UNIT 2 CLASS SLIDES

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Merger Antitrust Law
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Thinking Systematically about Antitrust Risk

Query

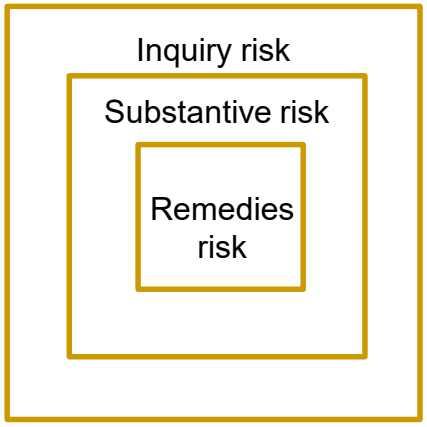
- You are counsel to TransDigm
  - Prior to signing the purchase agreement, they seek your advice on—
    - Whether the transaction will be investigated by the antitrust authorities?
    - Whether the DOJ or FTC will challenge the transaction on the merits?
    - Whether they can successfully defend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

Refresher: Anticompetitive effects

- Recall that the purpose of merger antitrust law is
  - to prevent the creation or facilitation of market power
  - to the likely harm of an identifiable group of customers through—
    - Increased prices
    - Reduced market output
    - Reduced product or service quality
    - Reduced rate of technological innovation or product improvement
    - [Maybe] reduced product variety

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)

Special Case #3:

Elimination of a potential entrant

In a high concentrated market, the acquisition by or of a firm that otherwise would have entered the market and thereby increased competition

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, repositioning, or output expansion* 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 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:
    - Close and unique competition between the merging parties ("unilateral effects")
    - Merging parties two of the largest firms in the market
    - The merger eliminates a "maverick"

Another basic distinction

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

Synergies/Efficiencies

Synergies/efficiencies

- Some definitions
  - *Synergies* (a business term)
    - Benefits to the company from the transaction that lower the combined firms' costs or increase its revenues
  - *Efficiencies*
    - The term used in antitrust analysis for synergies that benefit consumers

Efficiencies are relevant to the antitrust analysis only to the extent they are passed on or otherwise benefit to customers

Efficiencies

- Types of efficiencies enabled by the deal
  - Customer value-enhancing efficiencies
    - Making existing products better or cheaper, or
    - Creating new products or product improvement better, cheaper, or faster
  - Cost-saving efficiencies
    - Reductions in duplicative costs
    - Increases in the productive efficiency of the combined operation (e.g., through best practices, transfer of more efficient production technology)
  - Anticompetitive synergies
    - Eliminating competition on price, quality, service, or innovation and so increase profits (horizontal theory of anticompetitive harm)
    - Creating an incentive and ability to withhold important/ essential products or services used by competitors and so eliminate competition and increase price (vertical theory of anticompetitive harm)

Efficiencies

- Efficiencies play two roles in an antitrust merger analysis
  1. They provide an explanation why the acquiring firm is pursuing the deal (and probably paying a significant premium) that does not depend on price increases to customers or other anticompetitive effects
  2. In some cases, efficiencies can tip the agencies into not challenging the deal
     a. Where efficiencies exist *inside* a problematic market: A defense if efficiencies negate the anticompetitive effects that otherwise would likely occur
     b. Where efficiencies exist *outside* of the problematic market: Not cognizable as a legal defense but can appeal to prosecutorial discretion

Efficiencies

- To be credited by the investigating agency, synergies must be:
  1. Merger-specific
     - That is, they could not be obtained in the absence of the merger
  2. Verifiable by sufficient evidence
  3. Would completely and immediately be sufficient to offset any anticompetitive tendencies of the merger
  4. Not be the result of an anticompetitive effect of the transaction
- Agency view
  - Efficiencies were usually given very little weight by the end of the Obama administration
  - (Surprisingly), the same perspective has continued during the Trump administration

Structuring the Defense

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

- Bottom line:

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. Business rationale
   - What is Transdigm's business rationale for making the acquisition (i.e., how will TransDigm make money by acquiring SCHROTH)?
2. Customer benefits
   - How, if at all, will customers benefit from the transaction?
3. Consumer complaints
   - Are any customers likely to complain about the transaction and, of so, what will they say?
4. Power to raise prices
   - In any product line, would TransDigm have the power to increase its profits (if it wanted) 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. Competitive overlaps
   - In what product lines do TransDigm and SCHROTH compete in the United States?
6. Other competitors
   - 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 an 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?