MERGER ANTITRUST LAW

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Tuesdays and Thursdays, 3:00-5:00 pm
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READING GUIDANCE

Class 2 (September 3): Predicting Merger Antitrust Outcomes (Unit 2)

On Thursday, we will explore how to predict merger antitrust law enforcement outcomes with only limited information. More often than not, only limited information will be available at the beginning of a transaction, when the purchase price and terms of the deal are being negotiated and only a handful of senior executives know about the prospect of a transaction. Still, predictions need to be made about the antitrust risk the deal presents and the likelihood that divestitures or other changes need to be made in the transaction to enable the deal to close. The client—whether buyer or seller—needs a sense of the antitrust outcome in order to negotiate the purchase price the deal and make informed judgments about tradeoffs in negotiating the antitrust risk-shifting provisions in the merger agreement.

Accordingly, we need a way to predict antitrust outcomes when only limited information is available. Before beginning to explore this model, we should draw an important distinction between how decision-makers (such as the DOJ, the FTC, or the courts) make decisions and how they explain or justify their decisions after they have made them.[1] A fundamental mistake all too many people make is believing that how a decision is *explained* or *justified* (say in a court opinion) describes how the decision *was made*. The two often are not 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 directly 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 concept of antitrust risk in a transaction. Much of the first part of this course will focus on anticipating 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. 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 class notes provide a way to think systematically about antitrust risk (slides 3-7). 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

[1] In the philosophy of science, this distinction is between the "context of discovery" and the "context of explanation."

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) to raise an antitrust question about the deal in a forum that requires an answer.
2. *Substantive risk* is the risk that the transaction violates the antitrust laws. Substantive risk arises if and only if there is an inquiry. The 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 conclusion 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," most particularly consent decrees requiring the divestiture of some of the businesses or assets of the merging parties to a third party that will then operate the divested businesses or assets in competition with the merged firm.[2] The idea of a "fix" is to enable an independent third party to "step into the shoes" of the divesting firm, preserve the premerger level of competition, and so negate the antitrust concern and eliminate the antitrust violation.[3] Assessing remedies risk requires an evaluation of the minimally reasonable fix (and likely a range of other more onerous fixes), the likelihood of the acceptance of the fix by the relevant decision-maker (the investigating agency or the court), and the associated costs of the fix to the merged firm.[4] Evaluation of the remedies risk must also take into account the possibility that there is no fix that would cure the antitrust problem.[5]

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[2] A typical "fix" in a horizontal merger (that is, a combination of two competitors) is the divestiture of 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 of 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.

[3] "Fixes" are central to merger antitrust law, since most investigations in which the DOJ or FTC concludes that the merger violates the antitrust law are resolved through a precomplaint curative divestiture, not through litigation.

[4] These include the loss of synergies associated with the divested businesses, any discount from going-concern value that the divestiture seller likely will have to accept since merger divestitures are usually made in "fire sale" conditions, and the transactions costs associated with the divestiture sale.

[5] We will discuss this more in Unit 4, but the acceptance of a precomplaint fix is purely within the discretion of the investigating agency. The agency may refuse to accept a consent decree for any reason, including an arbitrary. Agency decisions to refuse to accept a consent decree are not subject to review under the Administrative Procedure

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 as we saw in Unit 1 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 should be changed —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.[6]

Substantive antitrust risk. 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 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. In evaluating antitrust risk, we need to focus primarily on the facts that influence the agency's decision to challenge the transaction and much less on how the agency explains this decision after the fact.

In Class 2, we will examine a model that predicts agency prosecutorial decision-making outcomes. The class notes first provide some more detail on Section 7 of the Clayton Act (slides 10-13) and then turn to describing the predictive model. Concentrate on the general

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Act. Unless provided by statute, only "final" agency actions are reviewable under the APA, 5 U.S.C. § 704, and a decision to refuse to settle an investigation is not a "final agency action" because it is interlocutory and does not impose an obligation, deny a right, or fix a legal relationship. *See* Bennett v. Spear, 520 U.S. 154, 177 (1997) (holding that agency action is "final" within the meaning of the APA only if (1) action marks the "consummation" of the agency's decisionmaking process, and (2) second, the action must be one by which "rights or obligations have been determined," or from which "legal consequences will flow"). In addition, it is likely that a decision to refuse to settle is "committed to agency discretion by law" and so exempt from APA review under 5 U.S.C. § 701(a)(2).

[6] I should emphasize that this is a personal approach and not a view on what the formal rules of ethics governing lawyers necessarily require. Some attorneys 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 noncriminal scenario.

principles (slides 14-30). You can skim the special cases (slides 31-34); we will get into this in excruciating detail later in the course.

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 litigated merger antitrust cases, 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.

Merger Guidelines. Notwithstanding the lack of any reference to the 2010 DOJ/FTC Horizontal Merger Guidelines in the predictive model, I have included them in the reading. You are going to have to read them sometime, and gaining some familiarity with them now will help you throughout the course. The DOJ press release (pp. 3-5) gives a good introduction. Study the table of contents (pp. 7-8) so that you understand the basic organizational structure of the Guidelines. Review Section 1 (pp. 9-10), which you should have read for last Tuesday's class. Read Sections 2 and 3—Evidence on Adverse Competitive Effects (pp. 10-14) and Targeted Customers and Price Discrimination (pp. 14-15)—with some care. You can skim the rest of the Guidelines (pp. 15-42) 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. 43) and of Commissioner Tom Rosch (pp. 44-47) 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. 48-53), which you can just skim or skip altogether.[7]

"Bad documents." If you are interested in the types of unhelpful things the merging companies can write, read the 1995 *Microsoft* DOJ complaint (especially 56-58, 65) and the 2007 *Whole Foods* FTC complaint (especially pp. 73-78, 79-80). My suggestion is that you leave these materials until last and if you still have the time and interest, take a look. Otherwise, skip them.

[7] The first set of merger guidelines were issued in 1968 by the Department of Justice. *See* U.S. Dep't of Justice, Merger Guidelines (May 30, 1968). The guidelines were revised by Baxter in 1982 and covered both horizontal and nonhorizontal transactions. *See* U.S. Dep't of Justice, Merger Guidelines (June 14, 1982) (published at 47 Fed. Reg. 28,493). The FTC refused to join the 1982 guidelines and instead issued their own separate statement of how the Commission would assess mergers and acquisitions. *See* Fed. Trade Comm'n, Statement Concerning Horizontal Merger Guidelines (June 14, 1982). After a minor revision in 1984, the guidelines were significantly revised in 1992. *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (Apr. 2, 1992). Although the 1992 guidelines reflected the same conception of the goals of merger antitrust law as the 1982 guidelines, the 1992 guidelines were limited to horizontal transactions. The 1992 guidelines significantly enhanced the economic techniques to analyze horizontal mergers. Notably, the FTC joined in issuing the 1992 guidelines. The guidelines were again revised in 2010. *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (rev. Aug. 19, 2010). The 2010 guidelines, which continue to be limited to horizontal transactions, remain in effect today. For more on the historical development, see Evolution of the Merger Guidelines in the Unit 2 supplemental materials.

Synergies. The next section of the class notes introduces synergies or, as they are sometimes commonly called in antitrust analysis, efficiencies. 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 products better, cheaper, or faster to the direct benefit of customers, which in turn increases the demand for the merged firm's products;[8] 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.[9]

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 37-43 for a quick practical introduction and Section 10 of the 2010 DJ/FTC Horizontal Merger Guidelines (pp. 37-39) for some sense of how the agencies treated synergies.

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. Completely and immediately sufficient to offset any anticompetitive tendencies of the merger, and
4. Not 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 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

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[8] As a general rule, when I say "products" and mean both products and services.

[9] 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.

of the merger for failure of the parties to model the anticompetitive effects of the transaction to the investigating agency's satisfaction.[10] As a result, by the latter years of the 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. 87-94).

Putting things together. Finally, the remaining slides in the deck attempt to put everything in this unit together (slides 45-50) 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.

[10] As we will discuss in class and develop in more detail later in the course, 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 firm's expected future earnings, do not count in the antitrust analysis as a procompetitive offsetting factor (see slides 45-47).