CLASS 2 SLIDES

Unit 2. Predicting Antitrust Enforcement Challenges

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Thinking Systematically about Antitrust Risk

Query

- You are counsel to TransDigm
  - Prior to signing the purchase agreement, TransDigm's management seeks 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?

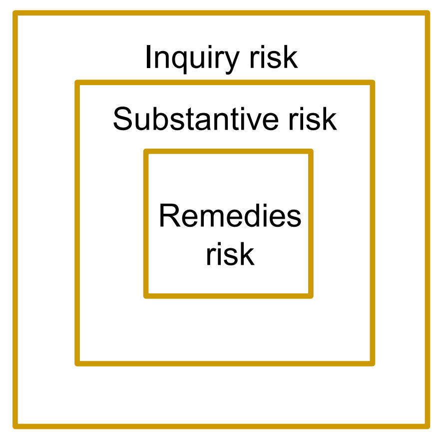
These are the fundamental questions every client asks at the beginning of a deal

These are questions about antitrust risk. How can we best explain to a client what is the antitrust risk 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,
    2. The *reward* that the challenger will obtain from a successful challenge, *and*
    3. The *costs* to the challenger of raising the challenge

In other words, inquiry risk depends on the expected value *to the challenger of raising the antitrust question*

- The first factor is a function of the substantive risk—so we need to study that first

Substantive risk

- Definition
  - The risk of being unable to successfully defend the transaction on the merits
- Can be defined in relation to either—
  - The outcome of a DOJ/FTC merger investigation, *or*
  - The outcome of a litigation on the merits

Substantive risk: Costs

- There are costs associated with substantive risk that incurred in defending a transaction regardless of the outcome—
  - Delay/opportunity costs
  - Management distraction costs
  - Expense of investigation/litigation and other out-of-pocket costs

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 do we make that prediction?

First, an important distinction

- Basic distinction #1
  - *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 fundamental task in effective advocacy is recognizing this distinction and making your argument appeal simultaneously to the "heart" and "mind" of the decision-maker

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 through—
    - Increased prices
    - Reduced market output
    - Reduced product or service quality
    - Reduced rate of technological innovation or product improvement
    - [Maybe] reduced product variety

Under the consumer welfare standard, modern antitrust law looks to effects on customers

Effects on suppliers (including labor) rarely count unless there is a consequent effect on customers

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
- *Corollary*: No deal is too small not to be challenged

Assessing substantive antitrust risk

- Key factors in the decision to challenge horizontal mergers:
  1. The existence of incriminating company documents (or occasionally incriminating public statements by management)
  2. The number of other realistic alternative competitor-suppliers for each identifiable customer group
  3. Closeness and uniqueness of competition between the merging parties
     - Especially evidence of unique head-to-head price competition between the merging parties
  3. Customer complaints
  4. Barriers to entry/repositioning
  5. "Natural experiments"
  6. [Empirical] economic analysis
  7. History of actual or attempted collusion/coordination in the market

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—
    1. Increased prices
    2. Reduced market output
    3. Reduced product or service quality
    4. Reduced rate of technological innovation or product improvement
    5. [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 successfully defending a deal *improve* if—
  - There are demonstrable powerful forces that constrain price increases or other anticompetitive behavior beyond the mere number of incumbent competitors
  - Three 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

- Defenses
  - These forces are *legal defenses* if they are sufficient in likelihood and magnitude to completely offset the likely customer-harming aspects of the transaction
  - Basic distinction #2
    - *Negative defense*: The merger is not anticompetitive in the first instance
    - *Affirmative defense*: Even if the merger is anticompetitive, it is nonetheless not unlawful
  - Technically—
    - A *negative defense* denies an element of the plaintiff's prima facie case
    - An *affirmative defense*
      - accepts the elements of the prima facie case as true, but
      - raises matters outside of the prima facie case that provide a justification or an excuse to absolve the defendant from liability

There are no affirmative defenses in modern antitrust law

Basic structural tests for horizontal mergers

- The chances of successfully defending a deal *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 (“unilateral effects”)
    2. *Asymmetrically large transaction* combing two of the largest firms in the market
    3. The merger eliminates a “*maverick*”

Another basic distinction

- 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 make its case to the agency decision makers and, if necessary, in litigation

So what are the sources of evidence?

Major sources of evidence

1. Company documents submitted with the original HSR filing
2. Company responses to second requests in an HSR Act review
   - Ordinary course of business documents
   - 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 responses in staff interviews and 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

Major sources of leads

1. Competitor responses to staff interviews and to and to DOJ Civil Investigative Demands (CIDs) or FTC subpoenas
   - *Query*: Why do competitor responses about adverse competitive effects of horizontal transactions only provide leads and not evidence?
2. Financial analyst reports
3. Trade journal and newspaper reports

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

Synergies

- Types of synergies enabled by the deal
  1. Customer value-enhancing efficiencies
     - Making existing products better or cheaper
     - Creating new products or product improvement better, cheaper, or faster
  2. 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)
  3. 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 the efficiencies exist *inside* a problematic market, efficiencies are a defense if efficiencies negate the anticompetitive effects that otherwise would likely occur
     b. Where the efficiencies exist *outside* of the problematic market, efficiencies are not 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*

Customer evidence

- Recall the basic structural predictive test for horizontal deals:

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
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Customer evidence

- Recall the basic structural predictive test for horizontal deals:

Reduction in Bidders/Competitors*		Critical predictive factor
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	

Critical predictive factor

In the absence of bad documents and other exacerbating factors, ***customer evidence*** is the key determinant whether the deal will be challenged

1. How can antitrust deal counsel assess the likely customer evidence the DOJ/FTC will find?

What can you do, if anything, as antitrust deal counsel to help minimize adverse customer evidence?

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 harm customers
   - 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 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?

Bonus Class Exercise (time permitting)

It is September 2016. Nicholas Howley, the CEO of TransDigm, is considering making an acquisition of the SCHROTH commercial airlines safety restraint business. He is asking you for a preliminary antitrust risk analysis of this deal. You know no facts, but Mr. Howley is happy to answer your questions at the meeting. He is also skeptical that the deal presents any material antitrust risk.

Prior to the meeting: Learn what you can

1. Look at the web sites of both companies
   - Learn about their businesses
   - Try to assess whether there are any product overlaps
2. Search the Internet and newspaper archives using "TransDigm and SCHROTH" as the search term

Assume that you find from this research that—

- *The deal involves a horizontal overlap in safety restraints for commercial airlines*
- *TransDigm is the dominant firm in the business*
- *SCHROTH is a new entrant with a small share*
- *There are few if any other firms in the business*

But no other meaningful information

Goals of the meeting

1. *Teach* the client the operational test for Section 7 illegality
2. *Ask* the client the most important factual questions
3. *Communicate* your view of the antitrust risk in a way that the client understands
4. *Provide* any strategic advice as to how the client might minimize antitrust risk

Teach the client the operational test

- Reasons to start here
  1. Unless the client understands the test, she will not be persuaded by your advice

     The client will not be persuaded unless they can replicate your analysis

  2. If the client understands the test, she is more likely to give complete and meaningful answers your factual questions
  3. If the client knows the test, they can continue to think after she leaves the meeting about what other facts may be relevant and follow up with you to sharpen the risk analysis
  4. The client needs to know the operational test as they move forward with the transaction

     Start prepping them with the first meeting so that they can understand the antitrust implications of—
     - *What they write in their documents*
     - *What they say to the press and to customers*
     - *What they say in meetings with the investigating agency*

Teach the client the operational test

- Clayton Act § 7
  - Governing merger antitrust statute
  - Prohibits transactions that "may substantially lessen competition"
- But what does this mean *operationally*?
  - A transaction "may substantially lessen competition" when it is likely to harm an identifiable group of customers through—
    1. Increased prices
    2. Reduced market output
    3. Reduced product or service quality
    4. Reduced rate of technological innovation or product improvement
    5. [Maybe] reduced product variety

Teach the client the operational test

- Tell the client how the investigating agency is going find the facts about likely competitive effect
  - The HSR reportability and merger review process
    - Time to ask the first question to find out if the deal is likely to be reportable
  - The investigating agency will—
    - Entertain a presentation from the parties on the deal
    - Interview—and perhaps later depose under oath—you and other relevant employees in both companies
    - Obtain massive amounts of the documents of both companies
    - Interview customers and competitors (and maybe obtain documents and data from them)
    - Analyze win-loss records of the companies in bidding for projects
    - Perhaps engage economists to analyze the likely competitive effects of the transaction

Teach the client the operational test

- Bottom line
  - The agency's conclusion on the likely effect on customers will determine the outcome of the investigation
    - NB: It is the *agency's conclusion*, not necessarily the truth, that counts
  - The best defense is a good offense
    - Can we argue that the deal is a "win-win" for the merging parties *and* the customers?
    - Companies do not do deals out of the good of their heart—they do deals to make money
    - Do we have a story consistent with the business model for the transaction, the documents and other company evidence and the likely customer responses in staff interviews that the deal will be good for customers?

Best story*: The transaction will enable the combined company to make money by reducing costs and by making better products faster to the benefit of our shareholders and our customers*

Ask the client questions

1. What is the deal rationale?
   - How will TransDigm make money from the transaction?
   - Are there any documents on the business rationale?
     - If so, what do they say?
   - What are the implications of the business model for customers?
2. What will the company documents say about competition between the two companies?
3. Who are the customers and what will they say to the agency?
4. Do we have a sales pitch that we can give to the customers that the deal will be good for them?
   - Will they accept it?

Communicate the antitrust risk

- *Answer the client's question*: Based on what you learned in the meeting, what is the antitrust risk presented by the deal?
  - It is not sufficient for you to form a view as to the antitrust risk
  - You must meaningfully communicate the nature of this risk to the client so that the client can make informed business decisions
    - If the client does not understand your advice, she cannot act on it
    - If the client is not persuaded that your advice is correct, she will not act on it
- Best explained in terms of—
  - Substantive risk
  - Inquiry risk
  - Remedies risk

So what would you tell Mr. Howley about the risk of a TransDigm/SCHROTH deal in each of these areas?

Provide any strategic advice

1. Emphasize the need for a compelling sales pitch for the deal to customers of *both* companies
   - Offer to help the relevant business people develop this pitch and when and how to roll it out
   - Note that it is the customers of the target company that are typically the most difficult to persuade
     - Will eventually need to work with the target company as to how best persuade its customers
2. Emphasize the need for care in drafting documents
   - “Bad” documents alone can kill a deal
     - Avoid creating documents that suggest—implicitly as well as explicitly—that the deal could harm customers
     - Some documents are “bad” because they were carelessly phrased or factually incorrect, not because the speak the truth—These can also kill a deal
   - If there is one, include the procompetitive business rationale for the deal in as many documents as possible

Provide any strategic advice

3. Consider whether the deal can be structured so as to make it non-HSR reportable to minimize inquiry risk
4. Consider delaying opening any deal discussions with the target until at least November and perhaps late January
    - Why?

Final thoughts

1. Caution the client that this advice is only preliminary and depends on what the client has told you in the meeting
2. Note that more work should be done
   - Would like to send the client a *preliminary information request* for easily obtainable documents and data
   - When confidentiality considerations permit, would like to set up a *meeting with knowledgeable employees* to further develop the facts and the argument
3. Note all documents created at the request of counsel should have the following prominent legend:

PRIVILEGED AND CONFIDENTIAL
Prepared at the request of counsel

   - Whenever possible, this should be machine readable

Final thoughts

4. Note that at some point in the process we will need to bring the target company onboard
   - The target's evidence and customer outreach program will be equally if not more critical to the outcome of any merger review
   - Note that we should be able to work with the target company under the "common interest" privilege
5. The target, unless incompetently advised, is likely to recognize the antitrust risk in the transaction
   - Should expect that the target will attempt to negotiate some provisions in the purchase agreement to—
     - Decrease the risk of a deal failure, and
     - Compensate the target for risk that cannot be eliminated