MERGER ANTITRUST LAW

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Georgetown University Law Center
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Tuesdays and Thursdays, 3:00-5:00 pm
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GRADED WRITTEN ASSIGNMENT

Instructions

Submit by email by 8:00 pm on Monday, November 22
Send to wdc30@georgetown.edu
Subject line: Merger Antitrust Law: Graded Homework Assignment

Assignment

Calls for a memorandum.

You are an attorney in the Defense, Industrials, and Aerospace Section (DIA) of the Antitrust Division. DIA is reviewing Tornado Pens' pending acquisition of Conway Writing Corporation, two fountain pen manufacturers, for $95 million in cash.

The investigating staff recommends that the Division challenge the transaction under Section 7 in the nationwide sales of luxury fountain pens, which the investigating staff defines as fountain pens with a wholesale price of $130 or more. The staff argues that the transaction would produce a combined firm with a 50.6% market share in the staff's proposed market and easily predicate that *Philadelphia National Bank* presumption. The staff argues that the prima facie case is further strengthened by likely coordinated and unilateral anticompetitive effects resulting from the merger. The merging parties vigorously dispute the market definition and urge several alternatives in which they claim the *PNB* presumption is not triggered. The merging parties also dispute that the transaction would produce coordinated or unilateral effects and offer several additional defenses assuming arguendo that the staff can establish a prima facie case. The investigating staff does not credit those defenses.

Joyce Davenport, your section chief, has asked you to prepare a memorandum independently assessing whether DIA should recommend to the Assistant Attorney General that the Division challenge the transaction. In particular, Ms. Davenport is seeking your analysis of how strong the Division's prima facie case of a Section 7 violation is likely to be and whether the Division can defeat the defenses the merging parties advanced during the investigation. Market definition is a central issue in this matter, and, in addition to analyzing the merits of the staff's and merging parties' position, Ms. Davenport invites your thoughts on any alternative market definition and competitive analysis that you believe should be considered. Finally, if you recommend a challenge, Ms. Davenport would like you to address what consent decree relief, if any, the Division should be willing to accept.

The staff's investigation revealed the following facts:

A fountain pen is a writing instrument that uses a metal nib to apply a water-based ink to paper. The pen draws ink from an internal reservoir through a feed to the nib and deposits it on paper through a combination of gravity and capillary action. The fountain pen dates back to 973 when Ma'ad al-Mu'izz, the caliph of the Maghreb, requested a pen that would not stain and was given a pen with a built-in reservoir for the ink that could be held upside down without leaking.[1] Over the centuries, fountain pens improved due to an increased understanding of the role that air pressure plays in the operation of the pen and numerous innovations in more free-flowing inks, the iridium-tipped gold nib, and construction materials. By the 1880s, fountain pens were in mass production, with Waterman of New York City the leading manufacturer, and fountain pens soon became the nation's most popular writing instrument. By the 1960s, however, refinements in ballpoint pens and roller pens gradually ensured their dominance over fountain pens for most uses. That said, fountain pens continue to be the writing instrument of choice for calligraphers and others who view them as superior due to their relative smoothness and versatility. In addition, some fountain pens have become a status symbol as a luxury good, and manufacturers have produced models with status-conscious appeal. In recent years, the demand for fountain pens, especially more expensive pens that some consumers believe reflect prestige or status, has been growing.

Today, fountain pens are differentiated products manufactured and sold on a spectrum of quality and prices. All manufacturers sell and advertise their fountain pens nationwide and wholesale prices of under \$35 to over \$400 on a continuum with no clear breaking points.[2] Costs, and hence prices, increase as more expensive materials are used and as skilled artisans replace mass manufacturing techniques. Price also increases with consumer perceptions of the "status" or "prestige" associated with the pen. There are no clear "breaking points" in the spectrum of fountain pens and no broadly accepted industry or public segmentation of fountain pens. However, some third-party market research reports divide fountain pens into "writing instruments" where the prestige or status value of the pen is low (fountain pens with a wholesale price of less than \$100) and "prestige pens" where purchasers seem to value the pen more for its status than as a writing instrument (fountain pens with a wholesale price of \$100 or more).

Image advertising is essential to maintain the "prestige" status of the more expensive fountain pen. Over the last decade, firms with wholesale prices over \$100 have consistently followed the industry standard of spending about 10% of their revenues in advertising. This advertising is designed to maintain the prestige image of the pen; very little advertising is on price and there is no comparative advertising against other brands of fountain pens. In addition, to maintain the prestige of their fountain pens, manufacturers with wholesale prices over \$100 generally sell through jewelry stores and high-end specialty shops and avoid mass-market outlets such as Target and other department stores. By contrast, manufacturers of fountain pens with wholesale prices under \$100 spend a significantly lower portion of their revenues on advertising, advertise

1 See Clifford E. Bosworth, *A Mediaeval Islamic Prototype of the Fountain Pen?,* 26 J. Semitic Stud. 229 (1981).

2 In this problem, we will ignore the more expensive fountain pens, including the superexpensive limited edition fountain pens, such as the Caran d'Ache Gothica (\$487K), the La Modernista Diamond (\$265K), the Prince Rainier III Limited Edition 81 (\$256K), and the Montblanc Bohème Papillion Limited Edition (\$230K).

more on price rather than image, and sell through mass outlets rather than jewelry stores and high-end specialty shops.

Tornado, the tenth largest fountain pen manufacturer by revenues, produces and sells 360,000 fountain pens in the United States at a wholesale price of $150 with a margin of 40%. Tornado's closest competitors are Conklin ($110) and Quality Writing ($180). Conway, the twelfth largest fountain pen manufacturer, produces and sells 100,000 pens at a wholesale price of $220 with a margin of 50%. Conway's closest competitors are Quality Writing ($180) and Nettuno ($250). The staff also determined that the minimum margin for fountain pens is at least 30% and often much larger, especially for the more expensive pens.

For each manufacturer, wholesale prices are uniform throughout the United States. Although there is some discounting among retailers for pens with a wholesale price of less than $100, all manufacturers that sell pens at $100 or more set suggested retail prices, and retailers consistently follow those suggested prices. Each manufacturer also supports cooperative advertising by its retailers with uniform advertisements throughout the United States. Prices are transparent since retailers readily share price lists they receive from a manufacturer with the manufacturer's competitors.

Ten years ago, the five most expensive fountain pen manufacturers—Tornado, Quality Writing, Conway, Nettuno, and Accutron—formed the Luxury Fountain Pen Association to cooperate in promoting higher-end, more expensive fountain pens. However, the association does not appear to do very much. The association rarely meets, does not have an executive director or staff, and does not collect or distribute any data from its members. Although some members have suggested from time to time that the association should lobby Congress for protective tariffs or collect and distribute market data, there has been insufficient support to move forward.

Relative market shares in fountain pens with wholesale prices over $100 have been stable for many years. Prices for these pens increased at about the same rate as the rate of inflation for jewelry products shown by the U.S. Bureau of Labor Statistics in its Producer Price Index for Jewelry.[3] Although there has been some entry and exit of firms with products with wholesale prices under $100, there has been no attempt at entry by new firms with wholesale prices over $100 for the last decade or more. Nor have incumbent manufacturers introduced new product lines of pens with wholesale prices above $100 in the last ten years. The staff found that it takes years of extensive advertising to establish the "prestige" necessary to sell fountain pens with wholesale prices over $100 in sufficient volume to be profitable. To date, firms have not been willing to make this investment. It also takes extensive additional advertising by an incumbent firm to increase its market share materially. Even with this additional advertising, there is significant risk that the product will not "catch on" with consumers and that other firms will increase their own advertising in response. Even so, demand for fountain pens with wholesale prices over $100 has been steadily increasing in recent years for a number of years. The staff reports that several reputable companies have floated the idea that they might enter with a pen at

[3] *See* U.S. Bureau of Labor Statistics, *Producer Price Index by Industry: Jewelry and Silverware Manufacturing: Jewelry, Gold and Platinum* [PCU3399103399101], *retrieved from* FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/PCU3399103399101.

or above the $100-price point or expand their existing product line to include a higher-priced pen in light of this increasing demand.

In the investigation, Tornado told the staff that the acquisition of Conway would enable Tornado to grow its business, lower its costs, and diversify its product line. Tornado can increase its revenues by about 40% by acquiring Conway. At the same time, Tornado can lower its costs by $2.0 million annually by closing down Conway's headquarters and only production facility; consolidating all back office, sales, and marketing operations into Tornado's existing infrastructure; and moving all production into Tornado's factory. Tornado has sufficient capacity in its single manufacturing facility to absorb all of Conway's production and still have the capacity to significantly expand its production if and when demand warrants, although it will have to transfer some of Conway's artisans to the Tornado facility or hire new artisans to produce the Conway product. Moreover, after the consolidation of Conway into Tornado is complete—Tornado believes it will take about one to two years after the closing—Tornado plans to use part of its profits to launch a new product to compete at the $180 price point with Quality Writing. Tornado believes that it can sell at least 75,000 pens at the $180 price point within two years of introduction and sell even more in the succeeding years. Tornado says it will not have the free cashflow to expand its product line without the Conway acquisition.

The staff has contacted numerous retailers of fountain pens across the spectrum about the transaction. All of the retailers contacted by the staff were indifferent to the transaction; none of them expressed a concern that prices would increase or quality would decrease in any product as a result of the merger. Retailers did agree that some customers will consider Tornado and Conway pens as substitutes for one another. But they also confirmed that customers buying Tornado pens at more likely to look most closely at Conklin and Quality Writing pens as alternatives, while customers buying Conway pens look most closely at Quality Writing and Nettuno pens as alternatives. The staff has also reviewed the documents of the merging parties. The merging parties do not prepare strategic plans or other market analyses, and their documents shed little light on the nature of competition in the fountain pen space.

The investigating staff wants to recommend that the Division challenge the merger. The staff proposes to define the United States as the relevant geographic market and to define a product market of "luxury pens" consisting of fountain pens with wholesale prices of $130 or more. Of the five firms in this market, Tornado is the largest with a 35.9% share and Conway is the third largest with a 14.6% share. The staff proposes to make out its prima facie case primarily on the *PNB* presumption supported by arguments of coordinated and unilateral price effects. The attached tables summarize the staff's findings on the staff's HHI analysis in its luxury fountain pens market (Table 1) and the diversion ratios for the Tornado and Conway products (Table 2).

The merging parties have agreed that the United States is the relevant geographic market. The parties, however, strongly disagree with the staff's proposed market definition and offer three alternatives:

1. *Conglomerate merger*. The products of the two merging companies are sufficiently separated in price and quality so that they do not compete. For the products of each merging firm, two third-party fountain pens are closer substitutes in price, quality,

and consumer preference than the merger partner's product. Since the parties do not compete significantly, the merger will not create any reasonable probability of anticompetitive harm and hence will not violate Section 7.

2. *All fountain pens*. If the products of the merging parties are deemed to be in the same relevant market, then other distant substitute products should also be included in the relevant market. Using this logic, the merging parties contend that a market for luxury fountain pens may not be segregated out from what is a continuum of prices and qualities. Each fountain pen competes closely with the fountain pens with adjacent prices and qualities throughout the overlapping spectrum of pens, so that the relevant market should be all fountain pens. In this all fountain pens market, Tornado and Conway have shares of 8.2% and 3.4%, respectively, for a combined share of only 11.6%, a delta of 55, and a postmerger HHI of 880 (Table 3). The parties claim that these statistics are much too low to create any competitive concerns.

3. *Premium + luxury pens*. If an "all fountain pen" market is too large, then the parties submit that the relevant product market should be no smaller than premium pens ($100 - $130) and luxury pens ($130+).[4] In this market, the Tornado and Conway have shares of 18.9% and 7.7%, respectively, for a combined share of 26.6%, a delta of 292, and a postmerger HHI of 2171 (Table 4), which, the parties again claim, is much too low to create any competitive concerns.

Regardless of the market definition, the merging parties argue that their deal is procompetitive because of the cost savings it generates and the platform it gives the combined company to launch a new product at the $180 price point given the increase in demand in recent years for higher-priced "prestige" pens. Moreover, they argue that the transaction could not be anticompetitive. They say that the companies do not compete significantly against one another, that each merging party has at least two competitors closest to it in price and consumer preference than the merging counterparty, and that the vigorous competition with these closest competitors will not diminish as a result of the merger.

In addition, the merging parties note that both Visconti and Conklin, two significant manufacturers of pens that wholesale at $100 and $110, respectively, have repeatedly expressed interest in adding a more "prestige" pen at a higher price point given the increased consumer demand. The mechanics of fountain pen design are readily available and there are no technological barriers to entry. Tornado believes, and its internal emails confirm this, that if either Visconti or Conklin expanded their product line, they would do so at around the $150 wholesale price point where Tornado is. Tornado submits that it is concerned that any significant increase in the wholesale price of its pen would increase the likelihood that one of these companies would enter the market and compete directly against it at Tornado's price point.

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[4] The designation of fountain pens as standard (S), premium (P), or luxury (P) is common in the industry but without any standards pr consistency: what what manufactuer might call a "luxury" pen another manufacturer might consider only a "standard" pen. The particular designation of brands in the table is solely a creation of the staff and the parties in the investigation and do not reflect commonly accepted designations by the merging parties or other fountain pen manufacturers in the regular course of business.

Tornado submits that this concern further incentivizes it not to increase prices anticompetitively even if it had the ability to do so.

Tornado has repeatedly stressed that it has neither the ability nor incentive to raise prices for either product after the merger. In support of its contention, Tornado has offered to accept a consent decree that caps price increases in its existing products to no more than the rate of inflation for jewelry products shown by the U.S. Bureau of Labor Statistics' Producer Price Index for Jewelry. The staff recommends rejecting Tornado's consent decree offer.

The staff has contacted Visconti and Conklin and they each have confirmed their interest in expanding their product line into a more "prestige" pen around the $150 price point. While they each also said an increase in wholesale prices of pens between $130 and $180 would make entry more attractive, neither would say they would enter in that event. Also, both companies said they have not yet designed or test-marketed a new, more "prestige" product, prepared a financial analysis to test the profitability of such a product, or prepared a marketing plan of how they would roll out the product. Each company said that it would take at least a year or more after the product's introduction to conduct the extensive advertising necessary to gain customer acceptance and generate any meaningful sales.

Table 1

Luxury Fountain Pens

Firms	Price	Type	Revenues $	Share	HHI
Tornado (TP)	150	L	$54,000,000	35.93%	1291
QW	180	L	$45,000,000	29.94%	896
Conway	220	L	$22,000,000	14.64%	214
Nettuno	250	L	$17,500,000	11.64%	136
Accutron	295	L	$11,800,000	7.85%	62
			$150,300,000	100.00%	2599
Combined				50.57%	
Pre					2599
Delta					1052
Post					3650

* Type as defined by the investing staff: L (luxury), P (premium), and S (standard)

Table 2

Diversion Ratios

To:	Visconti	Conklin	Tornado	QW	Conway	Nettuno	Accutron
Tornado	0.2	0.3	–	0.4	0.1	0.0	0.0
Conway		0.1	0.2	0.3	–	0.3	0.1

Table 3

All Fountain Pens

Firms	Price	Type*	Revenues $	Revenues Share	Units	Units Share
Picasso	32	S	$48,000,000	7.31%	1,500,000	16.27%
Barker Brothers	50	S	$70,000,000	10.66%	1,400,000	15.18%
Oceanman	50	S	$60,000,000	9.14%	1,200,000	13.02%
Caran	55	S	$49,500,000	7.54%	900,000	9.76%
Pelikan	60	S	$48,000,000	7.31%	800,000	8.68%
Kingsman	70	S	$56,000,000	8.53%	800,000	8.68%
Opus	80	S	$40,000,000	6.09%	500,000	5.42%
Visconti	100	P	$80,000,000	12.18%	800,000	8.68%
Conklin	110	P	$55,000,000	8.37%	500,000	5.42%
Tornado (TP)	150	L	$54,000,000	8.22%	360,000	3.90%
QW	180	L	$45,000,000	6.85%	250,000	2.71%
Conway	220	L	$22,000,000	3.35%	100,000	1.08%
Nettuno	250	L	$17,500,000	2.66%	70,000	0.76%
Accutron	295	L	$11,800,000	1.80%	40,000	0.43%
			$656,800,000	100.00%	9,220,000	100.00%
Combined				11.57%		
Pre				825		
Delta				55		
Post				880		

* Type as defined by the investing staff: L (luxury), P (premium), and S (standard)

Table 4

Luxury + Premium

	Price	Type	Revenues $	Revenues Share	HHI
Visconti	100	P	$80,000,000	28.04%	786
Conklin	110	P	$55,000,000	19.28%	372
Tornado (TP)	150	L	$54,000,000	18.93%	358
QW	180	L	$45,000,000	15.77%	249
Conway	220	L	$22,000,000	7.71%	59
Nettuno	250	L	$17,500,000	6.13%	38
Accutron	295	L	$11,800,000	4.14%	17
			$285,300,000	100.00%	1879
Combined				26.64%	
Pre				1879	
Delta				292	
Post				2171	