

CLASS SLIDES

Unit 2: Predicting Merger Antitrust Law Challenges

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■ Homework assignment for Class 1

Relevant market	Harms and supporting allegations
1. Two-point lapbelts used on commercial airlines	<p><i>Alleged anticompetitive harms:</i></p> <ul style="list-style-type: none">Higher product pricesReduced rate of innovation and product improvements <p><i>Supporting allegations:</i></p> <p>Only 3 meaningful competitors premerger (Compl. ¶ 24) (A “3-to-2 merger”)</p> <ol style="list-style-type: none">1. AmSafe was by far the largest2. Small, privately held firm that had been in the market for years but gained little share3. SCHROTH, which entered the market with a new, innovative lightweight two-point lapbelt (“Airlite”), which it aggressively marketed to the major international airlines

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■ Homework assignment for Class 1

Relevant market	Harms and supporting allegations
2. Three-point shoulder belts used on commercial airlines	<p><i>Alleged anticompetitive harms:</i></p> <ul style="list-style-type: none">Higher product pricesReduced rate of innovation and product improvements <p><i>Supporting allegations:</i></p> <p>Only 2 meaningful competitors premerger (Compl. ¶ 26) (a “2-to-1 merger”)</p> <p>AmSafe was by far the largest</p> <ol style="list-style-type: none">1. “SCHROTH was aggressively seeking to grow its business at AmSafe’s expense”2. Probably means that SCHROTH had not achieved any significant sales yet, but that efforts to penetrate the market caused AmSafe to reduce prices

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Relevant market	Harms and supporting allegations
3. Technical restraints used on commercial airlines	<p><i>Alleged anticompetitive harms:</i></p> <ul style="list-style-type: none">Higher product pricesReduced rate of innovation and product improvements <p><i>Supporting allegations:</i></p> <p>Only 3 significant suppliers premerger (Compl. ¶ 28) (a “3-to-2 merger”)</p> <ol style="list-style-type: none">1. AmSafe (“leading supplier”)2. SCHROTH (“aggressively seeking to grow”)3. (Unnamed) international aerospace equipment manufacturer

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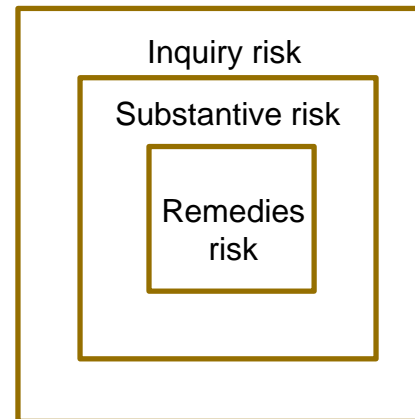
Relevant market	Harms and supporting allegations
4. Inflatable restraint systems used on commercial airplanes	<p><i>Alleged anticompetitive harms:</i></p> <ul style="list-style-type: none">Higher product pricesReduced rate of innovation and product improvements <p><i>Supporting allegations:</i></p> <p>Only 2 meaningful competitors premerger (Compl. ¶ 30) (a “2-to-1 merger”)</p> <ol style="list-style-type: none">1. AmSafe (which developed technology—offers both inflatable lapbelts and structural mounted airbags)2. SCHROTH (offers only structural mounted airbags), but “In recent years, SCHROTH had emerged as a strong competitor to AmSafe in the development of inflatable restraint technologies” <p>Sounds very weak to me</p> <p>May be some innovation competition (but maybe not that much)</p>

Thinking Systematically about Antitrust Risk

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



Costs associated with antitrust risk

- Outcome costs—Four possible outcomes:
 1. The transaction is cleared on the merits
 2. The parties restructure (“fix”) the deal to eliminate the substantive antitrust concern
 - “Fix-it-first”—Restructuring the deal preclosing to avoid a consent decree
 - Post-closing “fix” under a judicial consent decree (DOJ) or a FTC consent order
 3. The transaction is blocked and the purchase agreement is terminated
 4. The deal terminates without resolution
- Delay/opportunity costs
- Management distraction costs
- Expense costs

Substantive Risk: Predicting Merger Enforcement Outcomes

Clayton Act § 7

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

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

Clayton Act § 7

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“May be to substantially lessen competition”

- *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

Unless there are incriminating documents or statements on the other factors, price will be the focus of the analysis

- Forward-looking analysis

- Compare the postmerger outcomes with and without the deal
- Can view potential competitors today as future competitors tomorrow

Theories of anticompetitive harm

■ Major theories

1. Elimination of horizontal competition among current rivals
 - Unilateral effects
 - Coordinated effects
 - Elimination of a “maverick”
2. Vertical harm
 - Foreclosure of competitors (upstream or downstream)
 - Raising costs to rivals
 - Anticompetitive information access
3. Elimination of actual potential competition
4. Elimination of perceived potential competition

But this is all too complicated—

■ Basic distinction

- *Decision making*: How do the agencies decide a merger is anticompetitive merger?
- *Explanation*: How do the agencies explain why they believe that a merger is anticompetitive?

- 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 a defense of an outcome that the judge reached for other (unexplained) reasons

Assessing substantive antitrust risk

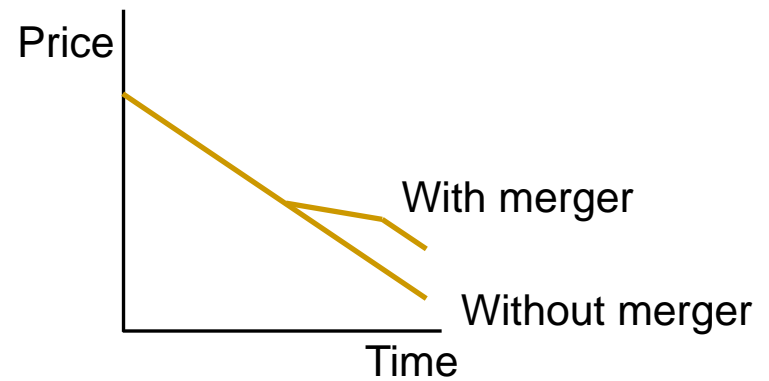
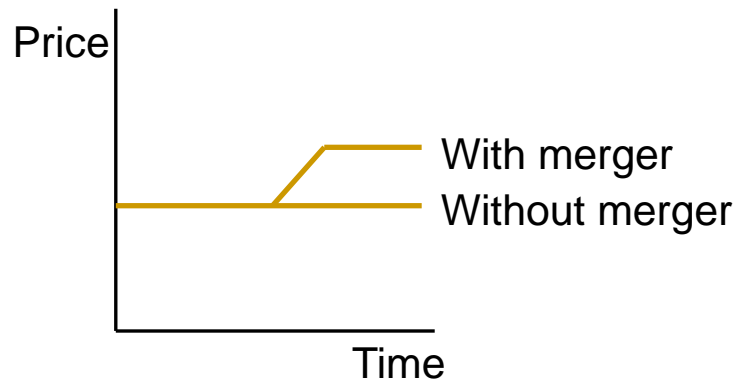
- So how do the DOJ/FTC approach merger antitrust investigations?
 - Recall that the purpose of merger antitrust law is to prevent the creation or facilitation of market power to the harm of customers in the market as a whole through—
 - Increased prices
 - Reduced market output
 - Reduced product or 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

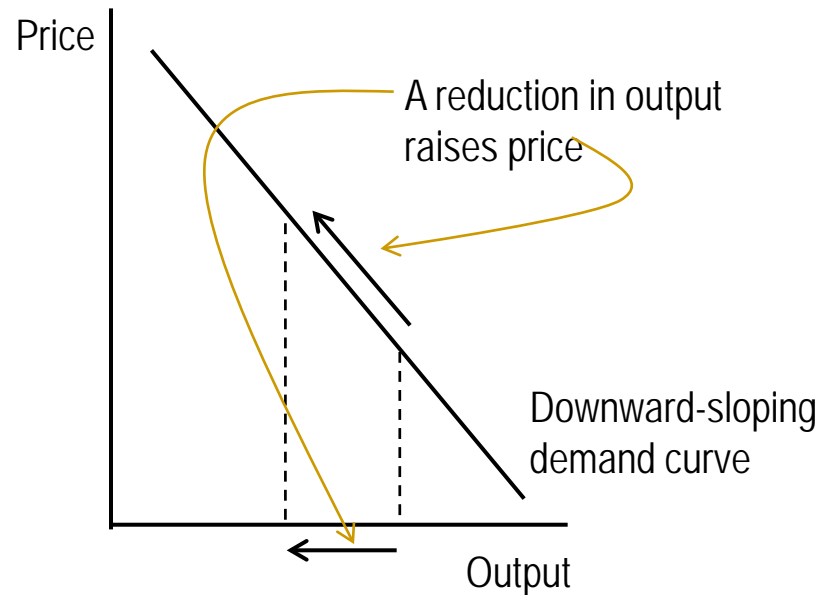
Assessing substantive antitrust risk

Examples of price increases



Assessing substantive antitrust risk

A Reduction in Output Implies a Price Increase



Assessing substantive antitrust risk

- Key factors in the decision to challenge horizontal mergers:
 - The existence of incriminating documents (or occasionally incriminating public statements)
 - 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 test 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, customer support, *and* minimal customer complaints
- 3 → 2 Almost always challenged unless there are no bad documents, and there is a compelling business rationale 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

Basic structural test for horizontal mergers

- Future competitors
 - If third parties, will increase the number of future competitors and reduce antitrust concern
 - If involved in the merger, will decrease the number of future competitors and can increase antitrust concern
- The chances of success
 - *Improve* if there are demonstrable powerful forces that constrain price increases beyond the mere number of players
 - E.g., powerful customers, low barriers to entry or repositioning
 - *Decrease* if there are factors that facilitate the exercise of market power in the wake of the transaction
 - E.g., close and unique competition between the merging parties
 - E.g., merging parties some of the largest firms in the market
 - E.g., 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 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

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

Synergies

- Synergies 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 close cases, large synergies can tip the agencies into not challenging the deal
- Types of synergies enabled by the deal
 1. Customer value-enhancing synergies
 2. Cost-saving synergies
- Overall
 - Synergies are very helpful in fashioning a procompetitive narrative
 - But agencies are (irrationally?) skeptical/hostile to the existence of synergies
 - Synergies will almost never outweigh prima facie evidence of an anticompetitive effect

Synergies

- To be credited by Investigating agency, synergies must be:
 1. Merger-specific
 - That is, 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
 4. Not be the result of an anticompetitive effect of the transaction
- Agency view
 - Efficiencies usually given very little weight in the Obama administration
 - *Query*: What will be the weight given to synergies in the Trump administration?
 - Apparent (surprising) answer: Not much

Canonical structure of a complete defense

1. The parties and the deal
2. The deal rationale
3. The market will not allow the deal to be anticompetitive

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■ Homework assignment for Class 1

□ Six questions for the company (Instructor's answer):

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

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□ Questions for the company (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?
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. To 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?

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□ Questions for the company (from homework submissions):

10. Would the potential 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 TransDigm have any documents or has it made any public statements suggesting that postmerger it will raise prices, reduce production, or decrease R&D investment?
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?