MERGER ANTITRUST LAW

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Georgetown University Law Center
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Tuesdays and Thursdays, 3:30-4:55 pm
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READING GUIDANCE

Class 2 (August 30): Predicting Merger Antitrust Challenges (Unit 2)

On Thursday, we will begin to explore how to predict merger antitrust law enforcement outcomes. We will draw several important distinctions in this course. The first is between how decision makers (such as the DOJ, the FTC, or the courts) come to their decisions and how decision makers explain or justify their decisions after they have made them. A fundamental mistake all too many people make is believing that how a decision is explained (say in a court opinion) describes how the decision was made. The two need not be the same.

Of course, decision makers only explain the decisions they make; they seldom if ever discuss how they made the decision. Accordingly, we will not be able to explore the actual process of how the agencies or the courts make their merger antitrust decisions. What we can do, however, is develop a model that predicts the decisions they are likely to make. That is the topic for this class.

Antitrust risk. Before we begin on the predictive model, we need to examine the notion of antitrust risk in a transaction. Much of the first half of this course will focus on analyzing and dealing with the antitrust risk associated with a pending merger or acquisition. Lawyers give advice; clients make decisions. The goal for a lawyer in the beginning of a deal is to get the client into a position to make informed decisions about how to proceed (if at all) in light of the antitrust risk the transaction presents. But a big problem for practitioners, and hence for clients, is how to convey a meaningful sense of the risk to the client. Overall, I find that antitrust lawyers do a terrible job on this.

The notes provide a way to think systematically about antitrust risk (slides 3-6). I find that by far the best way to think about antitrust risk is in three nested buckets: (1) inquiry risk, (2) substantive risk, and (3) remedies risk. This is a very natural way for business people to think about antitrust risk. While I am going to address these risks in the context of a merger, they apply to any situation where antitrust risk—or indeed any type of legal risk—is present.

1. *Inquiry risk* is the risk that the merits of the transaction will be seriously examined. Antitrust questions do not materialize out of thin air. Someone has to have both the incentive *and* the institutional means of raising the question. Inquiry risk can be easily analyzed by looking at the incentive and the institutional means of the various actors interested in the transaction (primarily, the federal enforcement agencies, the state attorneys general, competitors, customers, and occasionally suppliers).
2. *Substantive risk* is the risk that the transaction violates the antitrust laws. Substantive risk arises if and only if there is an inquiry. Analysis of substantive risk requires an identification of the possible theories of antitrust liability and defenses that could apply to the situation and then a dispassionate evaluation of those theories in light of the evidence

to which the parties have access (including their own documents) or can develop (notably expert evidence), as well as a judgment about the evidence that the investigating agency may develop from third parties that is not available to the merging parties (at least absent discovery in the course of litigation).

3. *Remedies risk* reflects the consequences of a finding that the transaction violates the antitrust laws. Remedies risk is analyzed in terms of the possible outcomes of a finding of a violation and their associated probabilities of occurrence. This includes the range of possible "fixes" (restructurings) of a transaction to eliminate the violation or otherwise negate the concern and the likelihood of their acceptance by the relevant decision maker—the agency or the court—and the associated costs of these restructurings, as well as the possibility that there is no "fix" that would eliminate the antitrust problem.[1]

I should note that, for me at least, a lawyer cannot ethically assist a client in proceeding with a transaction or course of conduct where the inquiry risk is essentially zero but the substantive risk is near or at 100%. That is, a lawyer needs something more to advise a client than a high level of confidence that the client will not get caught. That something more is a colorable argument that the course of conduct is lawful. A colorable argument does not have to be a winning argument nor does it have to comport with the judicial antitrust rules then in effect (since courts can change those through the common law approach to antitrust law). Although definitions vary, my definition in practice is that an argument—including an argument that the judicial rules applying the antitrust statutes—is colorable if I am comfortable making the argument to a judge I respect in open court and knowing that the argument will be reported through the various antitrust newsletters and blogs to the antitrust bar at large.[2]

Substantive antitrust risk. After a quick introduction to antitrust risk, we will turn to analyzing substantive antitrust risk (slides 7-39). I suggest that you read all of the slides even though we will not get through all of them on Thursday and may have to cover the reminder next Tuesday in class 3. You will find it helpful to have an idea of where all of this is going before we get started in class.

While inquiry risk is logically prior, you will get a better understanding of inquiry risk if we first examine substantive antitrust risk. When you read these slides, keep these two points in mind:

1. Substantive risk can be defined in one of two ways: (a) the risk that the DOJ or FTC will challenge a deal at the end of a merger review, or (b) the risk that at the end of a litigation the transaction will be found to violate Section 7 of the Clayton Act. For reasons we will discuss, almost all challenged transactions are either settled with a

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[1] A typical "fix" in a horizontal merger (that is, a combination of two competitors) is to divest a product line or business in the problematic area from one of the two merger companies. For examples, if two supermarket chains merge and there is an antitrust problem is the Chattanooga supermarket market, then the merging parties can "fix" the problem by agreeing to divest the all of the supermarket stores in Chattanooga owned or operated by one or the other the other merging parties to an independent third party that will continue to operate them as supermarket stores with the same competitive force as the divestiture seller.

[2] I should note that this is a personal approach and not a view on what the formal rules of ethics governing lawyers require. Some to whom I have spoken who know more about the formal requirements of the ethics rules agree with me where the conduct in question is criminal but say that my approach is more restrictive than necessary where the unlawful conduct would not be criminal. Others, however, are not so sanguine about the non-criminal scenario.

consent decree or voluntarily terminated. Very few challenged mergers proceed to litigation. Therefore, our initial focus will be on the risk that the investigating agency challenges the transaction and not on litigation outcomes.

2. As noted above, we will draw several important distinctions in the course. The first one is between the reasons the agency *decides* to challenge a transaction and the reasons the agency puts forth to *explain* why a challenged transaction is illegal. The process of decision-making can be quite different from the process of explanation.

We will focus in this class on a model that predicts agency prosecutorial decision-making rather than explanation. The class notes first provide some more detail on Section 7 of the Clayton Act (slides 7-13) and then turn to describing the predictive model (slides 14-36). You may find our discussion provides a somewhat different perspective of merger antitrust analysis than you saw if you have taken an antitrust survey course. Most of what you see in antitrust courses is how judges and occasionally enforcement officials explain the antitrust decisions they reached; my model looks to predicting what enforcement decisions the agency will make. It turns out that there is a big difference. You may also find it curious that my predictive model makes no reference to market definition, HHIs, diversion ratios, upward pricing pressure, or the 2010 DOJ/FTC Horizontal Merger Guidelines—staples in the explanation of merger antitrust enforcement decisions. Later, when we study merger antitrust litigation, we will examine these and other more formal concepts as we look at the reasons the agencies use in trying to convince a court that the transaction is illegal.

While you should focus more on the class notes, I also have included in the reading the 2010 DOJ/FTC Horizontal Merger Guidelines. The DOJ press release (pp. 4-6) gives a good introduction. Review Section 1 of the 2010 Guidelines (pp. 10-21), which you should have read for last Monday's class. Read Sections 2 and 3—Evidence on Adverse Competitive Effects (pp. 11-15) and Targeted Customers and Price Discrimination (pp. 15-16)—with some care. You can just skim the rest of the Guidelines (pp. 16-43) or even just look at the headings to get a rough sense of what else the Guidelines address. You will have the opportunity to read those sections in more detail as they arise in the case studies later in the course. The statements of FTC Chairman Jon Leibowitz (p. 44) and of Commissioner Tom Rosch (pp. 45-48) will give you an idea of what two important commissioners at the time thought of the Guidelines. My personal take on the 2010 Guidelines, which includes a somewhat unconventional view on why the agencies revised the Guidelines after 18 years, is memorialized in the S&S note to clients (pp. 49-54).

If you are interested in the types of unhelpful things companies can write, take a look at the 1995 *Microsoft* DOJ complaint (especially 57-59, 66) and the 2007 *Whole Foods* FTC complaint (especially pp. 74-79, 80-81). My suggestion is that you leave this until last and if you still have the time and interest, take a look. Otherwise, skip them.

Synergies. The next section of the class notes introduces synergies or, as they are sometimes commonly called in antitrust analysis, efficiencies (slides 37-52). Synergies are the private benefits the merged company obtains through the merger. Two major types of synergies are:

(1) customer value-enhancing synergies, which enable the merged firm to create new products or to make existing product better, cheaper, or faster; and

(2) cost-saving synergies, which reduce duplicative costs (e.g., by closing one of the two headquarters buildings) or increase the firm's productive efficiency of the combined operation (e.g., through best practices, transfer of more efficient production technology).

Importantly, benefits to the merged firm that harm customers (say being able to charge higher prices to customers because the transaction combined the only two competitors in the market) are not regarded as a synergy in merger antitrust analysis.[3]

A question in many transactions is whether the procompetitive synergies of a transaction somehow outweigh or offset the anticompetitive tendencies of the transaction. This will be a recurring focus in many of our case studies. For now, we are just introducing the subject. Read slides 37-52 for a quick practical introduction and Section 10 of the 2010 DJ/FTC Horizontal Merger Guidelines (pp. 38-40) for some sense of how the agencies treated synergies.[4]

Note that the Guidelines (and increasingly the courts) require that, to be considered in the antitrust analysis, synergies must be:

1. Merger-specific (i.e., could not be accomplished 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, and
4. Not be the result of an anticompetitive effect of the transaction

The DOJ and FTC have applied these criteria very restrictively. The agencies have rejected evidence of merger specificity as insufficient where it was at least conceptually possible for the merging companies individually to achieve the synergies individually—for example, by the target through additional R&D investment—even when the evidence was undisputed that the target had no plans to make the investment in the absence of the merger. Likewise, the agencies have rejected as insufficient evidence of variability the testimony of responsible company employees, even when the synergies estimates were relied upon by the acquiring firm's board of directors in approving the transaction, the resulting estimates reported in public announcement and SEC disclosure filings, and similar efficiencies achieved by the buyer in prior transactions. Finally, the agencies have rejected efficiencies as sufficient to eliminate any anticompetitive tendencies of the merger for failure of the parties to model the anticompetitive effects of the transaction to the investigating agency's satisfaction.[5] As a result, by the latter years of the

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[3] No doubt being able to charge higher prices because the transaction created more market power in the combined firm is a benefit to the firm and you sometimes see this reflected in the firm's documents as a "revenue synergy." While the transaction can increase revenues to the combined for reasons other than market power, when the DOJ and FTC read "revenue synergy" in a company's documents they assume that this is from the exercise of market power. Consequently, it is important for companies to be clear in their documents that any revenue synergy is from increasing, and not decreasing, the value proposition the firm offers its customers. Better yet, the term should be avoided.

[4] There is a little math in some of these slides. If you are not familiar with these types of diagrams or the math, do not worry about it. We will go over this in class.

[5] As we will discuss in class, in the usual neoclassical microeconomic models used in antitrust analysis a profit-maximizing firm will set its price so that its marginal revenue equals its marginal cost. This means that cost reduction synergies are cognizable only if the synergy reduces the combined firm's marginal cost of production and that fixed cost reductions (such as the elimination of duplicative facilities), while perhaps significant to the merging

Obama administration, the DOJ and FTC all but eliminated efficiencies from any serious consideration in determining whether a transaction presented a competitive problem. Much to the surprise of many observers, the Trump administration appears to be continuing this policy. I have included a critique of this approach by Commissioner Josh Wright in his dissent in the *Ardagh* case (pp. 88-95).

Putting things together. Finally, the remaining slides in the deck attempt to put everything in this unit together (slides 53-58) into a coherent defense of a transaction. This is a quick read.

If you have any questions or comments, send me an e-mail. See you in class.

Dale

P.S. It is time to start the lunches. If you have the time and interest in lunch on Friday, September 14, please let me know. I suggest Rosa Mexicano (F Street at 7th, across from the Capital One Arena) at 12:30 pm, but I welcome alternative proposals. If we can get a critical mass of students (between 3 and 5), let's do it. If there is an overflow, we will schedule a second lunch.

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firm's expected future earnings, do not count in the antitrust analysis as a procompetitive offsetting factor (see slides 45-47).