

Class 1 slides

Unit 1: TransDigm/Takata

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TRANS**DIGM* ***GROUP INC.

SCHIROTH



The Deal

Who was the buyer?

- TransDigmGroup Incorporated
 - Leading supplier of highly engineered airplane components
 - Delaware corporation
 - Headquarters: Cleveland, OH
 - Revenues (2016): \$3.1 billion



Who was the seller?

■ Takata Corporation

- Global manufacturer of automotive safety systems and products for automakers worldwide
 - Also diversified into aviation systems
- Headquartered in Japan
- Production facilities on four continents

- Manufacturer of the airbags subject to the massive recalls
 - U.S. recall of more than 42 million cars
- Bankruptcy
 - June 2017: Filed for bankruptcy protection in Japan
 - April 2018: Acquired by Key Safety Systems
 - Subsidiary of Ningbo Joyson Electronic Corp.
 - Rebranded as Joyson Safety Systems



What was the seller going to sell?

- The SCHROTH passenger restraint systems business
 - Designs and manufactures proprietary, highly engineered, advanced safety systems for aviation, racing, and military ground vehicles throughout the world
 - Acquired by Takata in 2012
 - Facilities in three locations
 - Arnsberg, Germany
 - Pompano Beach, Florida
 - Orlando, Florida
 - Employees: 260
 - Revenues (2016): \$37 million

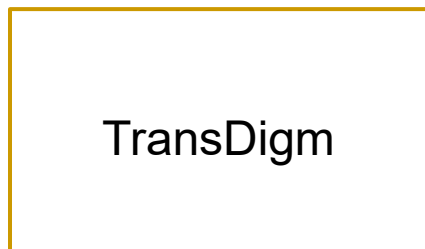


What was the transaction?

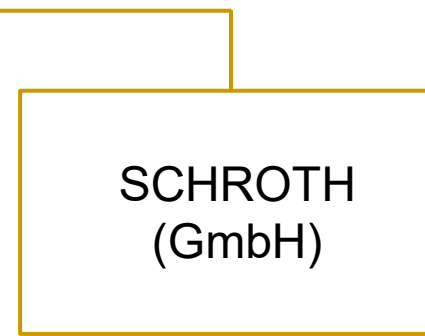
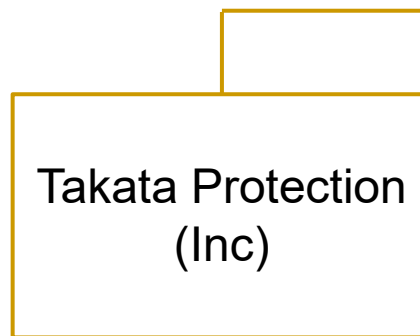
- TransDigm Group to acquire—
 1. Stock of SCHROTH Safety Products GmbH, *and*
 2. Assets of Takata Protection Systems, Inc.
- from Takata Corporation
- Purchase price: \$90 million
- Transaction closed: February 22, 2017

Summary of the deal structure: Before

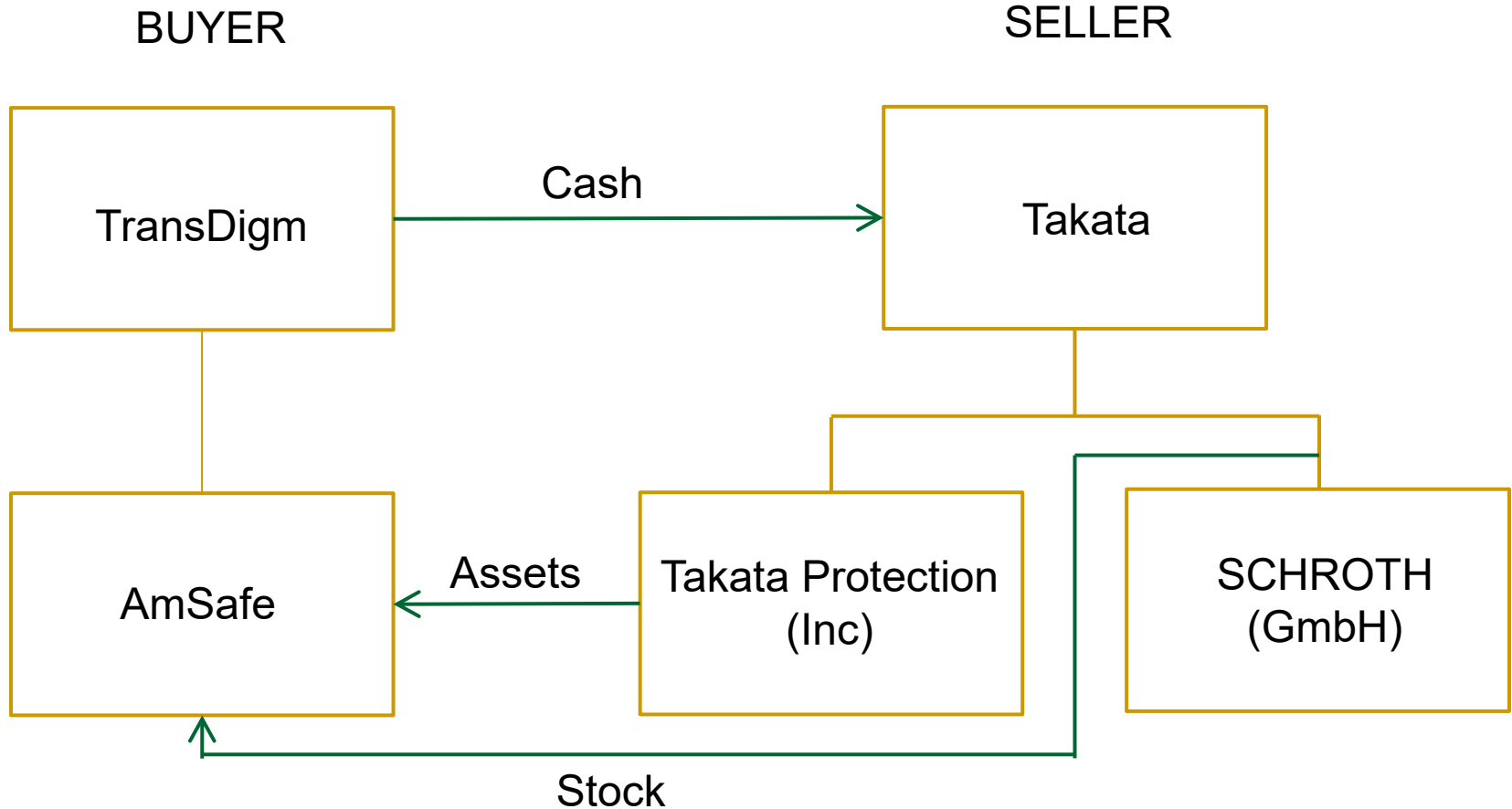
BUYER



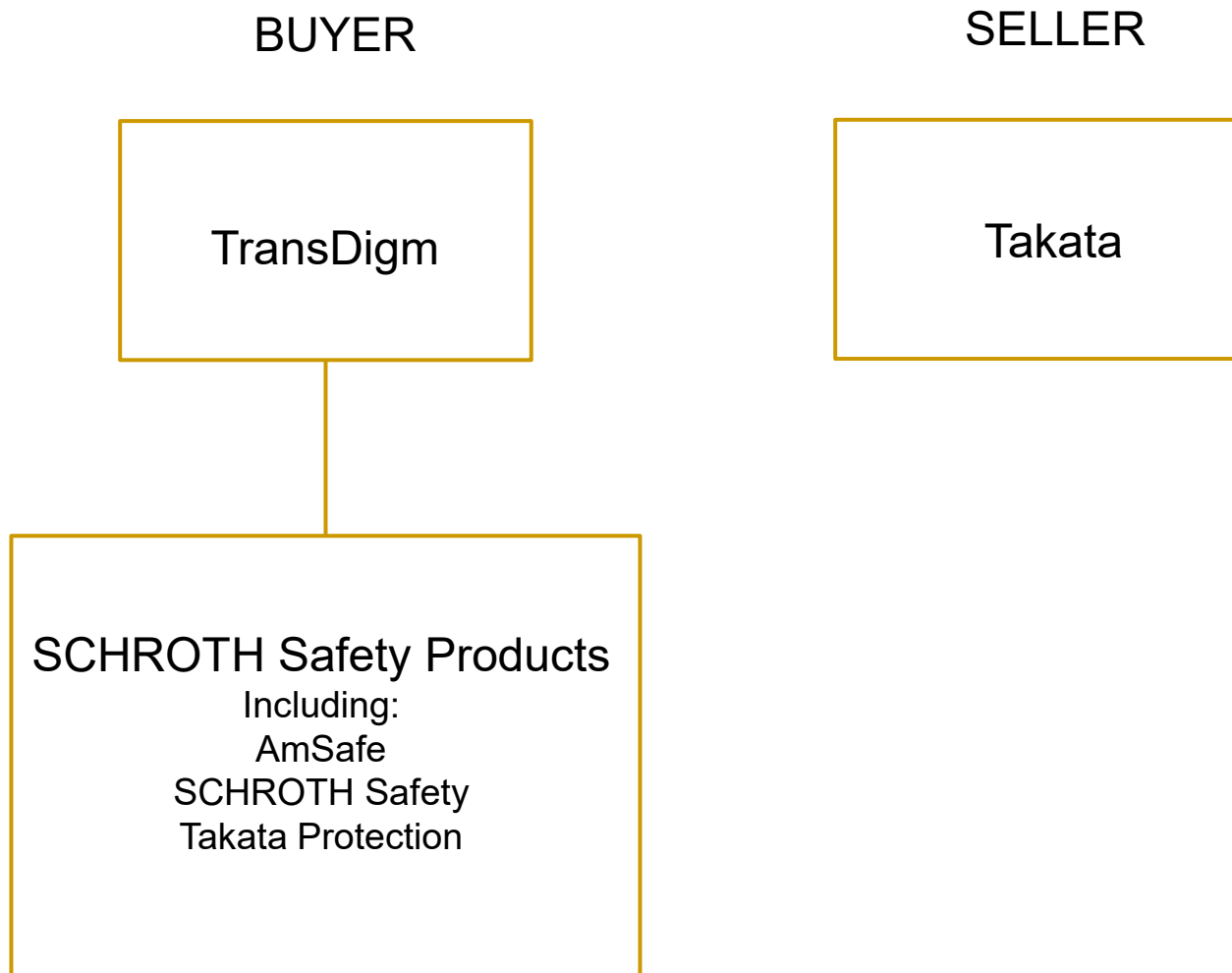
SELLER



Summary of the deal structure: Deal



Summary of the deal structure: After

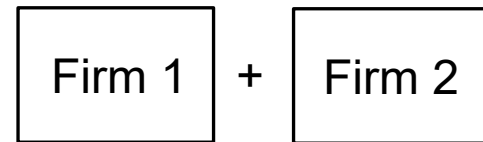


Is this a horizontal transaction?

- Yes

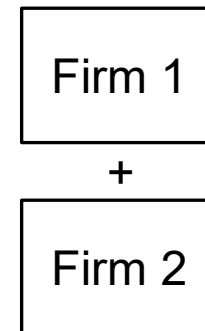
- Horizontal transactions:

- Combine two competitors
- Sell *substitute* products



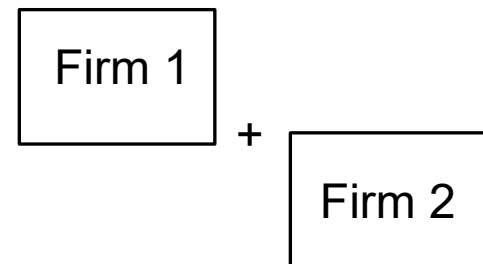
- Vertical transactions:

- Combine two firms at adjacent levels in the chain of manufacture and distribution
- May be extended to two firms that sell *complementary* products



- Conglomerate transactions

- Mergers that are neither horizontal nor vertical



Why did Takata want to sell SCHROTH?

- TO MAKE MONEY

- How?

- Purchase price more valuable than keeping the business
- Why might that be the case?
 - SCHROTH needed to compete aggressively to gain business from TransDigm:
 - Cost money to operate business and conduct R&D
 - Had to price aggressively
 - Probably not making much in profits
 - Had been at it for five years (Compl. ¶ 3)
 - May also have been an effort to obtain cash to stave off bankruptcy in light of the airbag litigations
 - Sale closed in February 2017, three months before Takata's bankruptcy filing

Why did TransDigm want to buy SCHROTH?

- TO MAKE MONEY
- How?
 - Acquisition would reduce pricing and innovation pressure from an aggressive new competitor
 - TransDigm's AmSafe subsidiary
 - World's dominant supplier of restraint systems used on commercial airplanes
 - Global revenues (2016): \$198 million
 - Headquarters: Phoenix, AZ
 - SCHROTH, after being acquired by Takata in 2012, embarked on an ambitious plan to capture market share from AmSafe (Compl. ¶ 3)
 - Competing on price
 - Investing in R&D
 - At the time of the signing of the acquisition agreement, SCHROTH was:
 - AmSafe's closet overall competitor
 - AmSafe's only meaningful competitor for certain types of restraint systems

The Law

Statutes

- What federal antitrust statutes could apply to the TransDigm/ SCHROTH transaction?
 - Clayton Act § 7
 - Sherman Act § 1
 - Sherman Act § 2
 - FTC Act § 5

Clayton Act § 7

- Provides the U.S. antitrust standard for mergers

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

- *Simple summary*: Prohibits transactions that—
 - “may substantially lessen competition or tend to create a monopoly”
 - “in any line of commerce” (product market)
 - “in any part of the country” (geographic market)

Called the *anticompetitive effects test*

Called the *relevant market*

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

The Sherman Act

- Sherman Act § 1

Every **contract, combination** in the form of trust or otherwise, or **conspiracy**, in **restraint of trade** or commerce among the several States, or with foreign nations, is declared to be illegal.¹

- Sherman Act § 2

Every person who shall **monopolize**, or **attempt to monopolize**, or **combine or conspire** with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony.²

¹ 15 U.S.C. § 1.

² *Id.* § 2.

The FTC Act

- FTC Act § 5

Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful.²

- NB: Unlike other provisions, not included in the definition of “antitrust law” in Clayton Act § 1
 - This will be important when it comes to private actions

¹ 15 U.S.C. § 45(a)(1).

Section 7 is the binding constraint

- The Sherman Act and FTC Act, as applied to mergers, are either coextensive or less restrictive than Section 7 of the Clayton Act

*Section 7 provides the antitrust test for all mergers**

* There is arguably an exception for acquisitions of “nascent” competitors (where Section 2 *might* be more restrictive—we will be looking for a test case)

- Consequently:
 - Invocation of the Sherman Act or the FTC Act is usually superfluous
 - Plaintiffs—including the DOJ and FTC—typically allege only a Section 7 violation
- State antitrust law
 - Not preempted by federal law
 - But no state has enacted a statute stricter than Section 7

The DOJ Investigation

Timing

- Was this transaction challenged before or after consummation?
 - After
 - Transaction closed Feb. 22, 2017
 - Complaint filed ten months later on December 21, 2017
- Why didn't the DOJ challenge the transaction before closing?
 - Probably did not know about it, *or*
 - Was aware of the transaction but not aware of its likely effect on competition
- Didn't the HSR Act filings alert the DOJ to the transaction before closing?
 - No. Apparently not reportable under the Hart-Scott-Rodino Act¹

¹ Clayton Act § 7A, 15 U.S.C. § 18a.

Hart-Scott-Rodino Act

- Requires large mergers and acquisitions to—
 1. File a *premerger notification report* with the DOJ and FTC
 2. Observe a *statutorily prescribed waiting period* before closing the transaction
 - a. *Initial waiting period*: 30 calendar days after filing (for most transactions)
 - b. *Final waiting period*: 30 calendar days after all merging parties have responded to their respective second requests (for most transactions)

NB: A *second request* is a subpoena-like document that—

 1. Contains document requests, narrative interrogatories, and data interrogatories
 2. Can only be issued during the initial waiting period
 3. Can only be issued once
- Idea:
 - Much more effective and efficient to block or fix an anticompetitive deal before closing than to try to remediate it after closing

Hart-Scott-Rodino Act

- Why wasn't the TransDigm/SCHROTH transaction reported under the HSR Act?
 - The purchase price was \$90 million in cash
 - The HSR threshold in 2017 was \$80.8 million
 - In 2022, the threshold is \$101.0 million
 - BUT—
 - Transaction involved the acquisition of—
 - *Stock* of SCHROTH Safety Products GmbH, *and*
 - *Assets* of Takata Protection Systems Inc.
 - Foreign asset exemption
 - The acquisition of assets located outside the U.S. do not account unless they have sales in or into the United States of \$80.8 million in 2017
 - Target had facilities in Florida and Germany
 - *Sales*: SCHROTH's total sales worldwide were \$43 million (press release)
 - *Assets*: If non-U.S. assets accounted for more than \$9.2 million of the purchase price, the assets would be exempt and the acquisition would not have been reportable

Hart-Scott-Rodino Act

- Not jurisdictional
- Agencies can review and challenge transactions—
 1. Falling below reporting thresholds
 2. Exempt from HSR reporting requirements
 3. “Cleared” in an HSR merger review
 - “Clearance”—a commonly used term—is a misnomer
 - No immunity attaches to a transaction that has successfully gone through an HSR merger review

The fact that the TransDigm/Takata deal was not HSR reportable did not preclude the DOJ from investigating and challenging the transaction even months after closing

DOJ investigation

- How did the DOJ find out about this transaction?
 - Maybe Boeing complained
 - Largest U.S. customer
 - Biggest beneficiary of SCHROTH's competition with AmSafe
 - Biggest loser from the merger
 - But it could have been others:
 - A smaller customer
 - A disgruntled current or former TransDigm employee
 - Probably not a third-party competitor (WHY NOT?)



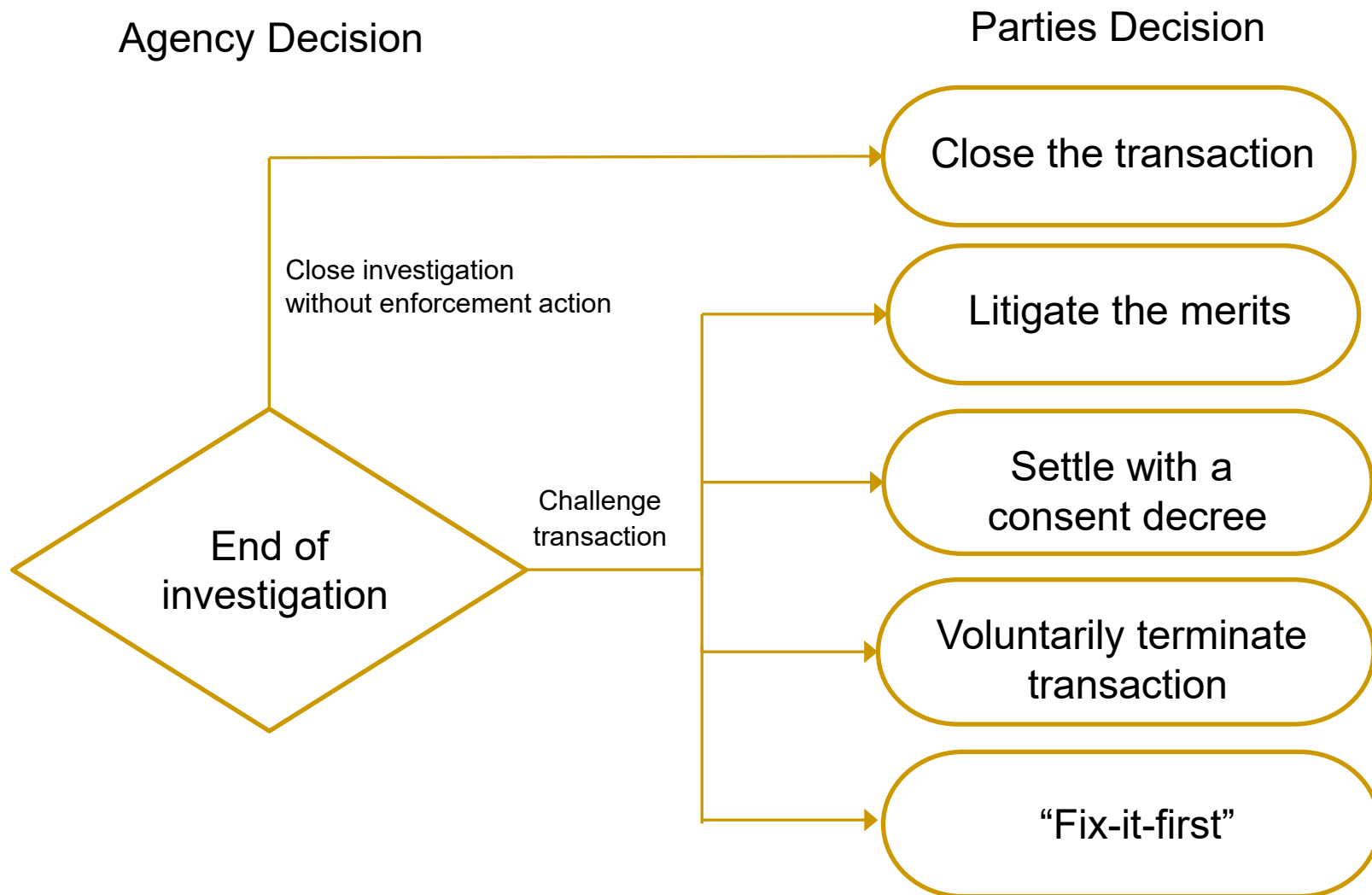
DOJ investigation

- What did the DOJ do after it learned about the transaction?
 - Opened an investigation

DOJ investigation

- How did the DOJ obtain testimony, documents, and data on which to base its antitrust analysis?
 - Typically would obtain from the parties pursuant to a *second request* under the HSR Act
 - But also has the power to issue *civil investigative demands* (CIDs)
 - Essentially precomplaint subpoenas
 - Can include document requests, narrative interrogatories, and data interrogatories
 - Is not quite compulsory process (i.e., not *self-executing*)
 - DOJ must first obtain a court order compelling compliance
 - May be issued any time during the course of an investigation
 - May be issued to both the merging parties and to third parties
 - Often ask for the same documents and data as a second request
 - Multiple CIDs may be issued in the course of an investigation to the same person

What were the possible investigation outcomes?



What happened here?

- The DOJ: Challenged transaction—
 1. Decided that TransDigm's acquisition of SCHROTH violated Section 7 of the Clayton Act, *and*
 2. Filed a complaint in federal district court seeking a permanent injunction requiring TransDigm to divest the business and assets it had acquired from Takata

- TransDigm: Settled with a consent decree
 - That is, TransDigm agreed to give the DOJ judicially-enforceable relief that was sufficient to negate the DOJ's competitive concerns

The DOJ Complaint

When was the complaint filed?

- December 21, 2017

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA
Department of Justice, Antitrust Division
450 5th Street, N.W., Suite 8700
Washington, D.C. 20530,

Plaintiff,

v.

TRANSDIGM GROUP INCORPORATED
1301 East 9th Street, Suite 3000
Cleveland, Ohio 44114,

Defendant.

Civil Action No.:

COMPLAINT

The United States of America, acting under the direction of the Attorney General of the United States, brings this civil antitrust action for equitable relief against defendant TransDigm Group Incorporated (“TransDigm”) to remedy the harm to competition caused by TransDigm’s acquisition of SCHROTH Safety Products GmbH and substantially all the assets of Takata Protection Systems, Inc. from Takata Corporation (“Takata”). The United States alleges as follows:

I. NATURE OF THE ACTION

1. In February 2017, TransDigm acquired SCHROTH Safety Products GmbH and substantially all the assets of Takata Protection Systems, Inc. (collectively, “SCHROTH”) from Takata. TransDigm’s AmSafe, Inc. (“AmSafe”) subsidiary is the world’s dominant supplier of restraint systems used on commercial airplanes. Prior to the acquisition, SCHROTH was

The forum

- In what court was the complaint filed?
 - United States District Court for the District of Columbia (DDC)
- Why in DDC?
 - District court had—
 - *Personal jurisdiction* over the parties, *and*
 - Was a proper *venue* for the action
 - Historically, the DDC has been the most desirable forum for litigation from the DOJ's perspective
 - They know the judges
 - As a bench, the judges are experienced and sophisticated in the application of the merger antitrust laws—and frequently found in favor of the DOJ
 - Prosecutors do not have the hassle of moving out of town in the event of a trial

The defendant

- Who was the defendant in the case?
 - TransDigm
- Why wasn't Takata named as a defendant?
 - Why would it be?
 - Not necessary given the nature of the relief the DOJ was seeking (divestiture of acquired business)
 - Takata would have been a necessary party only if the DOJ was seeking recession (unwinding) of the transaction

Other possible plaintiffs

- Who else could have brought a Section 7 challenge against the transaction?
 1. Federal Trade Commission
 2. State AGs
 3. Customers
 4. Competitors
 5. Suppliers (in some circumstances)

- Some observations
 - States and private parties may also sue under state law if a state statute so provides
 - Treble damages are available only for injuries actually sustained
 - Can occur only after the transaction has been consummated
 - Damages cannot be obtained in connection with transactions that have not closed

Section 7 violation: Essential elements

- What are the elements of a Section 7 violation?
 1. An acquisition of stock or assets
 - Includes mergers under state law
 2. Where, in a relevant market
 - Product dimension
 - Geographic dimension
 3. The effect “may be substantially to lessen competition or tend to create a monopoly”
 4. Also need Commerce Clause jurisdiction

Element 1: An “Acquisition”

- Was there an acquisition here?
 - Yes. TransDigm Group acquired—
 - *Stock of SCHROTH Safety Products GmbH, and*
 - *Assets of Takata Protection Systems, Inc.*
- from Takata Corporation

Element 2: Relevant markets

- What was the relevant geographic market alleged in the complaint?
 - Worldwide (Compl. ¶ 22)

Element 2: Relevant markets

- What were the relevant product markets alleged in the complaint?
 1. Two-point lapbelts used on commercial airplanes



2. Three-point shoulder belts used on commercial airplanes



Element 2: Relevant markets

- What were the relevant product markets alleged in the complaint?

3. Technical restraints used on commercial airplanes



4. Inflatable restraint systems used on commercial airplanes (uses airbag technology)



Element 3: Anticompetitive Effect

- What were the anticompetitive effects of the acquisition alleged in the complaint?
 1. Increased prices
 - Prior to the acquisition, customers could and did “play off” the companies against each other to obtain better prices (Compl. ¶ 32)
 - Postmerger, the next closest competitor will not be as price-competitive with the combined firm as SCHROTH was to AmSafe
 2. Reduced innovation
 - Companies also competed against each other through R&D to develop new and better products (Compl. ¶ 32)
 - Could save significant money by curtailing R&D activities postmerger
 3. Significantly increased market concentration
 - Combined the only two significant players in the markets (Compl. ¶ 31)
 - Not really an anticompetitive effect under the prevailing consumer welfare interpretation
 - But the Supreme Court in the 1950s-1960s regarded it as the primary anticompetitive effect—included because of that precedent

Element 3: Anticompetitive Effect

- What were the factual allegations in support of an anticompetitive effect in each market?
 1. Two-point lapbelts used on commercial airlines



- Only three meaningful competitors premerger (Compl. ¶ 24)
 - AmSafe was by far the largest
 - Small, privately held firm that had been in the market for years but had gained little share
 - SCHROTH, which entered the market with a new, innovative lightweight two-point lapbelt (“Airlite”), which it aggressively marketed to the major international airlines
- *Competitive effects implication:*
 - When three competitors are reduced to two, the remaining competitors are more likely to engage in oligopolistic coordination, which would result in a higher equilibrium market price and reduced rates of innovation

Element 3: Anticompetitive Effect

- What were the factual allegations in support of an anticompetitive effect in each market?
 2. Three-point shoulder belts used on commercial airlines



- Factual allegations
 - ❑ Only two meaningful competitors premerger (Compl. ¶ 26)
 - ❑ AmSafe was by far the largest
 - ❑ “SCHROTH was aggressively seeking to grow its business at AmSafe’s expense”
 - ❑ Probably means that SCHROTH had not achieved any significant sales yet, but that efforts to penetrate the market caused AmSafe to reduce prices
- *Competitive effects implications*: “Merger to monopoly,” resulting in higher prices

Element 3: Anticompetitive Effect

- What were the factual allegations in support of an anticompetitive effect in each market?
 3. Technical restraints used on commercial airlines



- Only three significant suppliers premerger (Compl. ¶ 28)
 - AmSafe (“leading supplier”)
 - SCHROTH (“aggressively seeking to grow”)
 - (Unnamed) international aerospace equipment manufacturer
- *Competitive effects implications:*
 - “3-to-2 merger,” resulting in higher equilibrium market prices

Element 3: Anticompetitive Effect

- What were the factual allegations in support of an anticompetitive effect in each market?
 4. Inflatable restraint systems used on commercial airplanes



- Only two meaningful competitors premerger (Compl. ¶ 30)
 - AmSafe (which developed technology—offers both inflatable lapbelts and structural mounted airbags)
 - SCHROTH (offers only structural mounted airbags)
 - “In recent years, SCHROTH had emerged as a strong competitor to AmSafe in the development of inflatable restraint technologies”
 - Sounds very weak to me
 - May be some innovation competition (but maybe not that much)

Element 4: Effect on Interstate Commerce

- What were the factual allegations in support of an effect on interstate commerce?
 - “TransDigm sells restraint systems used on commercial airplanes throughout the United States. It is engaged in the regular, continuous, and substantial flow of interstate commerce, and its activities in the development, manufacture, and sale of restraint systems used on commercial airplanes have had a substantial effect upon interstate commerce.” (Compl. ¶ 9)

Defenses to the prima facie case

- How, if at all, could TransDigm defend against the DOJ's prima facie case?
 - First, an important distinction: Negative/affirmative defenses
 - *Negative defense*: Negates an element of the prima facie case
 - Defendant: "My conduct will not result in any anticompetitive harm"
 - *Affirmative defense*: Even assuming the plaintiff has established its prima facie case, the challenged conduct is nonetheless excused or justified
 - Defendant: "I did it, but my conduct is not culpable"
 - There are no affirmative defenses in antitrust law
 - Canonical forms of negative defenses in antitrust cases
 1. Rebut the factual predicates of the DOJ's prima facie case
 2. Multiple, significant competitors
 3. Ease of entry or positioning
 4. Countervailing bargaining power ("power buyers")
 5. Efficiencies

Sometimes called *downward pricing pressure defenses*

Would any of these defenses likely work?

Relief

- What relief was the DOJ seeking?
 - Civil injunctive relief (see IX. Request for Relief)—
 - Declaration that TransDigm's acquisition of SCHROTH violated Section 7
 - Injunction ordering TransDigm to—
 1. divest all assets acquired from Takata Corporation in the challenged transaction, *and*
 2. take any further actions necessary to restore the market to the competitive position that existed prior to the acquisition
- Could the DOJ have sought other types of relief?
 - Criminal sanctions but only if challenged under Sherman Act § 1
 - Treble damages on behalf of injured U.S. government agencies under Clayton Act § 4A

The Consent Decree

What was the consent settlement?

- TransDigm agreed to a consent decree to divest SCHROTH (including the Takata Protection assets) to a third-party divestiture buyer approved by the DOJ

What is a consent decree?

- A *consent decree* is a final judgment in a case entered by consent of the litigating parties rather than an adjudication of the merits
- Sanctions for breach
 - A consent decree is a *judicial order*
 - Enforceable through civil and criminal contempt sanctions

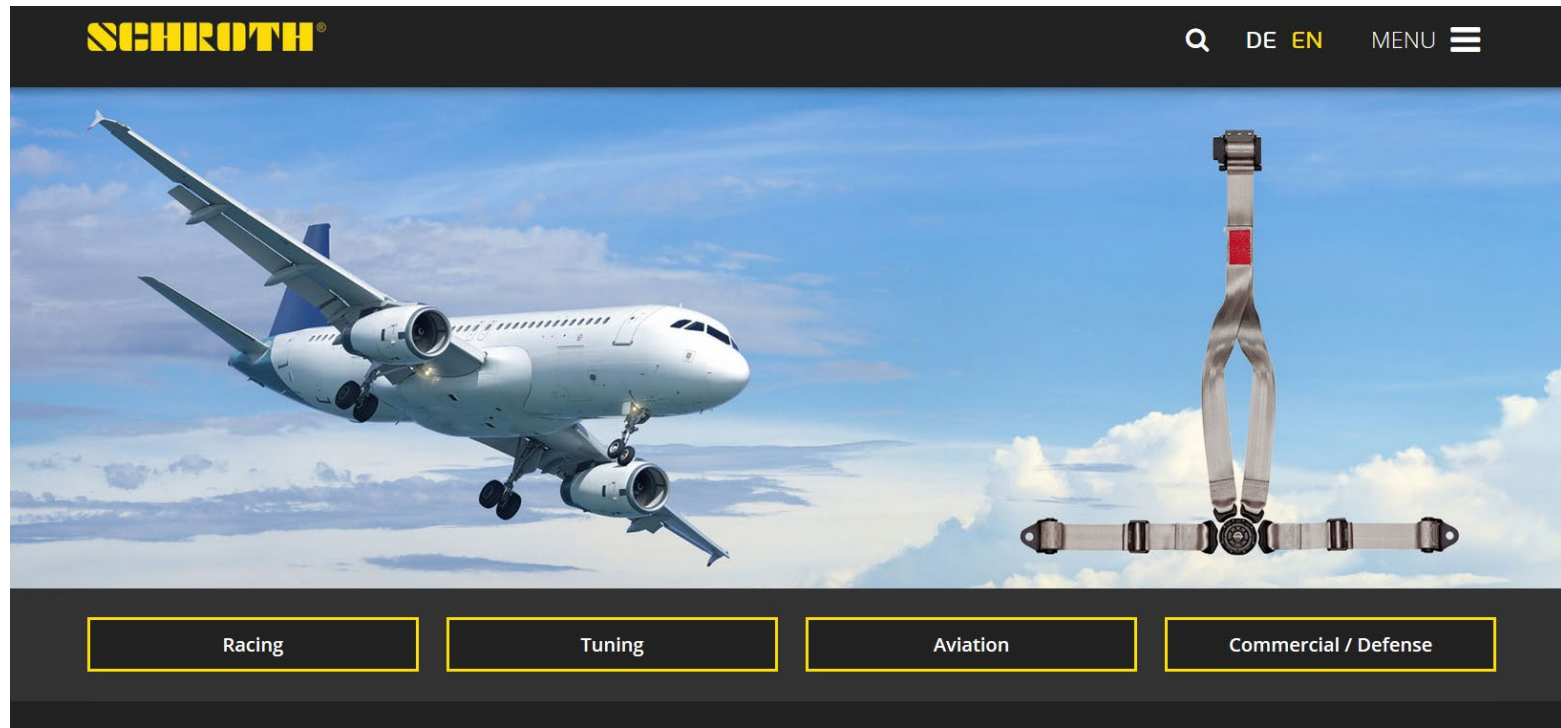
Business rationale

- Why did TransDigm agree to divest SCHROTH?
 - What were TransDigm's alternatives?
 1. Continue the litigation
 2. Settle with a consent decree acceptable to the DOJ
 - Why did TransDigm agree to settle?
 - Almost surely the least costly alternative
 - DOJ had a strong case: TransDigm was very likely to lose the litigation, and the DOJ would have obtained a litigated permanent injunction ordering the same divestiture
 - When did TransDigm agree to settle?
 - In the course of the investigation—Prior to litigation
 - Complaint and proposed consent decree were filed simultaneously with the court

The divestiture buyer

- To whom did TransDigm sell SCHROTH?
 - A management-led leveraged buyout (MBO)
 - Business unit's management + a private equity investor
 - Why sell to management?
 - The DOJ probably wanted a “buyer upfront”
 - An MBO was probably both—
 - The quickest solution, *and*
 - Offered the greatest return
 - Did the MBO get a good purchase price?
 - Probably
 - Consent decree solutions almost always involve a “fire sale” of the divestiture assets
 - TransDigm 10-K reported a \$32 million impairment charge to write down the assets to fair value. (p. 21)
 - TransDigm paid \$90 million to acquire SCHROTH
 - So it is likely the MBO paid only about \$58 million for the business
 - Actually, \$61.4 million (from TransDigm 8-K, Jan. 26, 2018, at 3.

SCHROTH today



- ❑ Approximately 250 employees
- ❑ Sales volume around \$50.2 million