta, the largest set of challenges came under the category of "NA," *i.e.,* no indication of attorney involvement. This category accounted for 80 percent of the DOJ's challenges to Delta's privilege log; it accounted for six percent of Northwest's challenges. In response, the parties examined a sample of the challenged documents – documents authored solely by outside counsel – and quickly found the program had generated errors. For example, counsel found many documents in this sample denoted "NA," notwithstanding the presence of attorneys' names and other information in the log. Examples of documents challenged in this category included an email from Delta's lead antitrust counsel (a former Assistant Attorney General of the DOJ) to the client's Deputy General Counsel, copying other outside antitrust counsel (including other former DOJ and FTC attorneys) and the client's General Counsel. Additionally, a sampling of documents authored solely by members of Delta's General Counsel's office found more than 175 documents marked "NA."

Counsel notified the DOJ of these inconsistencies and explained their willingness to correct errors in the privilege log, but stated that they were not willing to review over 23,000 challenges to Delta's log and 5,000 challenges to Northwest's log when the reviews thus far had produced such significant error rates. In response to questions on the erroneously marked "NA" documents, the DOJ indicated the program had misread the verbal formulations used in the privilege log. An adjustment in the program's formula, however, resulted in an additional 25 documents being marked "NA" on the Delta side, rather than a reduction in the number of documents.

Apparently, the program is set to look for asterisks denoting attorneys in the privilege log itself. Some attorneys were denoted with asterisks in the appendix names index but not in the log itself and the program did not cross-reference the names list with the log. Further, it appears that where the program read the phrasing of the log and determined that the phrasing required the sender to be an attorney, it flagged the document as deficient even if the recipient was an attorney.

If the DOJ plans to use such a program in a future review, it will be useful for counsel to ask the DOJ precisely how it wants claims phrased so that they will pass through the program's filter. In future large document productions where the parties expect to have sizeable numbers of privileged documents, parties also should expect the DOJ to require meticulous adherence to the exact instructions of the Second Request's privilege requirements, including the precise verb structure and wording or phrasing of the privilege claim for each document.

On a more substantive note, the DOJ also asserted that the work product privilege did not cover documents created by counsel leading up to the merger and during the government's investigation, including the drafts of the initial PowerPoint presentation that parties made to the DOJ regarding the transaction. This category of documents comprised 29 percent of the DOJ's challenges to Delta's privilege claims and three percent of the challenges to Northwest's privilege claims. The DOJ asserted that the parties did not prepare these materials "in anticipation of litigation." In support of this position, they cited Rule 26(b)(3), which states, "[m]aterials assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other nonlitigation purposes are not under the qualified immunity …" Among the documents that the DOJ took issue with were counsels' analysis of the competitive issues present in the merger and strategy documents. The DOJ asserted that the parties could not reasonably anticipate litigation in this matter and therefore work product privilege did not apply (attorney-client privilege, however, still protected most of these documents).

Given the particular circumstances of this merger, we believe the DOJ's position on this issue was, and remains, debatable. The two most recent prior legacy airline merger attempts had ended in litigation or with the announcement that litigation would commence. Under the existing case law, the work product

privilege applies where there is an "objectively reasonable" anticipation of litigation.[3] In *In re Sealed Case,* the D.C. Circuit held that documents prepared by counsel for the Republican National Committee in response to news reports questioning the legality of its relationship with another organization were prepared in anticipation of litigation even though the Federal Election Commission had yet to file a formal complaint. This finding hinged on one attorney's affidavit stating that the media attention created concern and a different attorney's more general statement that "from the time the (NPF) was formed, I and the RNC were concerned about the substantial likelihood of potential litigation…"[4] In explaining that standard, the D.C. Circuit has held that for a document to meet the standard of "prepared or obtained in anticipation of litigation," the "lawyer must at least have had a subjective belief that litigation was a real possibility, and that belief must have been objectively reasonable."[5]

Courts also have found it "objectively reasonable" to anticipate litigation — even several years in advance — when the "surrounding circumstances" indicate a lawsuit is likely, as was the case here.[6] The DOJ's apparent view that work product protection exists only when litigation is filed or imminent seems inconsistent with case law.[7] The D.C. Circuit's jurisprudence makes clear that it will not take an overly restrictive view of the criteria for work product protection:

> Weakening the ability of lawyers to represent clients at the pre-claim stage of anticipated litigation would inevitably reduce voluntary compliance with the law, produce more

---

[3] See In re Sealed Case, 146 F.3d 881, 884 (D.C.Cir. 1998).

[4] Id. at 886.

[5] Equal Employment Opportunity Comm'n v. Lutheran Soc. Serv., 186 F. 3d 959, 968 (D.C. Cir. 1999) (quoting In re Sealed Case, 146 F.3d at 884) (further citing In re Sealed Case, the EEOC Court found that Lutheran Social Services faced a "virtually identical" situation as the RNC. Employment Opportunity Comm'n v. Lutheran Social Services, 186 F. 3d at 968. Lutheran hired counsel prior to being sued because it had good reason to fear litigation (anonymous complaints alleging a hostile workplace environment) and was in fact later sued.); Id. at 969.

[6] See Atlantic Richfield Co. v. Current Controls, Inc., 1997 WL 538876 (W.D.N.Y. 1997) (in-house counsel provided legal advice regarding a potentially contaminated site roughly four years prior to the EPA giving notification of an investigation; however, the Court found that "[i]n light of the surrounding circumstances - including the EPA's activities and the nature of environmental law, which often leads to litigation involving numerous parties with past or present associations with contaminated property - that belief was objectively reasonable."); Id. at 2.

[7] See also Guzzino v. Felterman, 174 F.R.D. 59, 63 (W.D. La. 1997) (litigation need not necessarily be imminent as long as the primary motivating purpose behind the creation of the document was to aid in possible future litigation); Osterneck v. E.T. Barwick Industries, Inc., 82 F.R.D. 81, 87 (N.D.Ga. 1979).

litigation, and increase the workload of government law-enforcement agencies.[8]

In light of the fact that the DOJ had challenged two of the three legacy carrier mergers in the ten years preceding Delta/Northwest, counsel believed this position to be correct. This difference of opinion was never settled.

While the DOJ's challenges did not result in a re-review of the challenged documents or a production of those documents, addressing the issues raised by the DOJ, and particularly the automated program, required significant resources and threatened to divert the parties' attention from substantive issues late in the investigation. To avoid these potential issues in the future, we recommend engaging the DOJ staff early in the Second Request process to determine how it prefers parties to submit their logs, including the precise language the automated review program will look for when assessing different privilege claims.

Section III: When Are the Parties' Documents No Longer the Parties' Documents — CIDs to Outside Consultants

The Delta General Counsel's office retained Bain & Company on behalf of both airlines to assist with the integration planning process that was directed and led by the companies' top leadership and implemented by more than twenty working groups of executives. At the companies' request, Bain established and served as the host for an integration eRoom for both companies. The eRoom permitted the companies' executives to post drafts, preliminary integration plans, and projected figures for anticipated cost savings. Throughout the antitrust review process, but particularly beginning in late July, the integration planning process produced ever-more detailed and refined plans. These plans continued to be refined and updated through the close of the merger.

Counsel knew from the beginning that efficiencies would play a significant role in the DOJ's decision. The Second Request called for the parties to turn over the documents underlying their cost savings figures. The timing agreement called for the parties to produce a white paper on the parties' efficiencies claims and documents supporting the efficiency claims. The parties also promised to produce a final set of efficiency numbers and additional supporting documentation one month prior to the DOJ staff's decision date.

However, after the parties' response to the Second Request, and following submission of the initial white paper on efficiencies, the DOJ issued a Civil Investigative Demand directly to Bain seeking "documents in [Bain]'s possession custody or control," which included the contents of the integration eRoom. As this information post-dated the period covered by the Second Request it was not required to be produced by the parties in the Second Request response; in fact,

---

[8] Id. at 887.

most of these documents were created after the parties had complied with the Second Request.

As in all mergers, the cost savings figures continued to evolve as the companies worked with each other to plan the post-merger corporation. Much of the data and drafts in the eRoom were unintelligible without lengthy explanation from the integration teams. For this reason, the parties had produced to the DOJ relevant materials from the due diligence process and interim intelligible supporting documentation from the integration planning process, and had agreed to provide the final numbers and documents once planning was essentially completed. Under considerable time pressure, the DOJ sought to fill this gap in the production, and took the somewhat unusual step of demanding the parties' in-process, draft materials directly from Bain. The CID called for Bain (not the parties) to produce both documents prepared by Bain and documents prepared by Delta and Northwest employees and posted to the eRoom. This request sought documents that the DOJ could have requested directly from the parties through CID.[9]

The parties took the position that Bain was not in "control" of the documents, any more than a document-hosting e-discovery vendor is in control of documents provided to that vendor for a Second Request review by the parties. At the time of the request, Bain was acting as an agent of Delta (production of Bain's internal documents was not challenged by the parties except as to Bain's role as an agent of the parties). Delta and Northwest provided these documents for their own use and sharing on a site hosted by Bain. At no time did the parties submit these documents to the eRoom for Bain's use. The parties objected to this attempt to seek the parties' documents from what was, in effect, a document host and agent of the company. In lieu of Bain producing these documents, the parties offered to produce the documents from the eRoom voluntarily as they became complete (or at least intelligible).

The DOJ responded that the documents resided on Bain's computer system, which Bain set up and administered. Therefore, the DOJ viewed these documents as within Bain's custody or control, or at least in Bain's possession. As such, the DOJ asserted that Bain must produce these documents pursuant to the CID. The DOJ also stated that a voluntary production of the materials by the parties would be welcome, but would have no effect on Bain's obligation to produce the eRoom documents. The parties resolved the issue by permitting production of the materials by Bain following review by Bain's outside counsel. The parties simultaneously reviewed the documents as well, but this additional

---

[9] The DOJ issued CIDs to the investment banking firms that consulted on the deal as well, but this was not unusual. Most importantly, by the time CIDs were issued to the investment banks, the DOJ could be reasonably certain that the documents it received would not be unfinished or incomplete.

layer of review had no impact on the timing or substance of Bain's production to the DOJ.

While we believed our position on this issue to be correct, the time pressure of the Second Request review prevented us from challenging the CID. We also understand the DOJ's interest in and need to obtain key efficiency documents to complete its review. Because time pressures will always be present in any merger review, merging parties should weigh the benefits of utilizing third party consultants in light of the DOJ's apparent willingness to view them as separate entities subject to post-Second Request CIDs, rather than as agents of the merging parties. An additional concern is that the logic articulated by the DOJ to support seeking documents from Bain, as opposed to the parties, also would support, for example, seeking documents collected by a third party and housed on its system in preparation for a Second Request response.

Section IV: Looking for Sound Bites — the Effect of Private Litigation on Government Merger Review

On June 18, 2008, the Alioto Law Firm and Gray Plant Mooty Mooty & Bennett jointly filed suit against Delta and Northwest on behalf of 28 named plaintiffs seeking to enjoin the merger under Sections 7 and 16 of the Clayton Act. The complaint was filed in U.S. District Court for the Northern District of California, alleging that the merger would result in higher fares and reduced service due to increased concentration in a "national" airline market. The complaint also alleged that the national HHI would move from 1240 to 1509 because of the merger, which would supposedly facilitate collusion on prices and markets (notwithstanding the low HHIs). The suit further alleged that the transaction would precipitate additional mergers, a novel theory of antitrust harm.[10]

The private litigation immediately added complexity to the regulatory review and for a time procedurally complicated the parties' communications with the DOJ. Shortly after the parties made their Second Request production to the DOJ, the parties agreed to produce those same documents to the plaintiffs. In total, this amounted to more than 20 million pages of discovery. With the goal of closing the merger before the end of the year, the parties, the private plaintiffs, and the court agreed to a 10-day trial on the merits scheduled for November 2008. Only three months separated the date that the parties produced the Second Request materials to the private plaintiffs and the scheduled trial. In those three

---

[10] The Alioto Law Firm filed suit to block InBev's acquisition of Anheuser-Busch during the pendency of its suit against Delta and Northwest. That suit alleged that InBev was a potential entrant into the market and its entry would "probably lower prices or call to others not to increase their prices." The court denied a preliminary injunction in November 2008. See Ginsberg v. InBev, 2008 WL 4965859 (E.D. Mo. 2008).

months, the parties retained a testifying economic expert (Dennis Carlton of CompassLexecon), conducted depositions of 14 of the 28 named plaintiffs, and defended the depositions of multiple senior executives at Delta and Northwest.

The private complaint had an immediate chilling effect on the parties' ability to engage in substantive discussions with the DOJ. The purpose of a DOJ investigation is to determine whether a transaction presents a competitive problem, and DOJ staff has a long track record of bringing an objective and holistic approach to its analysis.[11] In contrast, private plaintiffs are focused exclusively on winning their case and are prepared to scrape together non-contextual evidentiary sound-bites to advance that cause. Because of the confidentiality provisions surrounding an HSR investigation, the merging parties have a high degree of confidence that their communications with the DOJ are secure. This facilitates engaging with the DOJ in relatively frank, unencumbered discussions on the issues. Once private litigation has commenced, however, merging parties are rightly wary of litigants' pursuit of derivative discovery to collect "purported" admissions or "alleged" positions or views of the government to support their case at trial.

For example, when engaging with the DOJ in discussions regarding the potential competitive effects of a merger, parties regularly would, in this limited context, accept points for the sake of argument that they in fact disputed in order to facilitate constructive dialogue on the issues. Because of the private suit, however, the parties in this merger had to exercise extreme caution to avoid creating even snippets or phrases that, cut and pasted out of context, could be characterized by the private plaintiffs as admissions of competitive harm. The plaintiffs could take any argument addressing specific concerns of the DOJ or any hypothesis about those concerns as admissions that the merger would have an anticompetitive effect, regardless of whether these were the parties' or the DOJ's ultimate belief or position. Thus, all white papers and advocacy pieces for the DOJ had to pass the exacting filter imposed by the need to guard against creating anything — even scattered phrases —that the plaintiffs' counsel could misuse.

The private litigation settled shortly before trial, and on the same day that the DOJ formally announced it would close its investigation of the merger.

Conclusion

The Delta/Northwest merger raised a number of significant issues concerning the steps to take during a DOJ merger review and how to handle a private suit while responding to a Second Request and submitting white papers to the DOJ. First, getting a timing agreement in place early can help the process

[11] Potential litigation by the DOJ also poses a risk to parties' open communication with the DOJ during its investigation. Thus, during any merger review, parties have to weigh the benefits and risks of relatively open discussions of economic theories and hypotheses with the DOJ.

move more quickly on both sides Second, in some reviews the DOJ may use a software program to challenge privilege claims. In these cases, it will aid both the parties and the DOJ to communicate on the exact verbiage the parties should use in privilege logs when asserting different types of privilege to ensure the logs will work with the program's filters.

Third, the government may take a narrow view of what documents qualify for work product protection. In our judgment, work product protection should apply to merger analysis conducted in anticipation of and during an HSR investigation, when the parties in the merger review have an objectively reasonable basis to believe that the investigation may result in a lawsuit. Moreover, while we understand that the DOJ may need to obtain documents from third-party consultants to the merging parties, we do not believe that issuing compulsory process to consultants retained by the merging parties to assist in the integration process is appropriate where those CIDs seek the parties' own documents. The extension of that logic could have significant consequences for companies subject to Second Requests who, for example, use e-discovery vendors for their collection, review, and production. If the DOJ decides to seek integration, efficiency, and other materials not covered by the Second Request, we hope they will seek these documents directly from the parties.

Finally, we note that despite the challenges and issues that inevitably arise during a significant Second Request review, by adhering steadfastly to all set deadlines, parties can successfully navigate the complexities of an exhaustive merger review process to meet their timing and outcome objectives.

[top]

Summary of ABA Brown Bag Program : "The Use of Price Effects Evidence in Consummated Merger Analysis"

David E. Altschuler

On February 26, 2009, the ABA Antitrust Section's Mergers & Acquisitions Committee and Healthcare & Pharmaceuticals Committee jointly sponsored a brown bag program to discuss the use of actual anticompetitive effects evidence in consummated merger analysis. The panel consisted of Mark J. Botti, a partner at Akin Gump Strauss Hauer & Feld LLP; Joseph Miller, Assistant Chief of the Litigation I Section in the Antitrust Division of the U.S. Department of Justice; and Gregory Vistnes, Vice President of Charles River Associates. Dionne Lomax, a partner at Vinson & Elkins LLP, moderated the discussion.

Actual Effects Evidence: A Legal Primer

Mr. Botti began the discussion by presenting an overview of the law regarding the use of actual competitive effects evidence in consummated merger analysis. He started by noting that the text of Section 7 of the Clayton Act[1]—which refers to acquisitions whose effects may "substantially…lessen competition" — does not accurately describe the state of the law with respect to actual effects. He explained that when courts and enforcement agencies examine "actual effects" under Section 7, they are not merely looking to see whether any competition has been lost, but rather, they are concerned with the effects that flowed from this loss to competition.

Mr. Botti highlighted some examples of courts and the enforcement agencies attempting to define the effects that are of concern. For example, in *United States v. Archer-Daniels-Midland Co.*, the Eighth Circuit explained that "[t]he lawfulness of an acquisition turns on the purchaser's potential for creating, enhancing, or facilitating the exercise of market power—the ability of one or more firms to raise prices above competitive levels for a significant period of time."[2] The DOJ/FTC Merger Guidelines, meanwhile, state that the exercise of market power that is of Section 7 concern is the ability of a seller to "profitably maintain prices above competitive levels for a significant period of time."[3]

David E. Altscheler *is an associate at Akin, Gump, Straus, Hauer & Feld LLP*

[1] 15 U.S.C. § 18.

[2] 866 F.2d 242, 246 (8th Cir. 1988).

[3] U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines (Apr. 2, 1992, rev. Apr. 8, 1997).

Mr. Botti then posed three key questions with respect to actual effects evidence and discussed how courts and the enforcement agencies have answered them.

First, in the consummated merger context, is a party *required* to show "actual effects" to prove a Section 7 violation? Mr. Botti contended that the answer to this question was pretty clearly no; proving a violation through a traditional market structure analysis suffices. Mr. Botti suggested that the Supreme Court's decades-old statement in *United States v. General Dynamics Corp.* that evidence of post-acquisition anticompetitive effects is not necessary to prove a Section 7 violation remains the law.[4] The agencies, for their part, seem to agree; in the Federal Trade Commission's 2006 challenge in *Hologic*, for example, the complaint pleaded a Section 7 "merger to monopoly" claim without relying on actual post-merger price effects and the FTC ultimately obtained relief.[5]

Second, *may* a party use proof of actual effects in support of their Section 7 claim? Here, Mr. Botti asserted that the answer was pretty clearly yes, though the question has not been addressed too directly by the enforcement agencies or the courts. Mr. Botti highlighted the DOJ's 2008 complaint in *United States v. Microsemi*, which pleaded a Section 7 violation based on a market structure analysis, but also cited several post-acquisition actual effects—including non-price effects—in further support of its claims.[6] He cautioned, however, that it was not clear that actual effects evidence would always prove persuasive to a court in a litigated case. For example, in the Sixth Circuit's 2005 decision in *United States v. Dairy Farmers of America, Inc.*, a case involving a partial acquisition, the court noted that "there is certainly no requirement that the anticompetitive power manifest itself in anticompetitive action before § 7 can be called into play."[7] Despite the fact that there was strong actual effects evidence, the court focused mostly on market structure analysis.

Third, may a litigant show *only* actual effects and sustain a Section 7 claim? With respect to the enforcement agencies, Mr. Botti contended that the DOJ appears to believe that actual effects alone can sustain a claim, pointing to

---

[4] 415 U.S. 486, 505 (1974). The Court explained that "the fact that no concrete anticompetitive symptoms have occurred does not itself imply that competition has not already been affected, for once the two companies are united no one knows what the fate of the acquired company and its competitors would have been but for the merger." *Id.* (internal quotation marks omitted). The Court stressed that Section 7 "deals in probabilities, not certainties" and that "the mere nonoccurrence of a substantial lessening of competition in the interval between acquisition and trial does not mean that no substantial lessening will develop thereafter…." Id.

[5] See generally Complaint, In re Hologic, Inc., FTC File No. 0150263 (F.T.C. July 7, 2006).

[6] See Complaint, United States v. Microsemi Corp., No. 1:08-cv-1311-AJT-JFA (E.D. Va. Dec. 18, 2008).

[7] 426 F.3d 850, 858 (6th Cir. 2005).

United States v. UPM-Kymmene Oyj[8] and *United States v. Oracle Corp.*[9] As for the FTC, Mr. Botti noted that the agency seemed to agree when it originally brought its post-merger challenge in *In re Evanston Northwestern Healthcare Corp.*,[10] but appeared to back off this approach as the case progressed.

The courts, meanwhile, have not provided a clear answer. Nonetheless, Mr. Botti believed that a court would sustain a Section 7 claim based solely on actual effects where there was no dispute that there had been an exercise of market power—for example, a sustained increase in price—after the consummation of the merger.

Analyzing Post-Merger Actual Effects Evidence

With the background law on the table, Mr. Vistnes turned to a discussion regarding the need to carefully scrutinize evidence of a post-merger price increase to determine its cause. Generally speaking, Mr. Vistnes noted that a post-merger price increase is most often explained by the merger's removal of the price disciplining force of competitors and the merged firm's exercise of market power. However, he suggested that a careful review of the reasons for a post-merger price increase can often turn up alternative non-market power-based explanations.

Mr. Vistnes offered two examples where a post-merger price increase might be not be the product of the merged firm's exercise of market power. First, he suggested that a post-merger price increase might be caused by the merged firm's exercise of *existing* market power. Although the notion that firms have market power that they do not choose to exercise is generally "an anathema" to economists, Mr. Vistnes contended that it was a potential explanation that parties and their economists should not overlook.

Second, Mr. Vistnes asserted that a post-merger price increase could be the product of the merger causing a change in any number of the merged firm's incentives or expectations. For example, the merger could result in the installation of a new management team with different revenue generating priorities or expectations about competition.

Mr. Vistnes then highlighted specific cases where there were potential arguments that a post-merger price increase was not caused by the exercise of market power. In *Evanston Northwestern*, for example, there were at least two such arguments. First, the post-merger price increases alleged by the FTC could have been the product of the merged firms learning more about market demand and concluding that it was stronger than they had previously believed.

---

[8] 2003-2 Trade Cas. (CCH) ¶ 74,101 (N.D. Ill. 2003).

[9] 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

[10] See, e.g., Complaint, In re Evanston Northwestern Healthcare Corp., Docket No. 9315 (F.T.C. Feb. 10, 2004).

Alternatively, the price increase might have been the product of advice from outside consultants that the merged firm retained who suggested that such a price increase was feasible.

Mr. Vistnes next turned the FTC's recent challenge in *Ovation Pharmaceuticals*. The FTC's complaint in *Ovation* alleged violations of Section 7 of the Clayton Act and Section 5 of the FTC Act in connection with Ovation's 2006 acquisition of the rights to a drug (NeoProfen) that was poised to receive FDA approval and compete with Ovation's dominant drug for the treatment of a congenital heart defect in infants (Indocin).[11] In support of both claims, the FTC highlighted the fact that immediately after acquiring NeoProfen, Ovation increased the price for Indocin by 1,300 percent.[12]

Mr. Vistnes noted that the FTC's theory of the case was that Ovation was a monopolist and that it acquired NeoProfen in an attempt to illegally maintain its monopoly, continue charging monopoly prices, and prevent NeoProfen from entering the market. However, the actual effects evidence—the 1,300 percent price increase—suggested that Ovation had not, in fact, been charging monopoly prices prior to the NeoProfen acquisition even though it was a monopolist.

Mr. Vistnes noted that FTC Commissioners Rosch and Leibowitz attempted to address this issue in concurring statements they filed in connection with the FTC's complaint. In the statements, the commissioners argued that Merck, who had owned the rights to Indocin before Ovation's acquisition in August 2005 and who had enjoyed a monopoly for many years prior, could not charge a monopoly price because it faced reputational constraints. Specifically, Merck had a large portfolio of drugs that were more profitable than Indocin and could not risk damaging its reputation by charging monopoly prices for a drug for premature babies. [13] Only when Ovation, which did not face these reputational constraints, acquired the drug could the price of the drug be profitably increased to monopoly levels. This price increase was still in progress when Ovation purchased the rights to NeoProfen from Abbott just four months later in order to preserve its monopoly power.

According to Mr. Vistnes, such a theory was not altogether different than the explanation that a post-merger price increase was caused by the installation of a new CEO at the top of a merged company. Mr. Vistnes contended that, at bottom, an increase in price caused by the removal of the "reputational" constraint was not a price increase caused by the exercise of market power and/or the loss of

---

[11] See Complaint, Fed. Trade Comm'n v. Ovation Pharm., Inc., No. 08-cv-6379 (D. Minn. Dec. 16, 2008).

[12] Id.

[13] See Concurring Statement of Commissioner J. Thomas Rosch, Federal Trade Commission v. Ovation Pharm., Inc., FTC File No. 0810156 (Dec. 16, 2008), available at http://www.ftc.gov/os/caselist/0810156/081216ovationroschstmt.pdf.

the price disciplining effect of competitors. The actual affects evidence therefore did not support the Section 7 claim in the traditional sense.

An Enforcer's Perspective

Next, Mr. Miller offered his perspective on the use of actual affects evidence from his vantage point at the DOJ Antitrust Division.[14] Because most of the Antitrust Division's time is spent investigating possible Section 7 violations rather than litigating them, Mr. Miller focused his presentation on the consideration of actual effects during the investigation phase.

Mr. Miller explained that in the consummated merger context, an investigation usually begins with a customer complaint about a price increase. Upon receiving the customer complaint, the DOJ will try to determine if there is an obvious non-market power-related explanation for the price increase such as inflation or an increase in the cost of inputs. Mr. Miller noted that this is a "quick and dirty" exercise by DOJ economists that does not reach the level of detail or subtlety discussed by Mr. Vistnes. At the same time this preliminary economic analysis is conducted, the DOJ also tries to collect and analyze other types of evidence that would corroborate the exercise of market power such as intent evidence.

In order to stave off a lengthier investigation, Mr. Miller suggested that it was critical for the merged firm to come forward with an explanation for the price increase that was not market-power related. If a respondent did not do so and the DOJ was unable to find one on its own, the investigation would likely continue and be allocated resources.

Once the Division decides to conduct a more robust investigation, how quickly and extensively the case proceeds to litigation turns largely on whether the underlying transaction was HSR reportable. Mr. Miller noted that in many non-reportable transactions, there is often a need for the DOJ to act quickly because of concern about preserving an effective post-merger remedy. This need can translate into a less rigorous or nuanced assessment of the economic issues and a lower overall certainty of success on the merits prior to a complaint's filing than in the HSR context. Mr. Miller noted, however, that the need to move quickly varies case-by-case; if assets can be divested relatively easily post-transaction, for example, the necessity of racing to the courtroom is diminished.

Additional Issues

With their presentations complete, the panelists raised and addressed numerous additional issues related to the use of actual effects evidence.

[14] Mr. Miller made clear that the views he expressed were his own and were not the views of the Department of Justice.

Mr. Botti highlighted the difficulties of determining how a court is to interpret and scrutinize actual effects evidence. For example, he noted that in *Microsemi*, the DOJ pointed to evidence of post-merger service problems and delays in support of its Section 7 claim. However, these service problems could be the product of the merger's poor implementation, not the exercise of market power. Would a court consider such an argument and, if so, how? Mr. Botti was not sure. Similar difficulties exist in the monopsony context: if the merged firm is successful in obtaining lower prices from suppliers after the merger, for example, will this automatically be evidence of a Section 7 violation or will courts actually scrutinize why the merged firm was able to obtain these lower prices?

Mr. Vistnes suggested that one way to increase confidence in actual effects evidence in a particular case is to corroborate such evidence with a traditional market structure analysis. Indeed, even if evidence of actual price effects is theoretically sufficient to prove a Section 7 violation, Mr. Vistnes contended that the better practice would be to present a market structure analysis as well.

Mr. Miller then turned to the issue of whether a post-consummation merger case can be brought without evidence of actual effects. He claimed that although actual price effects evidence is often an important consideration in bringing and sustaining a Section 7 claim, it is not a requirement for getting a complaint out of the agency or winning a case in court. Mr. Miller noted that there could be many reasons why actual price effects evidence might not exist in a particular case. For example, the merged parties maybe did not have enough time to exercise market power at the time of the challenge, or perhaps made a conscious decision not to immediately exercise it because of an awareness that the enforcement agencies would be monitoring their post-merger conduct.

When actual price effects evidence is available, Mr. Miller noted that price discrimination issues often arise. He suggested that it was not unusual to find that a firm with market power simultaneously raised prices to customers that have inelastic demand while maintaining prices at competitive levels for customers with less inelastic demand. Mr. Miller questioned whether there was a need to examine the overall welfare effects of a merger in such cases and cautioned that calibrating the balance too finely creates the threat of underenforcement. He suggested that where the DOJ can prove that there has been some actual harm to consumers, the defendant bears a heavy burden of persuasion to establish that there are other causes for the price increases.

Mr. Botti responded that Mr. Miller's suggested burden shifting framework might be too complicated. He contended that one should be able to look at all of a merged firm's customers, determine what percentage have faced a price increase, and act accordingly. At bottom, Mr. Botti suggested that the issue with actual price effects was pretty simple: was there a post-merger price increase overall and was this price increase substantial?

The panelists were then asked about Mr. Vistnes's point that a post-merger price increase might be caused by the merged firm simply "learning about demand" and whether this could be a plausible defense. Mr. Vistnes maintained that a merger improves information and that it is perfectly rational to expect that the increase in information would lead to a higher price. He observed that the FTC in *Evanston Northwestern* plainly disagreed with his contention.

Mr. Vistnes noted the disconnect between a firm "learning about demand" outside the merger context—which allows the firm to increase prices without fear of liability—and "learning about demand" in connection with a merger, which can trigger a potential Section 7 challenge upon a price increase. He underscored the fact that in the latter case, the price increase is not caused by an increase in market power. Mr. Miller cautioned that a post-merger price increase can simultaneously be caused by "learning about demand" *and* by the exercise of market power and that, when both are causes, the acquisition still runs afoul of Section 7.

The panel concluded with a question to Mr. Miller regarding at what point in time actual effects are measured and whether there was a "rule of thumb" regarding how long the DOJ would wait before bringing a case. He responded that where there was a concern that the transaction would result in anticompetitive harm that had not yet transpired, the DOJ should not wait for the actual effects to occur before bringing a case. He stressed that there was a "premium" on acting early where an enforcement action could preserve an effective post-merger remedy.

Mr. Botti noted that the law is clear that one can bring a Section 7 claim many years after a transaction has been completed. He observed, however, that the actual effects analysis becomes more complicated with the passage of time because there can be subsequent changes in market conditions that can make it more difficult to determine whether the actual effects at issue were caused by the exercise of market power gained from the merger.

[top]

Post-Close Caution: Antitrust Agencies Challenge Two Consummated Mergers

Scott A. Sher and Valentina V. Rucker*

In the last two weeks of 2008, the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ") brought two significant challenges to consummated mergers.[1] On December 16, 2008, the FTC challenged Ovation Pharmaceuticals' ("Ovation") 2006 acquisition of the drug NeoProfen (used for treatment of a congenital heart defect affecting premature infants) from Abbott Laboratories.[2] Two days later, the DOJ challenged Microsemi Corporation's ("Microsemi") 2008 acquisition of Semicoa Inc. ("Semicoa").[3] Microsemi and Semicoa both developed, manufactured and sold certain specialized electronic components—signal transistors and diodes[4]—used in military and space programs.

Scott A. Sher and Valentina V. Rucker *are a partner and an associate, respectively, in the Washington, DC office of Wilson, Sonsini, Goodrich & Rosati*

---

[1] On February 26, 2009, the Federal Trade Commission brought another consummated merger challenge, alleging that Lubrizol Corp.'s 2007 acquisition of the oxidate assets of Lockhart Co., a rival firm, violated the antitrust laws and lessened competition in the U.S. market for chemical rust inhibitors. Pursuant to a consent order, Lubrizol agreed to (a) sell the oxidate assets it acquired from Lockhart to third party Additives International LLC (AI) and (b) eliminate a non-compete provision contained in the original asset purchase agreement with Lockhart. Complaint, In re Lubrizol Corp. & Lockhart Co., No. 071 0230 (F.T.C. Feb. 26, 2009), available at http://www.ftc.gov/os/caselist/0710230/090226lubrizolcmpt.pdf; Order, In re Lubrizol Corp. & Lockhart Co., No. 071 0230 (F.T.C. Feb. 26, 2009), available at http://www.ftc.gov/os/caselist/0710230/090226lubrizoldo.pdf.

[2] Complaint, FTC v. Ovation Pharmaceuticals Inc., No. 08-cv-06379-JNE-JJG (D. Minn. Dec. 16, 2008), available at http://www.ftc.gov/os/caselist/0810156/081216ovationcmpt.pdf. It is worth noting that the State of Minnesota filed its own similar action the same day. Minnesota v. Ovation Pharmaceuticals Inc., No. 08-cv-06381-JRT-FLN (D. Minn. Dec. 16, 2008).

[3] Complaint, United States v. Microsemi Corp., No. 1:08 CV 1311 (E.D. Va. Dec. 18, 2008), available at http://www.usdoj.gov/atr/cases/f240500/240537.htm [hereinafter Microsemi Complaint]. The DOJ also filed a memorandum in support of emergency motion for a temporary restraining order and preliminary injunction, which resulted in an Order to Preserve and Maintain Assets on December 24, 2008. Order to Preserve and Maintain Assets, United States v. Microsemi Corp., 1:08 CV 1311 (E.D. Va. Dec. 24, 2008).

[4] "Transistors and diodes are semiconductor devices used to control the flow of electric current . . . transistors can be viewed as switches and diodes can be viewed as one-way valves. Both products begin as silicon wafers . . . [and] are then cut into small sections known as dies. These dies are packaged . . . into transistors and diodes." Microsemi Complaint at ¶10.

Neither transaction was reportable under the Hart-Scott-Rodino Act ("HSR Act").[5] Nonetheless, the enforcement agencies have the authority to review and challenge already consummated mergers, even though enforcement actions in such circumstances are relatively uncommon.[6] These two consummated merger challenges raise a significant question: were the facts of the two cases such that post-consummation review (and a subsequent challenge) was unavoidable, or did the parties' voluntary and avoidable actions cause the government agencies to act where they otherwise would not have?

Below, we describe the facts and the complaints from the *Ovation* and *Microsemi* cases, and make several modest points about the importance of careful post-close counseling—even where transactions are not subject to HSR Act review.

FTC v. Ovation Pharmaceuticals, Inc.

In *Ovation*, the FTC's complaint alleges that in August 2005, Ovation initially purchased rights to Indocin from Merck & Co. ("Merck"). At that time, Ovation did not compete against Merck in the market for therapies to treat a serious congenital heart defect in premature infants, known as patent ductus arteriosus ("PDA"). Merck agreed to manufacture Indocin and supply it to Ovation. Upon acquiring the rights to Indocin from Merck, Ovation raised the price of Indocin from approximately $26 to $36 per vial. The complaint alleges that "the price at which Merck supplied Indocin to Ovation was a small fraction of the $36 per vial that Ovation had previously charged for Indocin."[7]

Subsequently, in 2006, Ovation acquired NeoProfen, another PDA drug that was awaiting FDA approval at the time, from Abbott Laboratories. After the sale was finalized, Ovation raised the price of Indocin from $36 to approximately $500 a vial (a price increase of nearly 1,300 percent) and set the price of NeoProfen at approximately $483 per vial, once it had obtained FDA approval. Ovation then maintained these prices at or above the $500 level for several years.

According to the FTC's complaint, Ovation anticipated that NeoProfen's eventual approval by the FDA would reduce sales of Indocin, prompting Ovation to acquire NeoProfen from Abbott Laboratories.

The complaint further alleges that entry into the PDA market is difficult. The FTC's complaint contends that any future competitor of Ovation would need

---

[5] Hart-Scott-Rodino Antitrust Improvements Act of 1976, Pub. L. 94-435, 90 Stat. 1383 (1976) (current version at 15 U.S.C. § 18a (2008)).

[6] Clayton Act § 7, 15 U.S.C. § 18 (2008).

[7] Complaint at ¶19, FTC v. Ovation Pharmaceuticals Inc., No. 08-cv-06379-JNE-JJG (D. Minn. Dec. 16, 2008), available at http://www.ftc.gov/os/caselist/0810156/081216ovationcmpt.pdf [hereinafter Ovation Complaint].

to have its drug approved by the FDA in order to be sold in the United States, and that obtaining FDA approval is "a costly and time consuming process that takes substantially more than two years." Entry by a generic version of an existing drug product requires a manufacturer to develop and obtain FDA approval for the generic product as well. Although the FDA approved a generic version of Indocin in July 2008, to date, it has not entered the market.

Furthermore, characteristics of the market for PDA drugs also make entry unlikely. There are only approximately 30,000 infants affected by the illness, so the PDA drug therapy market is small relative to other pharmaceutical product markets.[8] Additionally, the patient population is "exceedingly fragile," so any new entrant will also have to overcome physicians' preferences.[9] Physicians who treat premature infants with PDA would have to forgo the use of a trusted product, used successfully (presumably) in the past, in favor of one that lacks such a history and may present unknown risks. Thus, the FTC posits, any savings gained by the use of a competitor's product would have to outweigh any risk that such use of an unfamiliar product on infants with severe illnesses would present.

Although the Commission unanimously approved the challenge to the NeoProfen acquisition—on the basis that the acquisition of NeoProfen eliminated a competitive price constraint on Ovation's pricing of Indocin—Commissioners Leibowitz and Rosch issued separate concurring statements stating that Ovation's earlier acquisition of Indocin from Merck should be challenged under Section 7 as well.[10] Specifically, Commissioner Rosch offered a novel theory, arguing that conduct that amounted to "evading a pricing constraint" was enough to incur liability for "tending to create a monopoly." He asserted that, when Merck was the owner of Indocin, it was unable to charge monopoly prices on Indocin because "the sale of Indocin at a monopoly price would damage [Merck's] reputation and sales of more profitable products." When Ovation purchased Indocin, it "had [in] effect . . . enabl[ed] Ovation to exercise monopoly power in its pricing of Indocin."[11] Commissioner Rosch made this contention even though, of course,

---

[8] Id. at ¶33.

[9] The FTC Complaint did not explain whether NeoProfen faced this barrier, but rather simply alleged that Indocin and NeoProfen are the only two FDA-approved drugs and physicians and hospitals consider them to be substitutes, or reasonable substitutes, for the majority of PDA patients.

[10] Concurring Statement of Commissioner J. Thomas Rosch, Federal Trade Commission v. Ovation Pharmaceuticals, Inc., available at http://www.ftc.gov/os/caselist/0810156/081216ovationroschstmt.pdf; Concurring Statement of Commissioner Jon Leibowitz, Federal Trade Commission v. Ovation Pharmaceuticals, Inc., available at http://www.ftc.gov/os/caselist/0810156/081216ovationleibowitzstmt.pdf.

[11] Concurring Statement of Commissioner J. Thomas Rosch, Federal Trade Commission v. Ovation Pharmaceuticals, Inc., available at http://www.ftc.gov/os/caselist/0810156/081216ovationroschstmt.pdf.

Ovation *did not* raise the price of Indocin to extreme price levels *until after* it acquired the rights to NeoProfen, as well.

United States v. Microsemi Corp.

In *Microsemi*, the DOJ's complaint alleged that before Microsemi's acquisition of Semicoa in July 2008, both companies manufactured small signal transistors certified by the Defense Supply Center Columbus ("DSCC"), a unit of the Department of Defense, at the Joint Army-Navy Technical Exchange-Visual Inspection ("JANTXV") and Joint Army-Navy Space ("JANS") levels of reliability on its qualified manufacturers list ("QML").[12] Further, Semicoa was positioning itself to manufacture and sell JANTXV and JANS diodes.[13]

The DOJ's complaint further asserted that as a result of Microsemi's acquisition of Semicoa, "prices for the relevant products have increased and likely will continue to increase."[14] The complaint specifically alleged that, without Semicoa as a competitor to Microsemi in the signal transistor market, Microsemi was able to selectively raise prices—*i.e.,* price discriminate—to customers it was aware could not substitute to lower grade components.[15] "One month after the acquisition, Microsemi warned the Department of Defense and the National Aeronautics and Space Administration ("NASA") to expect annual price increases in the 'lower teens.'"[16] Further, the CEO of Microsemi was quoted as stating: "I raised the prices because, simply, we could."[17]

The DOJ alleged that Microsemi's business strategy permits price discrimination against customers who require JANS products and would not be able to practically and cost-effectively switch to lower-grade products and perform their own testing in order to achieve the reliability built into a JANS qualification. Microsemi is "often aware of the individual projects for which . . . customers are seeking JANS components . . . [and] has even considered developing individualized sales strategies tailored to each customer."[18] With this

---

[12] Department of Justice, Press Release, Justice Department Files Antitrust Lawsuit Against Microsemi Corporation: Lawsuit Seeks to Restore Competition in Markets for Semiconductor Devices Used in Critical Military and Space Applications (2008) http://www.usdoj.gov/atr/public/press_releases/2008/240549.htm.

[13] Id.

[14] Microsemi Complaint at ¶3. The DOJ additionally alleged that "delivery times have become less reliable, and terms of service likely will become less favorable." Id.

[15] Id.

[16] Memorandum of United States in Support of Emergency Motion for a Temporary Restraining Order and Preliminary Injunction, United States v. Microsemi Corp., No. 1:08 CV 1311, 4 (E.D. Va. Dec. 18, 2008) (citing P. Ex. 20, Sampson Decl. ¶ 10.) [hereinafter Microsemi Memorandum in Support of TRO].

[17] Id.

[18] Id. at 10.

degree of customer awareness, Microsemi could profitably increase prices to only those customers who could not substitute.

The Complaint alleges that Semicoa was close to entering the diodes market and would have been a significant competitor to Microsemi: "Semicoa's entry into the market . . . likely would have benefited customers with lower prices, shorter delivery times, and more favorable terms of service, just as Semicoa's competition for sales of . . . small signal transistors benefited customers for those products."[19] Microsemi's acquisition of the Semicoa assets prevented this entry and therefore substantially lessened competition in the markets.

As in *Ovation,* the complaint alleges that entry was difficult. According to the DOJ, the market for the development, manufacture and sale of high reliability transistors and diodes is characterized by high entry barriers. These high reliability transistors and diodes are manufactured to exacting standards to ensure high performance under the most demanding conditions and are subject to a U.S. government system of qualification and certification to assure the required degree of reliability.[20]

Qualification includes a rigorous audit of a firm's production, assembly and testing facilities. Only if this audit requirement is satisfied can a company manufacture a sample lot of the product. And then, only if the testing of the lot is satisfactory can the company obtain a QML status. This process usually takes three to twelve months for a company that previously has QML qualified at least one of its products, and even longer if the company has never held such a qualification. The DOJ further notes that after achieving QML, "[q]ualifying to produce JANS parts takes additional time, effort, and money above that which is required to obtain qualification for lower-level QML parts."[21] Thus, "[e]ntry resulting in significant market impact likely would take more than two years."[22]

Importance of Post-Consummation Counseling

A few valuable lessons should be drawn from the *Ovation* and *Microsemi* challenges. Counsel should remind their clients that there is no "statute of limitations" on a merger challenge. In close cases, the agencies may decide not to challenge a transaction before consummation because they are not confident that the evidence supporting the likelihood of post-merger harm would be sufficient to persuade a court to enjoin the transaction. In some cases, a novel theory of harm may be deemed too speculative to pursue. Once a transaction is consummated, although market dynamics—*i.e.* eliminating a potential competitor, market share

---

[19] Microsemi Complaint at ¶42.

[20] Id. at ¶10.

[21] Microsemi Memorandum in Support of TRO at 4 (citing P. Ex. 20, Sampson Decl. ¶ 10.).

[22] Microsemi Complaint at ¶43.

increase, or high entry barriers—cannot be controlled by the acquiring company, post-merger conduct is in its sole discretion. When a firm implements post-merger price increases, the agencies' concerns are validated and the decision to take action becomes easier.

For these reasons, careful counseling concerning *post-merger* conduct is particularly important, as it can decrease the risk of a consummated merger challenge. In providing this advice, counsel should keep in mind the following issues:

First, dramatically rising prices will invite scrutiny and a potential challenge, even years after a transaction has closed, and even if the transaction was subject to an HSR review. This is especially the case in industries where cost containment is a high policy priority, as it is with healthcare and government spending. Although price changes could have nothing to do with the attainment of market power, a price increase following a merger may give customers ample reason to complain to the antitrust agencies and bring a transaction to the attention of the government, when the transaction otherwise might not have invited (or deserved) any scrutiny.

Indeed, although evidence of a price increase post-merger should not be sufficient to show an anticompetitive effect (and indeed, may not be evidence of such an effect),[23] it certainly can bring a transaction to the attention of the government agencies. In *Ovation,* the defendant raised prices by 1300 percent. In *Microsemi*, the defendant proposed significant price increases to select customers. To make matters worse, in both cases, the defendants raised prices to vocal and/or particularly vulnerable populations. Specifically, in *Microsemi*, the products acquired by Microsemi from Semicoa were used by the U.S. military services and the national security agencies in a wide range of applications. The DOJ's complaint and request for a hold separate agreement was accompanied by statements from customers for the high-reliability semiconductors at issue, including the Department of Defense, the United States Navy, the United States Air Force, and NASA.[24] Because transistors and diodes made by both Microsemi and Semicoa were used in large and complex military applications, including

---

[23] United States v. Archer-Daniels-Midland Co., 781 F. Supp. 1400 (S.D. Iowa 1991) (exclusively relying upon evidence concerning the post-close market structure and ignoring the behavioral evidence, including evidence of price increases or output reductions); see also United States v. Syufy Enters., 903 F.2d 659, 664, 666-67 (9th Cir. 1990) (relying on post-acquisition market structure—rather than on post-acquisition behavior—to conclude that a transaction did not raise competitive concerns); Complaint at 2, In re Lubrizol Corp. & Lockhart Co., No. 071 0230 (F.T.C. Feb. 26, 2009), available at http://www.ftc.gov/os/caselist/0710230/090226lubrizolcmpt.pdf (relying on the post-merger structure of the market, rather than behavioral issues, such a price changes, to support FTC complaint).

[24] Microsemi Memorandum in Support of TRO at 4 (citing P. Ex. 20, Sampson Decl. ¶ 10.) ("One month after the acquisition, Microsemi warned the Department of Defense and the National Aeronautics and Space Administration . . . to expect annual price increases in the 'lower teens.'").

satellites and submarines, when Microsemi raised the price to these government entities after the transaction closed, it alarmed important government constituencies, whose complaints carry special weight at the DOJ.

In *Ovation*, the facts were arguably even worse. The defendant raised the prices of critical prenatal medications to extraordinarily high levels. The price hike affected not only a vulnerable subset of the population, but also put further strain on the U.S. healthcare system. The FTC noted that "the artificially high prices that hospitals are forced to pay ultimately raise costs for families, tax-supported programs such as Medicaid, and other public and private purchasers."[25] In addition, the FTC alleged that Ovation's acquisition of NeoProfen raised cost to "federal and state agencies, [who] pay for drugs to treat PDA"[26] Notably, Commissioner Leibowitz, in his concurring opinion wrote: "Ovation's behavior is a stark reminder of why America desperately needs health care reform . . . ."[27]

At a minimum, the two cases illustrate that in concentrated markets, post-close price increases of significant magnitude will draw the attention of the agencies, particularly where prices are raised immediately following the closing of the transactions, and the customers paying those prices are important and vocal constituencies. Especially where price increases are unrelated to the exercise of market power, decisions to change the prices of products and/or services must be weighed against the potential that affected customers will complain to the antitrust authorities.

Of course, price increases, standing alone, are not themselves illegal. More than a price increase is needed to make out a case under Section 7 of the Clayton Act.[28] There must be a causal connection between the price increases and the merger in question. Predicting whether and how a merger may lead to higher prices is often difficult to do. However, where, as in the *Ovation* and *Microsemi* cases, market concentration is high, the merger removed an actual or potential competitor, and entry barriers are high, the agencies (and courts) are likely to infer such a causal connection.

---

[25] Ovation Complaint at ¶4.

[26] Id.

[27] Concurring Statement of Commissioner Jon Leibowitz, Federal Trade Commission v. Ovation Pharmaceuticals, Inc., available at http://www.ftc.gov/os/caselist/0810156/081216ovationleibowitzstmt.pdf.

[28] See Scott A. Sher, Closed but Not Forgotten: Government Review of Consummated Mergers Under Section 7 of the Clayton Act, 45 Santa Clara L. Rev. 41, 78 (2004).

> When considering post-acquisition evidence in a challenge to a closed merger, the courts and antitrust agencies cannot solely rely on evidence that following a merger, prices have increased, that the pace of innovation has slowed, or that output has decreased . . . . [T]he scope of admissible evidence must be extremely narrow and demonstrate that (1) any alleged anticompetitive effects are caused by a merger, rather than by subsequent and unrelated changes in the market, and (2) such effects are not merely short-term, transitory concerns.

Second, corporate communications are an important vehicle by which to inform customers about the effects and benefits of transactions, and customer messaging must carefully be considered. As in any pre-merger counseling context, in the post-merger context, companies must be aware of the content of the documents that they create, and recognize that such documents may end up in the hands of the DOJ or FTC, and serve as the basis to investigate and/or challenge even consummated transactions. The need for antitrust counsel to be involved in the creation of deal collateral, therefore, is important, and must not be ignored simply because a transaction did not require HSR reporting.

Third, the acquirer must be sensitive to its new customers' concerns, as these customers could be at the forefront of the enforcement agency's case. "Wronged" customers are more likely to provide affidavits and, if necessary, testimony to assist the enforcement agencies in building their cases. Thus, customer relations should be addressed with special care. Where the firm plans an eventual price increase, it is advisable to forewarn the customers and fully disclose the reasons for a price change and any benefits associated with such changes. For example, if the acquired product has been integrated into acquirer's products, adding value and improving the customer experience, these benefits should be fully communicated to customers before any price changes are effectuated.

Finally, if customer complaints are unavoidable, counsel should urge clients not to retaliate against complaining customers. In *Microsemi*, the defendant's threat of post-closing retaliation no doubt strengthened the government's hand in that case. As noted in the complaint: "Microsemi has already implemented significant price increases on the products sold to at least one major aerospace manufacturer and, moreover, has threatened to retaliate against that same customer for cooperating with the Department of Justice's investigation of the acquisition."[29]

Post-close counseling has become increasingly important as the HSR thresholds continue to rise (as of February 2009, the size-of-transaction threshold has reached $65 million), and as company valuations decline below that increasing threshold. Companies must consider the possibility of antitrust intervention in their post-close conduct, and plan accordingly. Particularly in concentrated markets, the specter of post-close review and challenge is significant. The risk of remedy is borne completely by the acquiring party, and the remedy in such circumstances often is divestiture of the businesses acquired, frequently at below-market prices (because purchasers know the assets must be sold to satisfy the government). In light of these significant risks, it is not only prudent, but vital, to make post-close planning a key part of evaluating and executing important acquisitions.

---

[29] Microsemi Memorandum in Support of TRO at 4 (citing P. Ex. 22, Bartmann Decl. ¶¶ 9, 16.).

[top]

Trends in FTC Merger Enforcement: Assessing the Most Recent Data

Michael L. Keeley, Russell M. Steinthal and Irina C. Rodríguez

On December 1, 2008, the Federal Trade Commission released the latest in a series of welcome reports providing empirical data on the Commission's horizontal merger investigations, which are now available for Second Requests issued during fiscal years 1996-2007 (i.e., from October 1, 1995 to September 30, 2007). In this article, by comparing the statistics released by the FTC in its December 2008 report with those contained in the previous report in the series, issued in January 2007, we report and comment on the newest available data, which covers the period from October 2005 through September 2007.

Reviewing the FY 2006 and FY 2007 Data

The FTC issued 58 Second Requests in fiscal years 2006 and 2007, 31 of which led to fully completed investigations. (An additional 16 filings were withdrawn by the parties before the Commission's investigation was concluded, and 11 were closed after a "quick look.") Table 1 shows the principal theory of competitive harm relied upon by the FTC in issuing each of the 31 Second Requests that were fully investigated:

Table 1: HSR Second Requests for FY 2006 – 2007 by Theory of Potential Violation

Type of Theory	# of Second Requests	% of Fully Investigated Requests
Horizontal	22	71%
Vertical	4	13%
Potential competition	4	13%
Buyer power / monopsony	0	0%
Joint venture	0	0%
Miscellaneous	1	3%

Michael L. Keeley *is a partner and* **Russell M. Steinthal and Irina C. Rodríguez** *are associates at Axinn, Veltrop & Harkrider*

Compared with the earlier data (FY 1996 – FY 2005), the most recent subset shows a slight decrease in the percentage of Second Requests based on a horizontal theory of competitive harm (from 79% to 71%), and the complete absence of any buyer power or joint venture investigations (of which there were 9

(4%) and 3 (1%) respectively from FY 1996 – FY2005). Conversely, the percentage of fully-investigated Second Requests based on vertical and potential competition theories increased slightly, from 9% to 13% and 5% to 13%, respectively. While it is possible that those differences reflect a change in FTC enforcement policy, the small numbers involved for each of the non-horizontal categories means that is difficult to rule out random change in the transaction mix presented to the FTC. It clearly remains the case, however, that most Second Request investigations are based primarily on horizontal competition issues.

The data shows that a lower percentage of Second Requests led to completed investigations over the most recent two years of the study. For the period FY 1996 – FY 2005, 17% of the tabulated Second Requests led to the associated HSR filings being withdrawn by the parties before the conclusion of the investigation, a number that rose to 28% of the sample for FY 2006 – FY 2007 (16 transactions). On the other end of the enforcement spectrum, 19% of Second Requests in the latter period (11 transactions) were resolved after a "quick look" (which the FTC report defines as those in which the investigation was closed "upon the receipt of limited, but dispositive information"), as compared with 10% in the earlier period.

Table 2, meanwhile, shows the number of markets involved in the 22 horizontal mergers included within the FY 2006 – FY 2007 data set:

Table 2: HSR Second Requests with a Primarily Horizontal Theory of Competitive Harm, for FY 2006 – FY 2007, Grouped by Number of Alleged Relevant Markets

# of Alleged Relevant Markets	# of Transactions	% of Horiz. Trans.	Total Relevant Markets
1	7	32%	7
2-4	9	41%	25
5-15	3	14%	20
16-50	2	9%	44
50+	1	5%	82

As the table shows, most of the transactions in the sample set had only a handful of relevant markets at most (73% in the 1-4 market range), which is roughly consistent with the earlier period, in which 79% of the studied transactions had 1-4 alleged relevant markets. At the upper end of the scale, there are so few transactions in each band that the variation could easily be random.

For each horizontal Second Request that was investigated to completion, the FTC also tabulated the number of investigations that were resolved with and without enforcement action (or in the FTC's terminology, "enforced" or "closed"). Table 3 shows the same data for FY 2006 – FY 2007 subset:

Table 3: FTC Horizontal Merger Investigations for FY 2006 – FY 2007, Grouped By Post Merger HHI and Change in HHI (Delta)

		Change in HHI (Delta)								
		0 - 99	**100 - 199**	**200 - 299**	**300 - 499**	**500 - 799**	**800 - 1,199**	**1,200 - 2,499**	**2,500+**	***TOTAL***
Post Merger HHI	**0 - 1,799**	0	0/2	0/3	0/2	0/4	0	0	0	0/11
	1,800 - 1,999	0	0	0	0/3	0/1	0	0	0	0/4
	2,000 - 2,399	0	0	0/2	1/4	0/2	0/1	0	0	1/9
	2,400 - 2,999	1	0	0	2/1	3/1	1/2	0	0	6/5
	3,000 - 3,999	0	0	1/0	0/3	3/4	16/2	2/6	0	22/15
	4,000 - 4,999	0	1/0	0	0	0/2	3/0	9/1	0	13/3
	5,000 - 6,999	0	2/0	1/0	1/0	5/0	1/0	20/4	5/1	35/5
	7,000 +	0	0	0	0	0	2/0	1/0	46/0	49/0
	TOTAL	0/1	3/2	2/5	4/13	11/14	23/5	32/11	51/1	126/52

While the data provide further confirmation that the thresholds listed in the Horizontal Merger Guidelines are not a particularly good guidepost for the FTC's modern practice, they do suggest some potentially interesting changes in recent years. First, whereas the FY 1996 – FY 2005 period included a considerable number of "enforcement" data points all up and down the HHI spectrum (for example, there were 17 enforcement actions taken where the post-merger HHI was less than 1,800 and the delta HHI was between 100 and 199), none of the FY 2006 – FY 2007 enforcement actions involved a post-merger HHI of less than 2,000 and only one had a post-merger HHI less than 2,400. More broadly, approximately 90% of the enforcement actions in the later period had post-merger HHIs of 3,000 or more and a delta HHI of at least 500. The same categories, by contrast, amounted to only 63% of the enforcement actions for the earlier (and longer) period.

Table 4 shows the transaction mix for FY 2006 – FY2007, sorted by the number of significant competitors. Again, the general (and expected) trend remains consistent with the earlier period — most enforcement actions are clustered in cases in which there are relatively few significant post-merger competitors.

Table 4: FTC Horizontal Merger Investigations for FY 2006 – FY 2007, Grouped by Number of Significant Competitors

		Outcome		
		Enforced	Closed	*TOTAL*
Significant Competitors	2 to 1	42	0	42
	3 to 2	36	2	38
	4 to 3	26	4	30
	5 to 4	18	8	26
	6 to 5	4	5	9
	7 to 6	0	7	7
	8 to 7	0	8	8
	9 to 8	0	6	6
	10 to 9	0	2	2
	10 +	0	10	10
	TOTAL	126	52	178

While the data for FY 2006 – FY 2007 initially stand out for the lack of any enforcement actions in cases in which there were six or more significant post-merger competitors, such actions actually accounted for only just under 2% of the earlier data set. The percentage of 2-1 transactions, meanwhile, stood almost constant, at 33% of enforcement actions. While there was thus still a large degree of consistency between FY 1997 – FY 2005 and FY 2006 – FY 2007, the overall enforcement rate dropped from 76% of qualifying Second Requests to 71% for the most recent two fiscal years. (Of course, the FTC's data do not permit an analysis of whether those changes were influenced by differences in either transaction mix or Second Request issuance standards, as opposed to FTC enforcement policy.)

The FTC report's industry-by-industry data are interesting, but because they are not directly comparable to the earlier data releases, we were unable to determine the FY 2006-2007 subset, and thus will not be discussing them here. The FTC did, however, provide comparable results for two types of *evidence* of likely competitive harm, specifically the presence of hot documents (which the FTC defined as those that "predict[] that the merger will produce an adverse price

or non-price effect on competition," but not documents that merely recognize close competition between the merging parties) and the presence of strong customer complaints about the proposed merger.

With respect to hot documents, what stands out is that the FTC did not identify <u>any</u> Second Requests in the FY 2006 – FY 2007 time period in which its staff identified the presence of hot documents; by contrast, the FTC found hot documents in 25 different markets in the earlier time period. However, the fact that the FTC only tabulates evidentiary information for transactions in which there were three or fewer relevant markets cautions against making too much of that observation — for example, the Whole Foods / Wild Oats Second Requests, which issued on March 15, 2007 (in FY 2007), and which famously identified a number of hot documents that figured in the FTC's ultimately successful (on appeal) challenge to the transaction, would have been excluded, as would most retail mergers (in which a higher number of alleged relevant markets is common).

Tables 5-8, meanwhile, summarizes the data for markets in which the FTC staff received strong customer complaints and those in which they might have, but did not. (The FTC report assumed that there was no chance of customer complaints in most retail mergers, and thus excluded such markets from this aspect of the study).

Table 5: FTC Horizontal Merger Investigations for FY 2006 – FY 2007, Grouped by Strong Customer Complaints

		Change in HHI (Delta)								
		0 - 99	**100 - 199**	**200 - 299**	**300 - 499**	**500 - 799**	**800 - 1,199**	**1,200 - 2,499**	**2,500 +**	***TOTAL***
Post Merger HHI	**0 - 1,799**	0	0	0	0	0	0	0	0	***0***
	1,800 - 1,999	0	0	0	0	0	0	0	0	***0***
	2,000 - 2,399	0	0	0	0	0	0	0	0	***0***
	2,400 - 2,999	0	0	0	0	1/0	0	0	0	***1/0***
	3,000 - 3,999	0	0	0	0	0/1	0	1/0	0	***1/1***
	4,000 - 4,999	0	0	0	0	0	0	0	0	***0***
	5,000 - 6,999	0	0	0	0	0	1/0	2/0	7/0	***3/0***
	7,000 +	0	0	0	0	0	2/0	0	26/0	***6/0***
	TOTAL	0	0	0	0	***1/1***	***3/0***	***3/0***	***33/0***	***11/1***

Table 6: FTC Horizontal Merger Investigations for FY 2006 – FY 2007, Grouped by No Strong Customer Complaints

		Change in HHI (Delta)								
		0 - 99	**100 - 199**	**200 - 299**	**300 - 499**	**500 - 799**	**800 - 1,199**	**1,200 - 2,499**	**2,500 +**	***TOTAL***
Post Merger HHI	**0 - 1,799**	0	0	0	0	0	0	0	0	***0***
	1,800 - 1,999	0	0	0	0	0	0	0	0	***0***
	2,000 - 2,399	0	0	0	1/0	0	0	0	0	***1/0***
	2,400 - 2,999	0	0	0	0	0	0	0	0	***0***
	3,000 - 3,999	0	0	0	0	0	0	0/1	0	***0/1***
	4,000 - 4,999	0	0	0	0	0/1	0	0	0	***0/1***
	5,000 - 6,999	0	0	0	0	0	0	0/3	0/1	***0/4***
	7,000 +	0	0	0	0	0	0	0	0	***0***
	TOTAL	0	0	0	***1/0***	***0/1***	0	***0/4***	***0/1***	**1/6**

Table 7: FTC Horizontal Merger Investigations for FY 2006 – FY 2007, Grouped by Strong Customer Complaints

		Outcome		
		Enforced	**Closed**	***TOTAL***
Significant Competitors	2 to 1	4	0	4
	3 to 2	5	0	5
	4 to 3	2	1	3
	5 to 4	0	0	0
	6 to 5	0	0	0
	7 to 6	0	0	0
	8 to 7	0	0	0
	9 to 8	0	0	0
	10 to 9	0	0	0
	10 +	0	0	0
	TOTAL	11	1	12

Table 8: FTC Horizontal Merger Investigations for FY 2006 – FY 2007, Grouped by No Strong Customer Complaints

		Outcome		
		Enforced	Closed	*TOTAL*
Significant Competitors	2 to 1	0	0	0
	3 to 2	0	0	0
	4 to 3	0	2	2
	5 to 4	1	4	5
	6 to 5	0	0	0
	7 to 6	0	0	0
	8 to 7	0	0	0
	9 to 8	0	0	0
	10 to 9	0	0	0
	10 +	0	0	0
	TOTAL	1	6	7

As shown in Table 5, the FTC ultimately brought an enforcement action in 11 of the 12 studied markets in which it received strong customer complaints (i.e., a credible concern that a significant anticompetitive effect would result from the transaction) in FY 2006 and FY 2007. By contrast, in the absence of significant customer complaints, the FTC enforced in only 1 of 7 markets. (As the tables show, the outlier in which the FTC enforced in the absence of complaints was a 5-4 merger, while the case in which it declined to enforce was a 4-3 merger.)

Finally, the FTC also tabulated the data for the three-or-fewer-market subset by whether or not entry would meet the likely, timely, and effective criteria set forth in the Horizontal Merger Guidelines. Notably, in the entire period from fiscal year 1996 through fiscal year 2007, the FTC did not bring any enforcement actions in qualifying transactions in which its staff determined that the ease-of-entry criteria would be met. The enforcement rate for transactions in which entry was viewed as difficult, meanwhile, fell slightly, from 81% for FY 1996 – FY 2005 to 78% for FY 2006 – FY 2007. Tables 9 and 10 show the latest data for difficult to enter markets, by both HHI and number of significant post-merger competitors:

Table 9: FTC Horizontal Merger Investigations for FY 2006 – FY 2007, Difficult Entry (Grouped by HHI Data)

		Change in HHI (Delta)								
		0 - 99	**100 - 199**	**200 - 299**	**300 - 499**	**500 - 799**	**800 - 1,199**	**1,200 - 2,499**	**2,500 +**	***TOTAL***
Post Merger HHI	**0 - 1,799**	0	0	0	0	0	0	0	0	0
	1,800 - 1,999	0	0	0	0	0	0	0	0	0
	2,000 - 2,399	0	0	0	1/0	0	0	0	0	***1/0***
	2,400 - 2,999	0	0	0	0	1/0	1/0	0	0	***2/0***
	3,000 - 3,999	0	0	0	0	0/1	0	2/1	0	***2/2***
	4,000 - 4,999	0	0	0	0	0	0	0	0	0
	5,000 - 6,999	0	0	0	0	0	1/0	2/2	0	***3/2***
	7,000 +	0	0	0	0	0	2/0	0	4/0	***6/0***
	TOTAL	0	0	0	***1/0***	***1/1***	***4/0***	***4/3***	***4/0***	***14/4***

Table 10: FTC Horizontal Merger Investigations for FY 2006 – FY 2007, Difficult Entry (Grouped by Number of Significant Post-Merger Competitors)

		Outcome		
		Enforced	Closed	*TOTAL*
Significant Competitors	2 to 1	4	0	4
	3 to 2	5	0	5
	4 to 3	4	3	7
	5 to 4	1	1	2
	6 to 5	0	0	0
	7 to 6	0	0	0
	8 to 7	0	0	0
	9 to 8	0	0	0
	10 to 9	0	0	0
	10 +	0	0	0
	TOTAL	14	4	18

Conclusions

In the absence of a complete statistical analysis, it is difficult to draw any firm conclusions from the FTC's latest data release. However, many of the trends that were noted when the Agencies first released empirical data on their merger reviews appear to still be true: the practical HHI thresholds in current use are, in general, higher than those set forth in the Horizontal Merger Guidelines; credible customer complaints are a significant factor in determining which mergers are challenged; and more concentrated markets (whether measured by HHI or the number of post-merger competitors) are significantly more likely to generate enforcement action than less concentrated markets. If anything, those trends became slightly, if noticeably, firmer in the last two year sample, which was entirely drawn from the chairmanship of Deborah Majoras, than in the larger data set, which reaches back to the Clinton Administration. Therefore, despite studies that suggest that FTC enforcement policy was less influenced by the change from Democratic to Republican leadership than that of the Antitrust Division, it will be interesting to see, over the coming years, whether the two years described in this

article end up being representative of a longer-term trend at the FTC, or simply a somewhat random selection of two years' transactions.

[top]

Important Changes To Canada's Competition and Investment Laws: More Certainty or Less?

Peter Franklyn and Shuli Rodal

Introduction

On March 12, 2009, the Parliament of Canada enacted Bill C-10 (Budget Implementation Act, 2009), which introduces the most significant amendments to the Competition Act ("CA") and to the Investment Canada Act ("ICA") in over two decades. By overhauling the existing merger review process, introducing new foreign investment rules based on national security grounds, and bringing Canada's conspiracy law more in line with that of the U.S., these amendments will have significant implications for merger transactions as well as other forms of collaborations involving businesses in Canada.

The discussion below outlines the principal changes contained in Bill C-10 relevant to merger and acquisition transactions affecting Canada, as well as the practical implications of these amendments. It should be noted, however, that some of the amendments require new regulations and guidelines in order to provide direction and clarity to the legal and business communities as to how they will be administered and enforced. Until such guidance is available, navigating some of the new provisions may be complicated and unpredictable.

It should also be noted that the amendments introduce major changes to the pricing, abuse of dominance and other provisions of the CA. These amendments provide much greater flexibility for businesses in Canada in terms of pricing and promotional activities, but at the same time for the first time impose multi-million dollar penalties on dominant firms for engaging in abusive conduct.

Amendments to the Competition Act

Competition Act Merger Review

1. Current Merger Review Process

Peter Franklyn and Shuli Rodal *are partners at Osler, Hoskin & Harcourt*

The amendments in Bill C-10 overhaul the Canadian merger review process that has been in place for over two decades. The former process was commenced with the filing of a short or long form filing, which triggered the commencement of a 14 day or 42 day statutory waiting period, following the expiry of which the transaction was permitted to close unless an injunction to delay closing was obtained by the Commissioner of Competition ("Commissioner") on the basis that more time was required to complete the review. However, these statutory timeframes did not necessarily correspond with the actual length of the Competition Bureau's ("Bureau") review process, which in more complex cases sometimes extended many months beyond the formal

waiting periods. To reflect this reality, the Bureau established non-binding service standard review periods (two weeks, 10 weeks or five months, depending on the complexity of the issues), which reflected the estimated timeframe within which the Bureau expected to be able to complete its review. While there was no statutory obligation on parties to a transaction to wait for affirmative comfort from the Bureau prior to closing once the waiting period had expired, it was common practice in Canada for parties to make it a condition of closing that a "no-action letter" was received prior to closing, stating that the Bureau had no present intention to challenge the transaction. An 'advance ruling certificate' or ARC, which is a more definitive form of clearance, may instead have been issued but only in clearly non-complex cases. The practice of awaiting affirmative clearance can be attributed to purchasers' understandable desire to minimize the risk that the Bureau would exercise its right to challenge completed transactions for up to three years after closing (unless an advance ruling certificate was issued and the transaction closed within one year of such issuance), in circumstances where a transaction would otherwise have proceeded upon expiry of the relatively short statutory waiting periods.

While the former Canadian merger review process as it evolved had certain advantages, such as flexibility, an iterative disclosure process and the opportunity to negotiate solutions without the pressure imposed by the looming expiry of a finite review period, it was also criticized on a number of grounds. For example, the lack of timing certainty was an issue where parties proposed to wait for affirmative comfort from the Bureau before closing, as it was often difficult to accurately estimate when such comfort would be obtained. While the Bureau was, according to its own measures, largely successful in adhering to its internal service standard review periods, the Bureau's practice was to "start the clock" on such periods only once it was satisfied that "sufficient information" had been received to commence the review, which may have been long after the initial filing was made. An additional criticism of the former system arises from the uncertainty inherent in the short form/long form process. While the parties could elect between making a short form or a long form filing (long form filings, which were burdensome to prepare, were intended to be used in complex cases), if they chose to submit a short form filing, they were exposed to the risk that the Commissioner may require a long form filing to be made, in which case the long form waiting period commenced only once the long form filing had been submitted. In order to avoid this risk, decisions were not uncommonly made to file long form filings in cases where predictability of timing was of sufficient importance (e.g. hostile takeover bids) even though the competition law issues that were likely to arise did not merit the extensive information that needed to be collected for a long form.

While these (and other) issues were of concern for some time, more recently, a number of additional factors increased the impetus for reform of the process. Most significantly, the Bureau came under greater pressure to complete its review of transactions within the statutory timeframes for review.

In this regard, there was an increased reluctance on the part of purchasers to await affirmative comfort from the Bureau prior to closing, with the result that certain high profile transactions were completed following the expiry of the statutory waiting period despite the Bureau not having completed its review.[1] Second, the Competition Tribunal ("Tribunal") confirmed that the test for the Commissioner to obtain an injunction to delay closing in order to complete its review is difficult to meet, because it requires that the Tribunal be satisfied that its ability to remedy the effects of a merger would be substantially impaired if the transaction were permitted to close (the injunction provisions remain in effect under the new regime). Concerns were also raised about the Bureau's use of formal investigative powers, and specifically, the section 11 court order process, which has been the Bureau's only means to compel the disclosure of information from merging parties where it was not otherwise provided in the initial mandatory pre-merger filings or supplemental voluntary filings.

Based on perceived concerns about timelines for the review process, the need for the Bureau to seek court orders to obtain additional information and the desire to harmonize the Canadian review process more closely with its U.S. counterpart, the blue-ribbon panel that was appointed to recommend changes to the CA ("Panel") recommended aligning the Canadian merger review process more closely with the U.S. process.[2]

2. Proposed Two Stage Merger Review Regime

The amendments introduce a U.S.-style two stage merger review process together with a reduction (from three years to one year) of the post-closing period during which a completed transaction may be challenged. The previous statutory waiting periods for short-form (14 days) and long-form (42 days) notification filings have now been replaced with an initial review period of 30 days followed by a discretionary second stage review triggered by the issuance of a 'second request' for information. The issuance of the second request 'stops the clock' until a complete response to the second request is submitted, following which a further 30 day period would run. The parties are permitted to close their transaction following expiry of the second 30 day period unless the Commissioner succeeds in obtaining an injunction to prevent or delay the closing.

Regulations prescribing the new form of filing have not been released, although it is expected that the new single filing form will be similar to the short-form filing used in the former process, with the possible addition of a requirement to disclose transaction agreements and documents which analyze the transaction (such as 4(c) documents in the U.S. which are required to be submitted with the Hart-Scott-Rodino Act (HSR) form). The Bureau has indicated that parties should

---

1 For example, Comm'r of Competition v. Labatt Breweries Ltd., [2008] FCA 22.

2 Competition Policy Review Panel, Compete to Win (June 2008) available at http://www.ic.gc.ca/eic/site/cprp-gepmc.nsf/eng/h_00040.html.

continue to file short form filings until the new form has been finalized (long forms may be filed if desired but the Bureau no longer has the right to compel the filing of a long form). The new system also preserves the ability of parties to request, and the Commissioner to issue, ARCs and issue waivers in non-complex cases (thereby exempting a transaction from the notification regime).

The adoption of a U.S.-style two stage merger review process is perhaps the most controversial of the CA amendments in Bill C-10, in large part because there was very little consultation on this proposed change. Some members of the Canadian competition bar have questioned the appropriateness of the U.S. style approach for the Canadian context and have raised concerns about delays in closing and potential increases in cost to the parties that may result from the new process.

It is hoped that the adoption of a U.S. style approach will result in greater timing certainty in the majority of cases and that all but the most challenging cases will be cleared in the initial 30 day period as has been the experience in the U.S. While it should be noted that benefiting from fixed timelines will, as a practical matter, require parties to abandon the practice of awaiting affirmative comfort from the Bureau and instead rely on the expiry of the applicable waiting period as a sufficient basis on which to complete a transaction, the new system, which provides the Bureau much longer timeframes to complete its review, arguably justifies adopting this approach. In addition, the adoption of a single filing form eliminates the uncertainty associated with the risk that the Bureau could unilaterally "bump" an initial short-form filing and require a long-form submission, which had led to the practice of filing burdensome long forms solely to avoid any risk of timing delay.

The challenge for the Bureau, as well as merging parties and their counsel, will be to avoid second requests in respect of transactions which raise some issues but do not warrant an in-depth review, and to manage the scope of second requests where these are issued. It will be advisable for merging parties to coordinate the timing of their Canadian filings more closely with U.S. filings than has often been the case in the past in order to avoid having the Bureau feel it needs to "get more time" by issuing a second request. It will also be important to continue the current practice of providing the Bureau with a detailed voluntary competitive impact statement at the time of the initial filing (or shortly thereafter).

It remains to be seen whether certain U.S. practices, such as "pulling and refiling" initial forms or entering into timing agreements, will develop in the Canadian context. Given the Bureau's resource limitations and concerns that have been expressed about the potential excesses that may be associated with the second request process (e.g. buying time by issuing overly broad second requests), it is hoped that second requests issued by the Bureau will not be as burdensome as those that typically are issued in the U.S. and that the Bureau will closely coordinate with its U.S. counterparts in preparing requests in cases that are subject to review on both sides of the border. In order to achieve the benefits of

harmonization that were contemplated by the Panel, it is hoped that the Bureau will make every effort to ensure that the timing of its reviews is coordinated with the U.S. (provided that the Canadian filing is made contemporaneously).

3. Penalties for Non-compliance

The amendments also provide new remedial powers to deal with actual or likely non-compliance with the new waiting periods, including structural penalties and a monetary penalty of up to C$10,000/day where parties have not complied with filing requirements. These new remedies are considerably more severe than those that have been in place until now (a maximum C$50,000 fine (which is the equivalent of the filing fee)). The more onerous penalty provisions may signal that the Canadian practice will become more aligned with the U.S. in its strict approach to gun jumping and violation of the pre-merger notification requirements.

4. Review Thresholds

In addition to these process changes, Bill C-10 increases the “size of transaction” threshold from C$50 million to C$70 million (C$140 million for “amalgamations”). In addition, this threshold is now indexed to inflation. (No change has been made to the existing C$400 million “size of parties” threshold).

Important Changes Affecting Other Agreements

Perhaps the most significant change introduced by Bill C-10 is the establishment of a dual-track approach to agreements among “competitors”. While the implementation of the new rules will be delayed for one year, the new dual-track approach replaces the current regime which requires that even so called ‘hard-core’ cartel activity “unduly” lessen competition in order to attract criminal liability. Under the new provisions, agreements with “competitors” (which include actual and potential competitors) to fix prices; allocate markets or customers; or control or restrict output will be subject to a strict *per se* criminal prohibition. All other agreements with competitors will be subject to review under a non-criminal framework, and subject to prohibition or other remedial action if the Tribunal finds, based on consideration of factors that mirror those under the merger provision (including efficiencies), that they are likely to lessen or prevent competition substantially.

In addition to distinguishing between competitor agreements which merit review under the civil standard rather than being treated as *per se* illegal, this dual approach will also require careful consideration of other “agreements” which may arise in the context of transactions. It is hoped that the Bureau will apply these new provisions judiciously in the context of assessing the permissible scope of integration planning, possible concerns about gun-jumping in merger transactions, as well as a “non-compete” agreements. The amendments provide a form of “ancillary restraints” defense for agreements that are shown, on a balance of

probabilities, to be ancillary to broader and otherwise legitimate agreements and are directly related to, and reasonably necessary for giving effect to, that broader agreement. As is the case in the U.S., there are likely to be disputes over whether a suspect provision of an otherwise valid agreement satisfies this ancillary defense.

The new conspiracy regime will only come into force in one year, although the new law will then apply not only to agreements that come into effect after that one year period, but also to existing agreements that continue in effect beyond the date at which the new conspiracy regime becomes law. This will have important implications for ongoing joint venture/collaboration agreements and alliances which will have to be assessed in light of the new law. During the one year transitional period, parties are entitled to seek and receive "free" binding opinions from the Bureau regarding the legality of any existing agreements. We expect that parties may decide to self-assess their potential liability rather than draw the Bureau's attention to their agreements.

Amendments to the Investment Canada Act

Bill C-10 introduces a number of amendments to the ICA, which are designed to decrease the regulatory burden on foreign investors seeking to invest in Canada. However, Bill C-10 also introduces long expected amendments to the ICA to provide the Canadian Government a broad right of review of proposed foreign investments that may be injurious to national security.

National Security Review

Since its enactment in 1985, the ICA has empowered the Canadian Government to review and approve direct foreign investments in Canada which exceed certain financial thresholds and result in an acquisition of control of a Canadian business. Prior to Bill C-10, Canada did not have a regime that permitted review of investments not otherwise subject to the ICA on national security grounds. While guidelines were released in December 2007 for investments by state-owned enterprises (which may also be relevant in the national security context), these guidelines have applied only to investments that were otherwise reviewable under the ICA.

The new national security review process is Canada's equivalent of the U.S. CFIUS process. The new regime applies not only to the types of investments currently covered under the ICA, but also to a much broader class of transactions. In contrast to CFIUS, under the new national security provisions, no *de minimis* or safe harbour thresholds have been identified. The new provisions are very broadly worded and apply to any investment "to acquire, in whole or in part, or to establish any entity carrying on all or any part of its operations in Canada" where that entity has assets, operations or employees in Canada. For example, an acquisition of a minority interest in an entity that may have relatively little connection to Canada could be subject to review. Accordingly, on its face the new

Canadian regime appears to be more extensive than its U.S. counterpart, although it remains possible that exemptions will be set out in regulations or guidelines. The legislation also confers broad discretion on the Minister of Industry to determine whether an investor is a non-Canadian and therefore subject to national security review.

These changes are likely to introduce considerable uncertainty, at least initially, over their potential application both retroactively to recently completed transactions (the amendments apply to any transaction completed after February 6, 2009, i.e. before the amendments came into effect) and to pending deals. Transactions completed between February 6, 2009 and March 12, 2009 will be subject to retroactive review if the Minister of Industry sends a notice to the non-Canadian investor within 60 days after the amendments received Royal Assent (which occurred on March 12, 2009). For reviews generally, details regarding the procedures to be followed, particularly timelines, are not yet known, as these are to be set out in regulations which are not yet available. At this stage, there is also no prescribed content for filings and no guidance available on what types of investments are likely to raise national security concerns.

The relevant test under the amendments is whether an investment by a non-Canadian "could be injurious to national security." The legislation does not provide any insight into what could be injurious to national security and it is hoped that guidance will be provided in regulations or other formal documents (similar to that set out in recent amendments to the U.S. national security legislation). However, we expect that the range of transactions that could potentially raise national security concerns will be quite broad, extending beyond traditional concepts of national sovereignty such as military or territorial integrity to include economic security, environmental security and human security.

The new legislation contemplates a review process that would be initiated by the issuance of a notice to the investor that the Minister of Industry "has reasonable grounds to believe that an investment by a non-Canadian could be injurious to national security." Like the U.S., it is expected that filings may also be voluntary, but this is not specifically dealt with in the legislation. The non-Canadian receiving such a notice is then prohibited from implementing the proposed investment until the issue is resolved. As these provisions apply to investments which are "implemented or proposed", it appears that completed transactions consummated after February 6, 2009 may be subject to national security review. Where determined to be warranted, a full review of the investment will be undertaken by Cabinet (the executive body of the government), which may then order the non-Canadian not to implement the investment or to divest itself of control of the Canadian business or of its investment. The investment may also be authorized to proceed if the investor provides undertakings or otherwise implements it on terms and conditions set out in the Cabinet order.

Although the new national security review process will for the first time entitle the Canadian Government to review a much broader range of transactions, we do not expect that the new process will result in significant numbers of transactions being disallowed on national security grounds. Since the ICA came into effect in 1985, Canada has clearly recognized the benefits of foreign investment and been restrained in exercising its right to disallow such investment. In fact, only one major transaction outside of the cultural sphere (where more restrictive policies apply)-- the Alliant/MacDonald, Dettwiler case in 2008--has been disallowed under the ICA since it came into effect. However, transactions raising national security issues are likely to take time to resolve, and will require a negotiation of solutions which may require concessions on the part of the investor, as well as a cooperative approach with other reviewing jurisdictions. Accordingly, the new national security review regime will need to be factored into valuation, timing and risk assessments where proposed foreign investments in Canada may potentially give rise to national security concerns.

Other Amendments to the ICA

Bill C-10 introduces two other significant changes to the ICA which are designed to reduce the regulatory burden on foreign investors. First, the amendments raise the review threshold for an acquisition of control of a Canadian business by a non-Canadian, other than a cultural business. The current review threshold of C$312 million based on the book value of the assets of the Canadian business will increase over a 5-year period to C$1 billion, based on the “enterprise value” of the Canadian business. Whether Bill C-10 achieves its full potential in realizing the objective or reducing the number of transactions subject to review remains to be seen, as the meaning of “enterprise value” has yet to be prescribed by regulations.

Second, Bill C-10 eliminates the significantly lower review threshold for businesses engaged in transportation, financial services and uranium production activities. However, the lower C$5 million review threshold for an investment in a “cultural business” has been retained.

Conclusion

While attempting to harmonize and align the Canadian merger and investment review process with its U.S. counterparts, the amendments outlined above raise a number of new issues that remain to be resolved. This will create uncertainty, at least in the short term, until it becomes clear how these new provisions will be applied.

About the Mergers and Acquisitions Committee

[top]

The Mergers and Acquisitions Committee focuses on issues relating to mergers, acquisitions and joint ventures. Committee activities and projects cover private litigation, both state and federal enforcement, and international merger enforcement activities.

Chair:

- James W. Lowe
  WilmerHale
  202-663-6059
  james.lowe@wilmerhale.com

- Scott A. Sher
  Wilson Sonsini Goodrich & Rosati
  202-772-1832
  ssher@wsgr.com

Vice-Chairs:

- Mike Cowie
  Howrey LLP
  202-383-7424
  CowieM@howrey.com

- Margaret A. Ward
  Jones Day
  202-879-3488
  maward@jonesday.com

- Dorothy B. Fountain
  Department of Justice
  202-514-3544
  Dorothy.Fountain@usdoj.gov

- Paul B. Hewitt
  Akin Gump Strauss Hauer & Feld LLP
  202-887-4120
  phewitt@akingump.com

Council Representative:

- Kenneth L. Glazer
  Federal Trade Commission
  202-326-3177
  kglazer@ftc.gov

About The Threshold

The Threshold is published periodically by the Mergers and Acquisitions Committee of the American Bar Association Section of Antitrust Law. The views expressed in the Newsletter are the authors' only and not necessarily those of the American Bar Association, the Section of Antitrust Law, or the Mergers and Acquisitions Committee. If you wish to comment on the contents of the Newsletter, please write to American Bar Association, Section of Antitrust Law, 321 North Clark, Chicago, IL 60610.

Co-Editors-in-Chief:

- Beau W. Buffier
  Shearman & Sterling LLP
  212-848-4843
  bbuffier@shearman.com

- Mary N. Lehner
  Federal Trade Commission
  202-326-3744
  mlehner@ftc.gov

- W. Stephen Smith
  Morrison & Foerster LLP
  202-887-1514
  ssmith@mofo.com

COPYRIGHT NOTICE
Copyright 2008 American Bar Association. The contents of this publication may not be reproduced, in whole or in part, without written permission of the ABA. All requests for reprint should be sent to: Director, Copyrights and Contracts, American Bar Association, 321 N. Clark, Chicago, IL 60654-7598, FAX: 312-988-6030, e-mail: copyright@abanet.org mailto:copyright@abanet.org.