CLASS 2 SLIDES

For September 5, 2019
Remainder of Unit 1 + Unit 2

Dale Collins
Merger Antitrust Law
Georgetown University Law Center

September 4, 2019

TRANSDIGM
GROUP INC.

SCHROTH

The DOJ Litigation

DOJ litigation

- What did the DOJ do at the end of the investigation?
  - Decided that the TransDigm's acquisition of SCHROTH violated Section 7 of the Clayton Act
  - Decided to bring suit to force TransDigm to divest business and assets it had acquired

When was the complaint filed?

- December 21, 2017

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA
Department of Justice, Antitrust Division
450 5th Street, N.W., Suite 8700
Washington, D.C. 20530,

Plaintiff,

v.

TRANSDIGM GROUP INCORPORATED
1301 East 9th Street, Suite 3000
Cleveland, Ohio 44114,

Defendant.

Civil Action No.:

COMPLAINT

The United States of America, acting under the direction of the Attorney General of the United States, brings this civil antitrust action for equitable relief against defendant TransDigm Group Incorporated ("TransDigm") to remedy the harm to competition caused by TransDigm's acquisition of SCHROTH Safety Products GmbH and substantially all the assets of Takata Protection Systems, Inc. from Takata Corporation ("Takata"). The United States alleges as follows:

I. NATURE OF THE ACTION

1. In February 2017, TransDigm acquired SCHROTH Safety Products GmbH and substantially all the assets of Takata Protection Systems, Inc. (collectively, "SCHROTH") from Takata. TransDigm's AmSafe, Inc. ("AmSafe") subsidiary is the world's dominant supplier of restraint systems used on commercial airplanes. Prior to the acquisition, SCHROTH was

Who was the plaintiff?

- The United States
  - Through the Antitrust Division of the Department of Justice

Makan Delrahim
Assistant Attorney General
Antitrust Division
U.S. Department of Justice

What statutes were allegedly violated?

- What antitrust statute(s) did the DOJ allege were violated by the transaction?
  - Clayton Act § 7 (Compl. ¶ 41)
- What other statutes might the transaction have violated?
  - Sherman Act § 1
  - Sherman Act § 2
  - FTC Act § 5
- Why didn't the DOJ allege violations of these other statues?
  - Unnecessary: Section 7 provides the binding regulatory constraint and all available relief
  - Also, only the FTC can bring actions under FTC Act § 5

The DOJ as plaintiff

- What gives the DOJ a right of action to bring an action in federal district court?
  - Clayton Act § 15 (Compl. ¶ 8)
    - Gives federal court the ***subject matter jurisdiction*** to adjudicate and restrain violations of the Clayton Act (including Section 7):

> The several district courts of the United States are invested with jurisdiction to prevent and restrain violations of this Act . . . .[1]

[1] 15 U.S.C. § 25.

The DOJ as plaintiff

- What gives the DOJ a right of action to bring an action in federal district court?
  - Clayton Act § 15 (Compl. ¶ 8)
    - Gives the DOJ a ***right of action*** to being injunctive relief actions in federal district court to prevent and remediate Clayton Act violations (including violations of Section 7):

> . . . and it shall be the duty of the several United States attorneys, in their respective districts, under the direction of the Attorney General, to institute proceedings in equity to prevent and restrain such violations.[1]

[1] 15 U.S.C. § 25.

The forum

- In what court was the complaint filed?
  - Federal District Court for the District of Columbia
- Why in DC?
  - District court had—
    - *Personal jurisdiction* over the parties, and
    - Was a proper *venue* for the action
  - DC is generally the most desirable forum from the DOJ's perspective
    - Know the judges
    - The judges know the merger antitrust laws
    - Prosecutors do not have the hassle of moving out of town in the event of trial

The defendant

- Who is the defendant in the case?
  - TransDigm
- Why wasn't Takata named as a defendant?
  - Not necessary given the nature of the relief the DOJ was seeking
    - Unless the DOJ was seeking recession of the transaction

Elements of a Section 7 violation

- Provides the U.S. antitrust standard for mergers

> **No person** engaged in commerce or in any activity affecting commerce **shall acquire**, directly or indirectly, the whole or any part of the **stock** or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the **assets** of another person engaged also in commerce or in any activity affecting commerce, **where in any line of commerce** or in any activity affecting commerce **in any section of the country**, the **effect** of such acquisition **may be substantially to lessen competition, or to tend to create a monopoly**.[1]

- *Simple summary*: Prohibits transactions that—
  - "may substantially lessen competition or tend to create a monopoly"
  - "in any line of commerce" (product market)
  - "in any part of the country" (geographic market)

Called the *anticompetitive effects test*

Called the *relevant market*

[1] 15 U.S.C. § 18 (remainder of section omitted)

Element 1: An "Acquisition"

- Was there an acquisition here?
  - Yes. TransDigm Group acquired—
    - Stock of SCHROTH Safety Products GmbH, and
    - Assets of Takata Protection Systems, Inc.

    from Takata Corporation

Element 2: Relevant markets

- What was the relevant geographic market alleged in the complaint?
  - Worldwide (Compl. ¶ 22)

Element 2: Relevant markets

- What were the relevant product markets alleged in the complaint?
  1. Two-point lapbelts used on commercial airplanes

  2. Three-point shoulder belts used on commercial airplanes

Element 2: Relevant markets

- What were the relevant product markets alleged in the complaint?
  3. Technical restraints used on commercial airplanes

  4. Inflatable restraint systems used on commercial airplanes (uses airbag technology)

Element 3: Anticompetitive effects refresher

- The anticompetitive effects test

> "[T]he effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly"

- *Modern view*: Transaction threatens—with a reasonable probability—to hurt *some identifiable set of customers* through:
  - Increased prices
  - Reduced market output
  - Reduced product or service quality
  - Reduced rate of technological innovation or product improvement
  - (Maybe) reduced product diversity

These are called *anticompetitive effects*

A firm that has the power to produce or strengthen an anticompetitive effect is said to have *market power*

- Forward-looking analysis

Element 3: Anticompetitive effects

- What were the anticompetitive effects of the acquisition alleged in the complaint?

  1. Increased prices
     - Prior to the acquisition, customers could and did "play off" the companies against each other to obtain better prices (Compl. ¶ 32)
     - Postmerger, the next closest competitor will not be as price-competitive with the combined firm as SCHROTH was to AmSafe
  2. Reduced innovation
     - Companies also competed against each other through R&D to develop new and better products (Compl. ¶ 32)
     - Could save significant money by curtailing R&D activities postmerger
  3. Significantly increased market concentration (Compl. ¶ 31)
     - Combined the only two significant players in the markets
     - Not really an anticompetitive effect under the prevailing consumer welfare interpretation
       - But the Supreme Court in the 1950s-1960s regarded it as the primary anticompetitive effect—included because of that precedent

Element 3: Anticompetitive effects

- What were the factual allegations in support of an anticompetitive effect in each market?
  1. Two-point lapbelts used on commercial airlines

- Only 3 meaningful competitors premerger (Compl. ¶ 24)
  - AmSafe was by far the largest
  - Small, privately held firm that had been in the market for years but gained little share
  - SCHROTH, which entered the market with a new, innovative lightweight two-point lapbelt ("Airlite"), which it aggressively marketed to the major international airlines

Element 3: Anticompetitive effects

- What were the factual allegations in support of an anticompetitive effect in each market?
  2. Three-point shoulder belts used on commercial airlines

- Only 2 meaningful competitors premerger (Compl. ¶ 26)
- AmSafe was by far the largest
- “SCHROTH was aggressively seeking to grow its business at AmSafe’s expense”
- Probably means that SCHROTH had not achieved any significant sales yet, but that efforts to penetrate the market caused AmSafe to reduce prices

Element 3: Anticompetitive effects

- What were the factual allegations in support of an anticompetitive effect in each market?
  3. Technical restraints used on commercial airlines

- Only 3 significant suppliers premerger (Compl. ¶ 28)
  - AmSafe (“leading supplier”)
  - SCHROTH (“aggressively seeking to grow”)
  - (Unnamed) international aerospace equipment manufacturer

Element 3: Anticompetitive effects

- What were the factual allegations in support of an anticompetitive effect in each market?
  4. Inflatable restraint systems used on commercial airplanes

- Only 2 meaningful competitors premerger (Compl. ¶ 30)
  - AmSafe (which developed technology—offers both inflatable lapbelts and structural mounted airbags)
  - SCHROTH (offered only structural mounted airbags)
  - "In recent years, SCHROTH had emerged as a strong competitor to AmSafe in the development of inflatable restraint technologies"
    - Sounds very weak to me
    - May be some innovation competition (but maybe not that much)

Element 4: Effect on Interstate Commerce

- What were the factual allegations in support of an effect on interstate commerce?
  - "TransDigm sells restraint systems used on commercial airplanes throughout the United States. It is engaged in the regular, continuous, and substantial flow of interstate commerce, and its activities in the development, manufacture, and sale of restraint systems used on commercial airplanes have had a substantial effect upon interstate commerce." (Compl. ¶ 9)

Defenses to the prima facie case

- How, if at all, did the complaint seek to negate any defenses to the prima facie case?
  - First, an important distinction: Negative/affirmative defense
    - *Negative defense*: Negates an element of the prima facie case
      - Defendant: “My conduct will not result in any anticompetitive harm”
    - *Affirmative defense*: Even assuming the plaintiff has established its prima facie case, the challenged conduct is nonetheless excused or justified
      - Defendant: “I did it, but my conduct is not culpable”
  - There are no affirmative defenses in antitrust law
  - Canonical forms of negative defenses in antitrust cases
    - Multiple, significant competitors
    - Ease of entry or positioning
    - Countervailing bargaining power (“power buyers”)
    - Efficiencies (customer benefits)

Defenses to the prima facie case

- How, if at all, did the complaint seek to negate any defenses to the prima facie case?
  - Contains allegations to preempt an ease of entry defense: Entry would be costly and could not occur quickly—
    - FAA certification requirements (cost and time)
    - Technical expertise
    - Economies of scale
    - Reputation
- Why didn't the complaint also try to preempt the other defenses?
  - Historical artifact
  - Preempting a defense is not required to make out a sufficient complaint

Relief

- What relief was the DOJ seeking?
  - Civil injunctive relief (see IX. Request for Relief)—
    - Declaration that TransDigm's acquisition of SCHROTH violated Section 7
    - Injunction ordering TransDigm to—
      1. divest all assets acquired from Takata Corporation in the challenged transaction, *and*
      2. take any further actions necessary to restore the market to the competitive position that existed prior to the acquisition
- Could the DOJ have sought other types of relief?
  - Criminal sanctions but only if challenged under Sherman Act § 1
  - Treble damages on behalf of injured U.S. government agencies under Clayton Act § 4A

So What Happened?

The aftermath

- What happened as a result of the DOJ's investigation and complaint?
  - TransDigm agreed to a consent settlement to divest SCHROTH (including the Takata Protection assets) to a third-party divestiture buyer approved by the DOJ

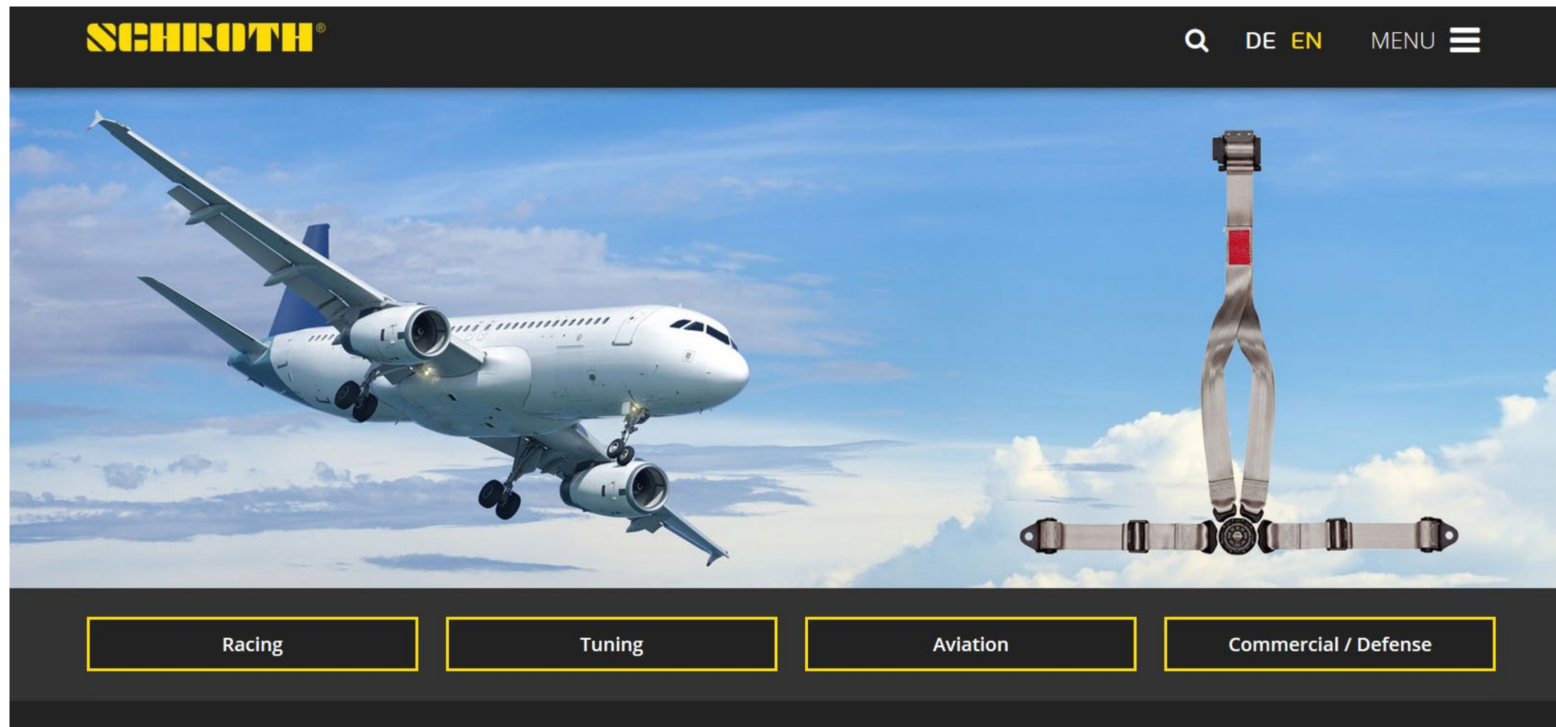
Business rationale

- Why did TransDigm agree to divest SCHROTH?
  - Look at the alternatives and pick the best one
  - What were TransDigm's alternatives?
    - Continue the litigation
    - Settle with a consent decree acceptable to the DOJ
    - No other choices in a postclosing challenge
  - Why did TransDigm agree to settle?
    - Almost surely the least costly alternative
    - DOJ had a strong case and TransDigm was very likely to lose the litigation, in which case the DOJ would have obtained a litigated permanent injunction ordering the same divestiture
  - When did TransDigm agree to settle?
    - In the course of the investigation—Prior to litigation
    - Complaint and proposed consent decree were filed simultaneously with the court

The divestiture buyer

- To whom did TransDigm sell SCHROTH?
  - A management-led leveraged buyout (MBO)
    - Business unit's management + a private equity investor
  - Why sell to management?
    - The DOJ probably wanted a "buyer upfront"
    - So an MBO was the quickest solution with the greatest return
  - Did the MBO get a good purchase price?
    - Probably
    - Fire sale
      - TransDigm 10-K reported a $32 million impairment charge to write-down the assets to fair value. (p. 21)
      - TransDigm paid $90 million to acquire SCHROTH
      - So it is likely the MBO paid only about $58 million for the business
      - Actually, $61.4 million (from TransDigm 8-K, Jan. 26, 2018, at 3)

SCHROTH today



- Approximately 250 employees
- Sales volume around €40 million

Thinking Systematically about Antitrust Risk

Query

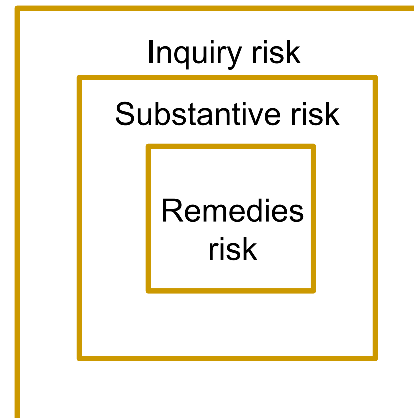
- You are counsel to TransDigm
  - Prior to signing the purchase agreement, they seek your advice on—
    - Whether the transaction will be investigated by the antitrust authorities?
    - Whether the DOJ or FTC will challenge the transaction on the merits?
    - Whether they can successfully defend on the merits?
    - If unsuccessful, what will be the consequences?

These are the fundamental questions every client asks in a deal

Three types of antitrust risks

- Inquiry risk
  - The risk that legality of the transaction will be put in issue
- Substantive risk
  - The risk that the transaction is anticompetitive and hence unlawful
- Remedies risk
  - The risk that the transaction will be blocked or restructured

Risks are nested



Assessing Substantive Risk

Focus first on substantive risk

- While inquiry risk comes first chronologically
  - Inquiry risk depends largely on—
    1. The *likelihood* that the challenger will prevail, *and*
    2. The *reward* that the challenger will obtain from a successful challenge
  - The first factor is a function of the substantive risk—so we need to study that first
- Substantive risk
  - Depends on—
    1. The costs to the parties of defending the transaction against the challenge,
    2. The likelihood that the parties will not be able to successfully defend their deal on the merits, *and*
    3. The costs to the parties of failing to defend successfully

Costs associated with substantive risk

- "Hassle" costs of defending—Incurred regardless of outcome
  - Delay/opportunity costs
  - Management distraction costs
  - Expense of investigation/litigation and other out-of-pocket costs
- Outcome costs—Four possible outcomes:
  1. The investigating agency clears transaction on the merits without taking enforcement action (a "clean deal")
  2. The parties restructure ("fix") the deal to eliminate the substantive antitrust concern
     - Restructure the deal preclosing to avoid a consent decree ("fix-it-first")
     - Post-closing "fix" under a judicial consent decree (DOJ) or a FTC consent order
  3. The investigating agency obtains an injunction from federal district court blocking the closing and the parties subsequently terminate their purchase agreement
  4. The parties voluntarily terminate the deal rather than settle or litigate

Assessing probabilities of substantive risk

Substantive risk depends on a *prediction* that the parties will not be able to successfully defend their transaction on the merits

So how to we make that prediction?

First, an important distinction

- Basic distinction #2
  - *Decision making*: How do the agencies ***decide*** a merger is anticompetitive?
  - *Explanation*: How do the agencies ***explain*** why they believe that the merger is anticompetitive?
- Why is this distinction important?
  - How the agencies (or the courts) explain their decisions often does not reveal why they decided on that particular outcome
  - What you read in judicial opinions may only be the justification of an outcome that the judge reached for other (unexplained) reasons

A predictive model

- We are going to look at a model that ***predicts*** merger antitrust outcomes
- The model does ***not purport to describe*** how the investigating agency in fact decides merger outcomes
- The model's only purpose is to predict enforcement outcomes, not be a description of agency behavior

Assessing substantive antitrust risk

- So how do the DOJ/FTC decide whether a merger is anticompetitive?
  - Recall that the purpose of merger antitrust law is to prevent the creation or facilitation of market power to the harm of customers in the market as a whole through—
    - Increased prices
    - Reduced market output
    - Reduced product or service quality
    - Reduced rate of technological innovation or product improvement
    - [Maybe] reduced product variety

Assessing substantive antitrust risk

- The predictive model—Three important rules
  1. Absent compelling evidence of significant customer harm from other sources, only ***price increases*** count
  2. The merger is anticompetitive if it is likely to result in a price increase or other competitive harm to ***any identifiable customer group***
  3. The agencies believe that ***no customer group is too small*** to deserve antitrust protection

Assessing substantive antitrust risk

- Key factors in the decision to challenge horizontal mergers:
  - The existence of incriminating documents (or occasionally incriminating public statements by management)
  - Closeness and uniqueness of competition between the merging parties
    - Especially evidence of unique head-to-head price competition between the merging parties
  - The number of other realistic alternative competitor-suppliers for each identifiable customer group
  - Customer complaints
  - “Natural experiments”
  - History of actual or attempted collusion/coordination in the market
  - Barriers to entry/repositioning

Basic structural tests for horizontal mergers

Reduction in Bidders/Competitors*

5 → 4	Usually clears if no bad documents and no material customer complaints
4 → 3	Usually challenged unless there are no bad documents and there is a strong procompetitive business rationale, some customer support, *and* minimal customer complaints
3 → 2	Almost always challenged unless there are no bad documents, and there is a compelling business rational that is strongly supported by customers and no material customer complaints
2 → 1	Always challenged

* Critically, these must be meaningful and effective alternatives from the perspective of the customer; "fringe" firms that customers do not regard as feasible alternatives do not count

Special Case #1: Unilateral effects

Two firms that compete very closely with one another but much less with other firms in the market

Special Case #2: Elimination of a maverick

Elimination of a firm that has been especially disruptive in the marketplace (a maverick)

Basic structural tests for horizontal mergers

- Future competitors (“Potential entrants”)
  - Third parties
    - Entry by a third party will increase the number of future competitors and reduce antitrust concern
  - A merging party
    - The merger will eliminate any incentive to enter the market for a merging party that otherwise would have entered in the absence of the transaction
    - Consequently, reduces the number of future competitors and can increase antitrust concern

Basic structural tests for horizontal mergers

- The chances of success *decrease* if—
  - If there are factors that facilitate the exercise of market power in the wake of the transaction
  - Major factors:
    1. Close and unique competition between the merging parties
    2. Merging parties two of the largest firms in the market
    3. The merger eliminates a "maverick"

Basic structural tests for horizontal mergers

- The chances of success improve if—
  - There are demonstrable powerful forces that constrain price increases or other anticompetitive behavior beyond the mere number of incumbent competitors
    - Major forces:
      1. *Entry or repositioning* by third-party competitors in response to anticompetitive behavior by the combined company
         - Requires low barriers to entry or repositioning
      2. *Powerful customers*, who can use their bargaining leverage to stop the combined firm from acting anticompetitively
         - Requires a detailed explanation of how the bargaining will work to constrain the combined firm
         - Defense on works firm-by-firm—Small firms without the requisite bargaining power can still be hurt
      3. *Efficiencies*, where the procompetitive pressure of the efficiencies outweighs the anticompetitive pressure of the increased market power
         - More on this below
         - Agencies very skeptical

Basic distinction #3

- Truth v. evidence
  - The agencies (and the courts) deal in *evidence*
  - Having the truth but being unable to prove it will not win the day
  - The investigating staff also needs evidence to be able to prove its case to the agency decision makers and, if necessary, in litigation

So what are the sources of evidence?

Major sources of evidence

1. Ordinary course of business documents of the merging firms
2. Company responses to second requests in an HSR Act review
   - Includes responsive documents and responses to data and narrative interrogatories
3. Interviews/testimony/public statements of merging firm representatives
4. Interviews with knowledgeable customers
5. Interviews with competitors
6. Customer and competitor responses to DOJ Civil Investigative Demands (CIDs) or FTC subpoenas
7. Analysis of bidding or “win-loss” data
   - Including the ability of customers to play the merging firms off one another
8. “Natural” experiments
9. Expert economic analysis

Structuring the Defense

Canonical structure of a complete defense

- The Collins approach—
  1. Describe the parties and the deal
  2. Describe the deal rationale
  3. Explain that the market will not allow the deal to be anticompetitive

Canonical structure of a complete defense

1. Describe the parties and the deal
2. Describe the deal rationale
   - Implicit (if not explicit) in the presentation is that customers will benefit and not be harmed by the transaction
   - That is, the profit-maximizing strategy for the combined firm is to shift the demand curve to the right and make money on increased volume, not increased prices
3. Explain that the market will not allow the deal to be anticompetitive
   - That is, customers have alternatives that they can use to protect themselves

Canonical structure of a complete defense

The best defense is a good offense:

The transaction is affirmatively procompetitive and *the market would not allow the deal to be anticompetitive even if the combined firm tried*

Homework Assignment for Class 2

The problem

The general counsel of TransDigm has asked you to begin a merger antitrust analysis of an acquisition by TransDigm of SCHROTH from Takata. The GC wants to start with a "quick and dirty" view of the problems that might arise in the United States. To this end, the GC will try to find the answers within the company to up to six questions. What six questions would you like to ask?

Instructor's answer

1. What is Transdigm's business rationale for making the acquisition (i.e., how will TransDigm make money by acquiring SCHROTH)?
2. How, if at all, will customers benefit from the transaction?
3. Are any customers likely to complain about the transaction and, of so, what will they say?
4. In any product line, will TransDigm be able to increase its profits by raising prices, reducing product or service quality, reducing investment in innovation or product improvement, or cut off supplies to competitors following the acquisition?

Instructor's answer

5. In what product lines do TransDigm and SCHROTH compete in the United States?
6. In each overlapping product line, are there significant other competitors to whom customers can turn to protect themselves in the event that TransDigm increases its price, reduces its product or service quality, or reduces investment in innovation or product improvement following the acquisition?

Questions from homework submissions

1. What are the relevant markets that will be affected by this acquisition?
2. How would you define the market (products/services and geography) for your products?
3. Will this acquisition substantially decrease competition in the relevant markets?
4. Does TransDigm have any current or potential competitors other than SCHROTH?
5. How big a player is TransDigm within the market?

Questions from homework submissions

6. For each product TransDigm's produces, please provide the names of all competitors and their respective market shares?
7. Will consumers be harmed by this acquisition by increase in prices?
8. Do customers "play off" TransDigm and SCHROTH against each other to get better prices?
9. What would TransDigm's new market share in an already highly concentrated market be after the acquisition?

Questions from homework submissions

10. Would the acquisition decrease innovation of future technologies or would TransDigm remain motivated to innovate?
11. Will consumers benefit from or be harmed by differences in product quality after the acquisition?
12. Has TransDigm received any customer complaints about the transaction?
13. What documents do the merging parties have that might reveal the intent of the transaction?
14. Does TranDigm have any documents or has it made any public statements suggesting that postmerger it will raise prices, reduce production, or decrease R&D investment?

Questions from homework submissions

15. How difficult is it for a new company to begin producing/offering the products in competition with TransDigm?
16. Will TransDigm discontinue any products after the acquisition?
17. Has TransDigm ever been accused or found guilty of actual or attempted collusion or coordination?