Class 17 slides

Unit 11: Sysco/US Foods

Professor Dale Collins
Merger Antitrust Law
Georgetown University Law Center

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Good things come from Sysco

US. FOODS™

KEEPING KITCHENS COOKING.™

Five new concepts

1. *Cluster markets* in product market definition
2. *Targeted customer markets* in product market definition
3. Use of *overlapping draw areas* to define geographic markets
4. *Second cost auction* theory of unilateral effects
5. "Litigating the fix"

The Background

The deal

- Sysco Corporation to acquire US Foods
  - Announced December 8, 2013
  - $3 billion of Sysco common stock (13% of combined company)
  - +$500 million of cash
  - Assumption of $4.7 billion of USF debt
  - Total transaction value: $8.2 billion
  - Agreement expires September 8, 2015 (21 months)

The parties

- Sysco
  - Publicly traded “broadline” distributor
  - Sales = $44 billion in food distribution sales 2013
  - #1 with about 17% of total food distribution sales nationally
  - 72 distribution facilities nationwide
- US Foods
  - Privately owned broadline distributor (Clayton, Dubilier & Rice and KKR)
  - Sales = $22 billion in food distribution sales in 2013
  - #2 with about 8.6% of total food distribution sales nationally
  - 61 distribution facilities nationwide

Deal rationale

- Creates a company with $65 billion in sales
  - Sysco (#1 w/17%) + USF (#2 w/8.6%) = Combined (#1 w/25.6% of total food distribution sales nationally)
    - Number 3: Performance Group (2.4%)
  - Would employ over 14,000 sales reps
    - No other company employs more than 1600
  - Would operate over 13,000 trucks
    - No other company operates more than 1600 trucks
- Immediately accretive to earnings
- Annual recurring synergies > $600 million (after 3-4 years)
  - Eliminate duplicative overhead
  - More leverage to lower costs of goods (COGS)
  - Optimize distribution facilities and logistics
  - Integrate sales force
  - Bigger platform for enhanced innovation and development of exclusive products

Industry background

- Food service distribution
  - Total industry sales nationwide = $231 billion (2015)
  - Supply a broad range of fresh, frozen, canned and dry food and non-food products to away-from-home food service operations
  - Customers include—
    - Independently owned single location restaurants, regional and national chain restaurants (majority of sales)
    - Hotels, motels, and resorts
    - Hospitals
    - Schools
    - Government and military facilities
    - Retail locations

Industry background

- Types of food distributors: Product range/channel
  1. Broadline
     - “One-stop” shop—carry everything
  2. Specialized
     - Meat
     - Seafood
     - Produce
     - Baked goods
  3. Systems distributors
     - “Customized” distributors for fast food, casual chain restaurants (e.g., Burger King, Wendy’s, Applebees)
     - Small number of SKUs
     - Often proprietary to chain
     - Very small sales forces
  4. Cash-and-carry and club stores
     - E.g., Restaurant Depot, Costco, Sam’s Club
     - Do not deliver
     - No sales force dedicated to individual customers
     - Typical customer: independent restaurant

Industry background

- Types of food distributors: Geographical distribution footprint
  - National
  - Regional
  - Local

Industry background

- Largest food distributors in the United States

Distributor	Distribution Footprint	Distribution Centers
Sysco	Nationwide	72
US Foods	Nationwide	61
Performance Food Group	Eastern/Southern U.S.	24
Gordon Food Service	Midwest, Florida, TX	10
Reinhart Foodservice	East, Mideast	24
Ben E. Keith Co.	Texas and bordering states	7
Food Services of Am.	Northwest	10
Shamrock Foods	Southwest, Southern Calif.	4
Local distributors	Local	1-5 each

Industry background

- Distribution centers
  - Key for broadline distribution

- 28-foot clear-height ceilings
- "Super-flat" insulated floor systems to meet strict temperature control standards
- Zoned to accommodate the storage of both perishable and dry goods

Distribution centers

- US Food distribution centers in 2017
  - Only three more centers than in 2013

The FTC investigation and litigation

- FTC investigated for one year
  - Second request issued on February 18, 2014 (a little over two months after signing)
  - Investigation ended February 20, 2015
- Fix-it-first solution:
  - On February 16, 2015, Sysco signed a deal to sell 11 of 61 USF distribution centers to #3 Performance Food Group
    - Announced Feb. 16, 2015
    - Conditioned on closing main deal
  - The centers to be divested largely located in the western U.S.
    - PFG had only one center in the West
    - PFG had 24 centers in East/South
  - Accounted for $4.5 billion in sales
    - About 20% of USF premerger sales
    - Would give PFG a total of $10.5 billion in sales
    - Compare to $60.5 billion for the combined firm post-divestiture
- FTC rejected the fix and brought suit
  - Joined by 11 states seeking relief under Clayton Act § 16 in their sovereign capacity
  - Parties "litigated the fix"

DOJ complaint

- Plaintiffs:
  - Federal Trade Commission
  - 10 states plus the District of Columbia
- *Filed*: February 20, 2015
  - 14 months after signing
- *Claim*: Acquisition, if consummated, would violate Section 7 in—
  - Nationwide foodservice distribution to “national” customers
    - Combined first and second largest broadline foodservice distributions
    - Results in a combined share of 59%-71% share and HHI deltas of 1500-1966 (depending on metric)
    - Second cost auction unilateral effects
  - 32 local markets
    - With combined shares as high as 90.3% and deltas as high as 4123
    - Second cost auction unilateral effects
- Prayer:
  - Preliminary injunction blocking the deal pending a final adjudication of the merits
  - *Query*: Should the states also have sought a permanent injunction?

The District Court

- Tried in the District Court of the District of Columbia
  - Judge Amit P. Mehta
    - Appointed by President Obama
    - Assumed office: December 19, 2014
    - Assigned case: February 20, 2015

  - Case was tried with the understanding that the parties would terminate their merger agreement if the PI was entered

Testifying experts

- FTC: Dr. Mark A. Israel
  - Senior Managing Director, Compass-Lexecon
  - Ph.D in Economics, Stanford University (2001)
  - Extensive testifying experience in antitrust cases (especially merger antitrust cases)

- Parties: Dr. Jerry Hausman
  - Professor of Economics, MIT
  - D.Phil, Oxford (1972)
  - Leading academic econometrician
  - Extensive testifying experience in antitrust cases (including merger antitrust cases)

The District Court

- Entered the preliminary injunction blocking the deal
  - Relevant markets
    - Nationwide broadline foodservice distribution to national customers
    - Local broadline foodservice distribution to local customers
  - Anticompetitive effects (upward pricing pressure)
    - *PNB* presumption
    - Unilateral effects in the national broadline customer market
    - Unilateral effects in local broadline markets
  - Defenses insufficient to put the prima facie case into dispute
    - The PFG "fix"
    - Dealing regionally by national customers
    - Entry/expansion
    - Efficiencies
  - Equities favored the entry of a preliminary injunction

PI entered: June 23, 2015
Deal terminated: June 29, 2015

Parties abandon the merger

- Costs to Sysco
  - $300 million breakup fee to US Foods
  - $25 million breakup fee to divestiture buyer Performance Food Group
  - $265 million to redeem financing
  - $258 million on integration planning and advisers
  - $100 million in historical financing costs, and
  - $53 million in computer systems integration

Total cost to Sysco: $1 billion

The District Court's Analysis

Organization of opinion

- Background
- Legal standard
  - Clayton Act § 7
  - FTC Act § 13(b)
  - *Baker-Hughes* three-step burden-shifting framework
- Relevant markets
  - The relevant product market
    - Broadline distribution as a relevant product market
      - Legal principles
      - Application of *Brown Shoe* "practical indicia"
      - Expert testimony
      - Conclusion
    - Broadline distribution to "national customers" as a relevant product market
      - Legal basis
      - Evidence
  - The relevant geographic market
    - National market
    - Local markets

Organization of opinion

- Probable effects on competition
  - *PNB* presumption
    - *PNB* presumption in the national customers broadline distribution market
    - *PNB* presumption in the local broadline distribution markets
  - Additional evidence of competitive harm
    - Unilateral effects in the national customers broadline distribution market
    - Merger simulation in the national customers broadline distribution market
    - Unilateral effects in local broadline markets
    - Event studies (“natural experiments”) in local broadline markets
- Defendants’ other rebuttal arguments
    - PFG divestiture
    - Existing competition
    - Entry/expansion
    - Efficiencies
- The equities
- Conclusion

The District Court Opinion
1. The Prima Facie Case
A. Relevant Product Markets

Product markets: Allegations

- FTC position: Two product markets
  1. Broadline foodservice distribution (as opposed to all food distribution) to all customers
  2. Broadline distribution to “national” customers

- Merging parties’ position
  - All foodservice distribution (including specialty distributors)
  - Rejects a product market limited to national customers

Two new concepts here:

1. *Cluster market of nonsubstitutable products*
2. *“Targeted customer” market*

Broadline Foodservice Distribution Cluster Market

Cluster markets: Principles

- Both the FTC and the merging parties alleged *cluster markets* consisting of largely nonsubstitutable products
  - Widely accepted in the case law
  - Some examples
    - Commercial banking services, grocery stores, drug stores, department stores, consumable office supplies, acute care inpatient hospital services
- Courts have generally accepted cluster markets as relevant product markets when:
  1. The products are traditionally offered by the same seller at the same point of sale
  2. The products appeal to the same type of customer
  3. The products exhibit economies of scope in purchasing
     - Customers are attracted by the totality of the products offered at the seller's location
     - Customers tend to select sellers more on the basis of their aggregate offerings and less on the offerings of single products

  NB: Generally, sellers have some flexibility in setting the prices of individual products without being constrained by competition from partial line or single product sellers, provided that the sellers remain competitive within their product offering as a whole[1]

[1] We will see a case where there is single product line competition in Staples/Office Depot.

Cluster markets: Principles

- Observations
  - Not well defined in the case law, but frequently adopted by courts
  - Has a “know it when you see it” quality
  - Accepted “for analytical convenience” when market shares are likely to be the same across products
  - Typically, analytic similarity is simply asserted rather than analyzed by courts

Cluster markets: Application in *Sysco*

- In *Sysco*, the dispute was not over whether the court should find a cluster market, but rather *what* cluster market it should find
  - *FTC*: Broadline foodservice distribution
  - *Merging parties*: All foodservice distribution, including—
    - Specialized wholesalers of meat, seafood, produce, and baked goods
    - Systems distributors for retail food chains (e.g., Burger King, Wendy's, Applebees)
    - Cash-and-carry and club stores (e.g., Restaurant Depot, Costco, Sam's Club)

Cluster markets: Application in *Sysco*

- *Court*: Broadline distribution as a product market
  - *Brown Shoe* "practical indicia" supports FTC's definition
    1. Product breadth and diversity
       - "One-stop shop" for almost any type of customer
       - Number of SKUs carried by other types of distributors pale in comparison
       - Offer private label products
       - Customers may buy from other types of distributors on a limited basis
    2. Distinct facilities and operations
       - Massive distribution centers
       - Large sales forces
       - Run channel as a separate business
    3. Delivery
       - Timely and reliable delivery critical
       - Broadline has sufficient fleet of service vehicles to offer frequent and flexible delivery schedules to meet customer needs
       - Including next-day delivery

Cluster markets: Application in *Sysco*

- *Court*: Broadline distribution as a product market
  - *Brown Shoe* “practical indicia” supports FTC’s definition
    4. Customer service and value-added services
       - For example, offer menu and nutrition-meal planning services
       - Food safety training for customers at distribution centers
    5. Distinct customers
       - Serve a wide range of customers that other channels cannot reach
    6. Distinct pricing
       - Typically price only against other broadline distributors
       - Not against higher-priced specialty or lower priced cash-and-carry
    7. Industry or public recognition
       - Recognizes broadline as a distinct channel

NB: The Court did not strictly look at the specific indicia listed in Brown Shoe*, but considered any qualitative evidence probative of cross-elasticity*

Cluster markets: Application in *Sysco*

- *Court*: Broadline distribution as a product market
  - Hypothetical monopolist test supports FTC's definition
    - Israel used an aggregate diversion ratio implementation[1]
      - Margin > 10% (using 10% as a lower bound is conservative since it gives a higher critical recapture rate than would the actual margins—making the HMT harder to satisfy)
      - SSNIP = 10%
      - Critical recapture formula:

$$R_{Critical} = \frac{\delta}{\delta + m} = \frac{10}{10 + 10} = 0.50 = 50\%$$

    - Data for actual recapture rates
      - For each company, built tracking database that showed, for each bidding opportunity, the incumbent distributor, the winning distributor, and the competing bidders
      - *Sysco*: Lost 70% of the bids to another broadline distributor as opposed to another type of food distributor
      - *USF*: Over 70% to another broadline distributor
    - Since R_i > 70% for both Sysco and US Foods → $R_i > R_{critical}$ and so broadline distribution is a product market
    - Rejected defendants' challenges to data and application
    - BUT agreed that the flaws in the data reduced the probative value of the test but still corroborative of result from other evidence

[1] Review the slides on one-product SSNIPs and aggregate diversion analysis in the Market Definition class notes (slides 120-53).

Cluster markets: Application in *Sysco*

- Accepted: Broadline distribution as a product market
  - Hypothetical monopolist test supports FTC's definition
    - WDC: Some questions you should be asking:
      1. The FTC's expert used the formula for uniform SSNIP recapture test. Is this the correct formula to use?
      2. Does the data used to estimate recapture rates suggest a one-product SSNIP or a uniform SSNIP?
  - The FTC used the same test that Warren–Bolton used earlier in H&R Block/ TaxACT:

If	$R_i^s \geq R^U_{Criticai}$	for all firms *i* in the candidate market
	$R_i^s > R^U_{Critical}$	for some firm *j* in the candidate market

Then the candidate market is [presumptively] a relevant market

    - Warren-Bolton—and apparently Israel as well—used this as a definitive test
      - But there is no proof of the proposition as a theorem
      - There is good reason to believe that it does not work
      - At best, the test is presumptive
  - What would have been the result of the analysis if the FTC's expert assumed that the data estimated one-product SSNIP diversions and used a one-product SSNIP critical recapture formula?
    - Would have failed for a 10% SSNIP: $R_{Critical} = \dfrac{\delta}{m} = \dfrac{10\%}{10\%} = 1 = 100\%,$ but actual recapture ratios were between 70%-80%

Targeted Broadline Foodservice Distribution Market to National Customers

Target customer market: Allegations

- The allegations
  - *FTC*: Alleged that within the broader broadline foodservice distribution market, there existed a relevant market of “national customers”
  - *Merging parties*: Argued that there was no separate market of “national” customers
    - Can purchase more regionally or locally
    - Consortia will form to protect these customers if the combined firm seeks to act anticompetitively
      - *Query*: Is this a proper objection to the existence of a national customer targeted market?
      - *WDC*: Goes to the participants in the market, not the market’s existence

Target customer market: Application in *Sysco*

- *Court*: Broadline distribution for national customers
  - *Rule*: A relevant market can be defined by a group of customers if they can be targeted for a price increase (citing the HMG § 4.1.4)
    - Here, national customers can be readily identified
    - Given the nature of the product, there is no arbitrage among purchasers
  - Notes
    - The targeted customers as a group may be charged discriminatorily *lower* prices than other customers
    - Nonetheless, the Merger Guidelines and the courts recognize that an actionable anticompetitive effect occurs when, as a result of a merger, the prices to the targeted customer group is likely to be higher that they were premerger, even if they remain below the prices charged to other customers

Target customer market: Application in *Sysco*

- *Court*: Broadline distribution for national customers
  - Market supported by *Brown Shoe* “practical indicia”
    - Industry and public recognition of distinct customer needs
      - Regional broadliners have formed cooperatives to bid for national customers (formed specifically to compete again Sysco and US Foods)
      - McKinsey report (done for Sysco) and other industry research studies support national customers as a distinct customer group with distinct requirements
      - Industry trade group (International food Distributors Association) recognizes the distinction
      - Defendants’ ordinary course of business documents support distinction
      - PROBABLY KEY: National customers testified that they would not switch to other channels to substitute for a broadline supplier
  - Aggregate diversion analysis corroborates the market
    - Analysis identical as in broadline generally
    - EXCEPT look to recapture only by broadline companies with a national footprint

Target customer market: Application in *Sysco*

- *Court*: Broadline distribution for national customers
  - Rejects defendants' arguments
    - The distinction between national and local is not arbitrary: reflects a preference by national customers for which they are willing to pay
    - National customers are identifiable—contracts are individually negotiated
      - No arbitration of products, so national customers can be charged different prices
    - Sysco and US Foods earn higher margins on sales to local customers than from sales to national customers, indicating that national customers can constrain the prices
      - *Court*: Customer testimony indicates that the lower margins more likely result from national customers playing Sysco and US Foods off each other

The District Court Opinion
1. The Prima Facie Case
B. The Geographic Markets

Geographic markets

- FTC allegations:
  1. National for broadline distribution to national customers
  2. Local for broadline generally
- Court: Legal standard
  - "[T]he area in which the goods or services at issue are marketed to a significant degree by the acquired firm" (*Marine Bancorp.*)
  - "[W]here, within the area of competitive overlap, the effect of the merger on competition will be direct and immediate" (*PNB*)
  - The Supreme Court has recognized that an "element of 'fuzziness would seem inherent in any attempt to delineate the relevant geographical market,' " and therefore "such markets need not—indeed cannot—be defined with scientific precision." (*Connecticut National Bank*)
  - WDC: Could have added that the Merger Guidelines give a more precise standard using the hypothetical monopolist test

Geographic markets: Application in *Sysco*

- *Court*: Accepts national broadline market for national customers:
  - Defendants plan on a national level and have “national account” teams dedicated to national customers
  - Their contractual pricing and service terms with national customers apply across regions
  - Their competition for national customers is largely other broadliners with nationwide coverage.
  - “Although the physical act of delivering food products occurs locally, for national customers the relevant geographic area for competitive alternatives is nationwide”—given how they are:
    - Marketed
    - Sold
    - Priced
    - Serviced
  - These are essentially the same factors that established the national customer product market—No further analysis
    - Only here the Court is addressing the relevant geographic market, not the relevant product market

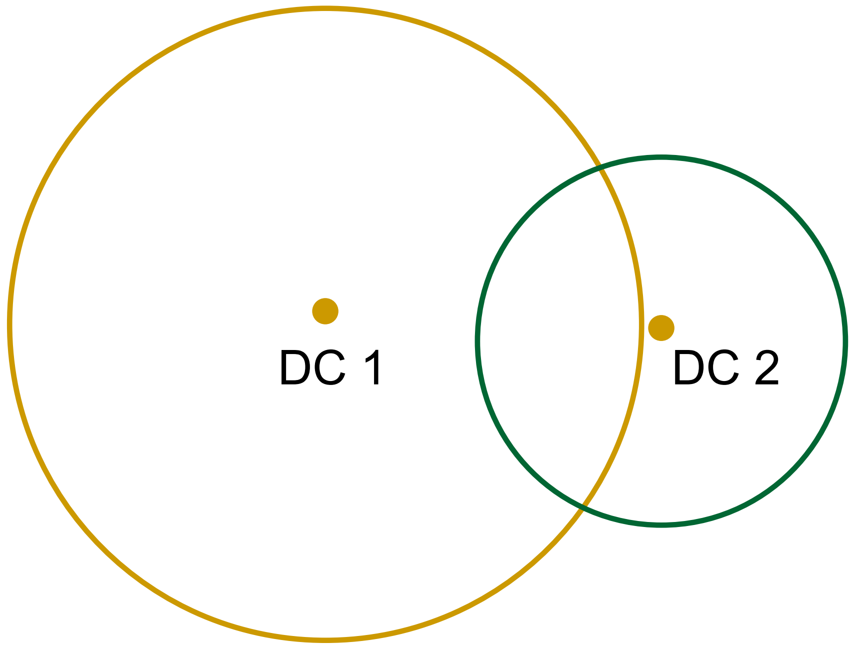
Geographic markets: Application in *Sysco*

- *Court*: Accepts FTC's local markets for all broadline foodservice distribution
- FTC methodology (overlapping draw areas)
  - *Step 1*: For each distribution center, determine the radius in which the center draws 75% of its revenues ("draw areas")
  - *Step 2*: Determine the "overlap areas"—these customers will have one less alternative supplier as a result of the merger
  - *Step 3*: Identify the broadline distributors who could compete for the overlap customers (using the distributor's 75% draw radius)
  - The relevant geographic market is defined by the area encompassing the competitive distributors

While there may be substantial data problems in applying this approach and some of the parameters can be debated, the "overlapping draw areas" approach is accepted as a valid geographic market definition technique

Local broadline markets

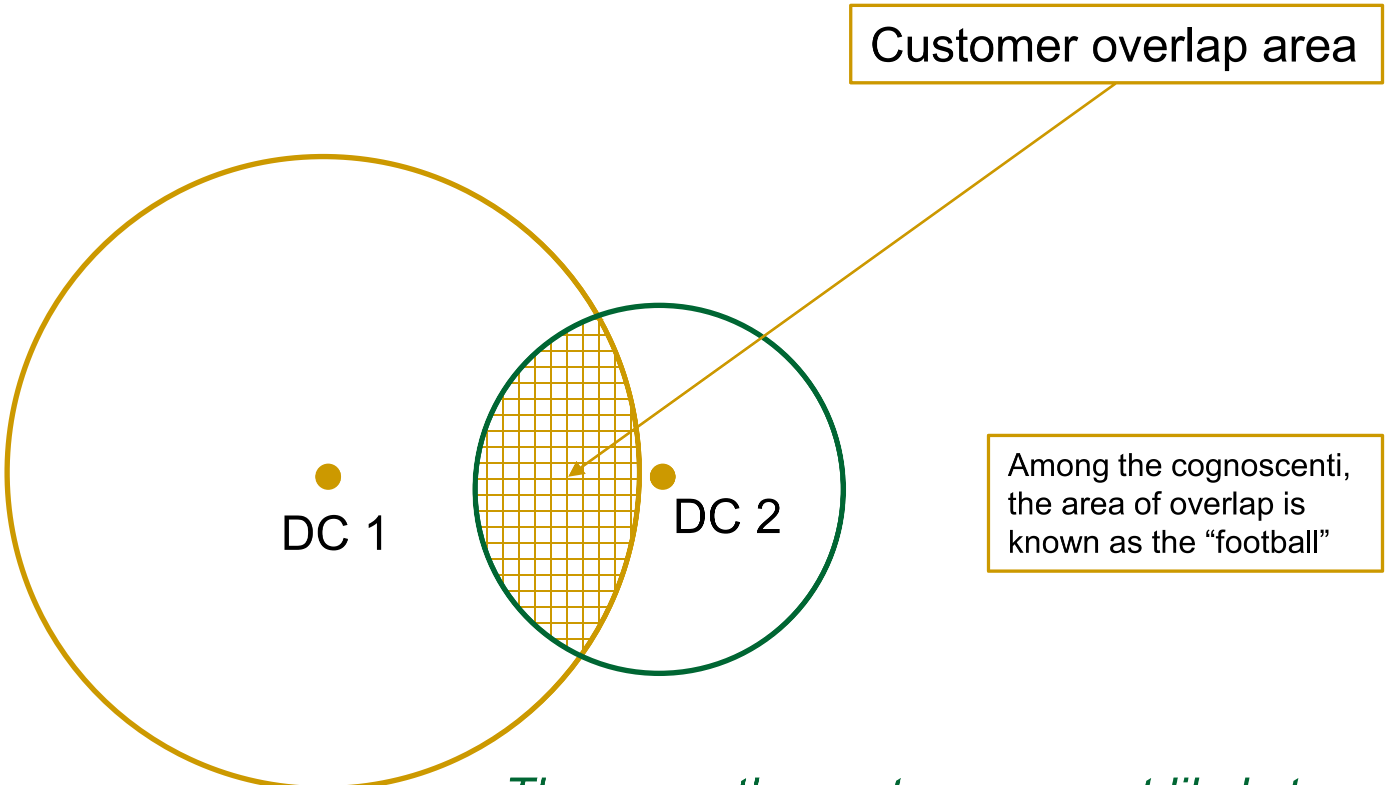
- FTC "draw area" methodology
  - *Step 1*: For each distribution center, determine the radius in which the center draws 75% of its revenues ("draw areas")



The percentage of revenues that determines the draw area can be a subject of dispute. But courts and agencies commonly accept 75%-80%. Careful practitioners and economists will perform a sensitivity analysis to see if the result change significantly with different percentages

Local broadline markets

- FTC "draw area" methodology
  - *Step 2*: Determine the "overlap areas"—these customers will have one less alternative supplier as a result of the merger

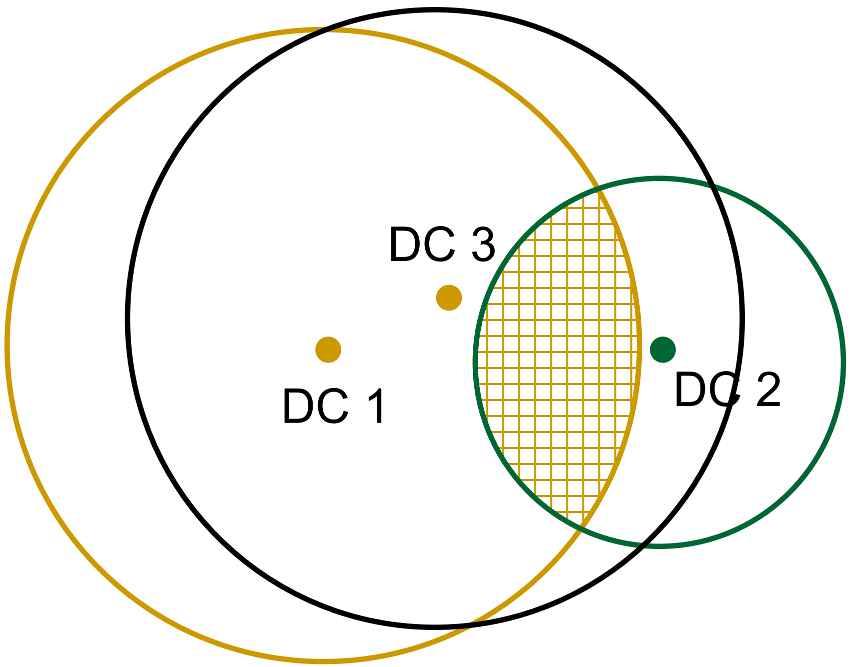


Among the cognoscenti, the area of overlap is known as the "football"

These are the customers most likely to be harmed by an anticompetitive merger

Local broadline markets

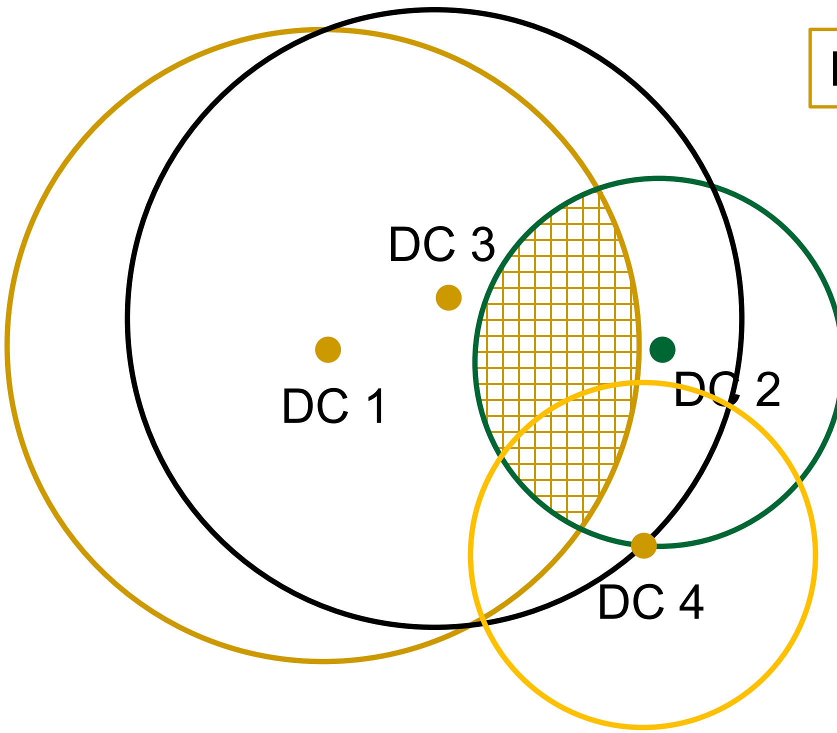
- FTC "draw area" methodology
  - *Step 3*: Identify the broadline distributors who could compete for the overlap customers (using the distributor's 75% draw radius)



DC 3 is in the market

Local broadline markets

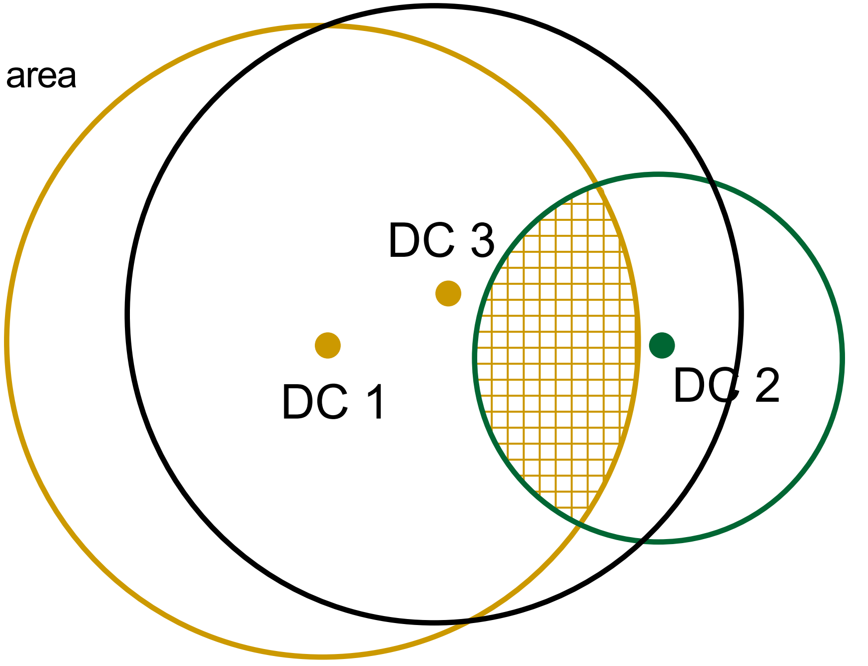
- FTC "draw area" methodology
  - *Step 3*: Identify the broadline distributors who could compete for the overlap customers (using the distributor's 75% draw radius)



DC 4 is not in the market

Local broadline markets

- FTC "draw area" methodology—So what is the relevant geographic market?
  - In principle, it should be defined by overlap area 9the "football")—these are the customers that are most likely to be harmed by an anticompetitive merger
  - The market participants are suppliers who could serve customers throughout the overlap area (here, firms 1, 2, and 3)
  - The market share of these participants should include:
    - Sales the distributor make in the overlap area
    - PLUS any diversion of sales into the area if prices were to increase by 5%
  - If the data does not permit this isolation, the market can be defined as the union of the three draw areas
    - Should still yield good results if suppliers will rapidly shift sales in response to a price increase in part of their sales area



Local broadline markets

- Defendants' response
  - Markets too small
    - Some suppliers will ship into the overlap area even though it is outside their defined draw area
    - By construction, 25% of a supplier's shipments will be outside its defined draw area
- Court
  - True, but the FTC's approach is a practical one that identifies areas that are likely to be competitively affected
  - KEY: Also, no indication in the opinion that expanding markets to meet defendants' criticism would have materially changed the results

Note: This is typical of courts' reactions. If the merging parties are going to argue that the FTC's market definition is wrong, to be persuasive they should prove an alternative market and show that within that market the merger will not have the requisite anticompetitive effect.

The District Court Opinion
1. The Prima Facie Case
C. The *PNB* Presumption

National broadline market for national accounts

- FTC's market shares

Table 18

Shares of Sales to National Broadline Customers, After Accounting for the Proposed Divestiture

	Post-Divestiture Shares	Post-Divestiture HHI's	
	Combined Share	HHI	Δ HHI
Baseline	71%	5,119	1,966
(i) National	68%	4,935	1,953
(ii) National + Imputed National	65%	4,549	1,799
(iii) National + Regional	66%	4,614	1,822
(iv) National + Systems	62%	4,217	1,643
(v) National + Regional + Systems	61%	4,087	1,590
(vi) Parties' Ratio of National	59%	3,809	1,500

- Defendants' position
  - Contested methodology and inputs
  - But offered no alternative calculations that showed that the *PNB* presumption was not triggered

National broadline market for national accounts

- Court:
  - "None of these arguments ultimately persuade the court that Dr. Israel's methodology or his market shares and HHI calculations are unreliable. The FTC need not present market shares and HHI estimates with the precision of a NASA scientist. The 'closest available approximation' often will do."
  - Last method most persuasive:
    - Assumed that all 16 of the top broadliners had the same national-local sales ratio as defendants did.
    - Implied a combined share 59%; Delta 1500; post-HHI 3809
    - Three times the delta in *Heinz*, which the DC Circuit found sufficient by a "wide margin"
    - Also consistent with estimates suggested by business data
      - Sysco & USF largest customers alone account for more than half of total national broadline sales of $28-$30 billion
      - Also, smaller broadline distributors likely to have a smaller national/local sales ratio than Sysco and USF, which would overestimate the numerator and underestimate the combined firm's share
    - Consistent with the only independent market analysis (Technomic)
  - COURT: *PNB* presumption established in national broadline market

Local broadline markets

- Merger challenged in 32 local markets
- Israel's estimates
  - Metrics
    - Square footage of distribution centers
    - Local broadline sales
    - Number of sales representatives

Table 21

Examples of Areas with Large Change in HHI despite Divestitures

CBSA	Post-Merger Combined Share	Delta HHI
Omaha-Council Bluffs, NE-IA	90.3%	1,410
Sacramento--Roseville--Arden-Arcade, CA	88.6%	2,974
Durham-Chapel Hill, NC	75.4%	2,807
Charleston-North Charleston, SC	80.2%	2,947
Birmingham-Hoover, AL	57.5%	1,542
Jackson, MS	66.0%	2,155
Memphis, TN-MS-AR	93.8%	4,123
Columbia, SC	72.8%	2,315
Raleigh, NC	71.3%	2,188
Lynchburg, VA	63.3%	1,588
Rochester, NY	63.7%	1,574

Local broadline markets

- Defendants
  - Same types of arguments as before—contesting methodology and inputs
  - But no alternative calculations showing that the *PNB* presumption is not applicable
- Court:
  - Numbers not perfect, but good enough to make a prima facie showing in the absence of opposition
  - Defendants' challenges not persuasive → FTC has established its prima facie case

The District Court Opinion
1. The Prima Facie Case
D. Additional Evidence of Anticompetitive Effect

Additional evidence of anticompetitive effect

1. Unilateral effects in the national customer market
2. Merger simulation for the national customer market
3. Unilateral effects in local markets
4. Local event studies on unilateral effects in local markets

Unilateral effects in national customer market

- Evidence
  1. Sysco and US Foods are usually the first- and second-lowest bidders in bidding for national customer accounts
     - Israel's RFP/bidding study (7 years of data—undoubtedly obtain by subpoena by the FTC)
     - Sysco lost to USF 2.5x more than to the next closest competitor
     - USF lost to Sysco 3.5x more than to the next competitor
  2. Parties' ordinary course of business documents show that they are each other's closest competitors
  3. Testimony from industry participants
  4. Independent market research reports
- *Court*: Credited Israel's analysis

At this point, Israel has provided qualitative and win-loss data to predicate a unilateral effects theory, which the Court accepted as sufficient. No further quantification.

Start here

Merger simulation for national customer market

- Israel: Used "second price auction model" to estimate price increases
  - Price determined by second lowest bidder
    - The idea is that the winning bidder will just undercut the price of the second lowest bidder
    - Assumes that bidding is "descending open cry" or—more realistically in this case—that the customers negotiate with each bidder privately and in the process reveal the lowest current bid price
      - Very common in bidding situations—almost surely the prevailing practice in national food distribution
      - This is the mechanism by which customer "play off" suppliers against one another
  - If #1 and #2 merge, then #3 becomes the second bidder and the merged firm's bid price increases to just below #3's bid price
  - *Competitive harm*: Difference between bid prices of #2 and #3
- Can also use costs rather than prices in an auction model
  - In other situations, where the bidders do not have good expectations of their competitors' bid prices but know their costs, the auction model can use costs.
  - The winning bidder will be the lowest cost firm to supply the customer and win at a price just below the cost of the second lowest-cost supplier to that customer.

Unilateral effects in national customer market

- Second cost auction theory: Example
  - The city of Jacksonville seeks lime for its municipal water treatment facility
  - Lime is mined and processed at a lime quarry and shipped to the customers
  - The cost of extracting and processing the lime is essentially the same for all suppliers, but shipping costs differ depending on the distance

  - Predicted results:
    - The closest lime quarry will win the contract at a price just below the cost of supply of the second-closest quarry
    - If the first and second lowest-cost supplier merge, the price will increase to just below the cost of the third lowest-cost quarry

Unilateral effects in national customer market

- *Requirements (costs version)*: The theory predicts a unilateral price increase from the merger if—
  1. The merger involves the first and second lowest-cost suppliers to one or more customers
  2. The customers can be targeted for price discrimination
  3. The third-lowest cost supplier has costs to supply the customer that are (materially) higher than the second lowest cost-supplier
  4. There are barriers to entry/expansion/repositioning that will impede a supplier postmerger from achieving the cost structure of the second lowest-cost supplier
- Application
  - Requires bidders to have accurate expectations of the costs of their competitors
    - NB: Can use bid prices rather than costs if bidders have good expectations of their competitor's bid prices
  - Diverted sales unilateral effects does NOT apply since there is no postmerger merger diversion/recapture of lost marginal sales

Note: We now have two distinct theories of unilateral effect:
1. *Recapture of diverted sales ("classical unilateral effects")*
2. *Second price/cost auction model in bidding situations*

Merger simulation for national customer market

- Israel's evidence—Used prices, not costs
  - Company emails recognizing that—
    - Sysco and U.S. Foods are each other closest competitors, *and*
    - The next closest substitute is a very distant third
  - Quantification of model
    - Using market shares and price-cost margins, estimated annual harm to national customers = $1.4 billion (without divestiture)
      - $900 million w/divestiture to PFG
    - Not clear from opinion what Israel did
      - The right way to do this is to calculate, for each bidding situation where Sysco and U.S. Foods were the top two bidders, the difference between the winning bid and the third lowest bid
- Defendants' criticism—bad data
- *Court*: Recognizes data deficiencies, but model is robust and consistent with other evidence of anticompetitive effect here

Unilateral effects in local markets

- Ordinary course of business documents
  - Shows Sysco and US Foods are each other's closest competitors for local customers in jointly served markets
- Testimonial evidence more equivocal (each for particular markets)
  - *FTC testimony*: Uniquely strong competitors of one another
  - *Parties*: Other equally strong or stronger competitors for local customers
  - *Court*: "Because of conflicting local market assessments, the court cannot draw firm conclusions about the competitiveness of the local broadline markets from the testimonial evidence."
- Second price auction analysis
  - Same economic analysis as in national market
  - *Court*: Evidence is somewhat more equivocal, but still strengthens FTC's prima facie case
- Court:

  Though the court finds the evidence of unilateral effects in the local markets to be less convincing than in the national customer market, the evidence nonetheless strengthens the FTC's prima facie case of merger harm.

Local event studies

- Israel:
  - Studied the effects of Sysco's opening of two distribution centers on prices paid by USF customers
    - USF operated distribution centers in the same 75% overlap area
  - Long Island, NY—July 2012
    - Regression analysis showed that entry resulted in a 1.4% decrease in USF's prices
  - Riverside, CA—June 2013
    - 0.6% decline
- The idea
  - If opening a merger partner's store in the draw area of the other merger partner's store lowers price, then the merger—which would eliminate competition between the stores—should increase price
  - BUT opening a store puts new capacity in the market, whereas the merger will not reduce market capacity unless the combined firm closes one of the two stores
  - Consequently, the quantitative price effects of opening a new store is unlikely to provide any quantitative implications of the price effects of the merger
    - *But it is directional*: If prices go up with the opening of a competitor's store, then price can be expected to go down with the merger

Local event studies

- Another problem here
  - Not “clean” studies—Sysco already had centers in these areas
  - This could have suppressed the price effect
- Israel: Interpreting the results
  - The new Riverside center was close to the existing Sysco center—so presumably price effects of Sysco’s presence had already occurred
  - By contrast, the new Long Island center was more distant to existing Sysco center and served more new business than the Riverside facility, resulting in larger price effects

Local event studies

- *Court*: Not convincing evidence that merger would harm local customers
  - Even if the Long Island study is taken at face value, the price effect is much smaller than found in other cases
    - *Staples* (1997): 13% difference in markets where Staples was not competing with another superstore
    - *Whole Foods*: WF dropped prices by 5% when another organic supermarket opened
  - “[T]he absence of convincing price effects evidence is the weakest aspect of the FTC’s case”
- *WDC*: Should FTC have presented these local event studies?

Anticompetitive effects: Conclusion

- *Court*: The FTC has presented a "compelling" prima facie case of anticompetitive effects

> In summary, the FTC has bolstered its prima facie case with additional proof that the merger would harm competition in both the national and local broadline markets. Although the FTC's case would have been strengthened with more convincing pricing effects evidence [the local event study], the court nevertheless finds that the FTC has presented a compelling prima facie case of anticompetitive effects. *See Baker Hughes*, 908 F.2d at 991 ("The more compelling the prima facie case, the more evidence the defendant must present to rebut it successfully."). The court now turns to Defendants' rebuttal arguments.

The District Court Opinion
2. Defendants' Rebuttal Arguments

Four lines of rebuttal

1. Post-divestiture, PFG will replace any competition potentially lost as a result of the merger (the "fix")
2. National customers can protect themselves by dealing more regionally
3. The entry of new competition and the repositioning of existing competitors will keep the industry competitive
4. Customers will benefit from efficiencies arising from the merger

1. The PFG "fix"

- *Defense*: Sysco's divestiture of 11 distribution centers to PFG, could with PFG's existing 24 distribution centers and 7 new centers to be financed by PFG's owner, will be sufficient to ensure continued competition and negate any anticompetitive effects of the merger
  - Shortly before the FTC complaint was filed, Sysco entered into an agreement to sell 11 USF distribution centers to PFG contingent on the main deal closing
  - In addition, PFG's owner, The Blackstone Group, committed to invest $490 million to develop 7 more centers and increase capacity in 16 of PFG's 24 existing centers
  - *Bottom line*: PFG would start with 35 distribution centers and eventually have 42 distribution centers

1. The PFG "fix"

- *Court*: Rejected fix as insufficient to defeat FTC's prima facie case
  - Appears to agree that merger should be analyzed with the PFG "fix" in place
    - Determine the anticompetitive effects of the merger in the absence of the fix
    - Ask if the fix negates the anticompetitive effects
  - Does not doubt—
    - PFG management's experience or commitment
    - Blackstone financial commitment to PFG

1. The PFG "fix"

- *Court*: Rejected fix as insufficient to defeat FTC's prima facie case
  - BUT PFG will not be as nearly competitive post-fix as USF is premerger:
    - PFG 5-year business plan projects that PFG will have less than ½ of the national broadline sales that USF had at the time of the merger
    - Even assuming PFG will be able to integrate the 11 USF centers effectively into its operation, it will start with only 35 centers—compared to Sysco/USF > 100 centers
      - WDC: Premerger, Sysco and USF had 72 and 61 distribution centers, respectively
      - Prenegotiation PFG internal strategy documents indicated that 35 distribution would not be enough to compete effectively with Sysco and USF (court did not provide details)
      - PFG said the same to the FTC in the vetting process (obviously seeking help from the FTC in obtaining more distribution centers, but this failed)
    - New centers and expansions PFG is planning to build, while perhaps they could plug the gap, will not come online for several years at best
    - PFG lacks experience in offering value-added services to some important segments (e.g., healthcare) that both Sysco and USF have premerger
    - Significant reliance on merged firm for 3-5 years under Transition Services Agreement (cuts against PFG as a strong independent competitive force)

2. Protection through regional dealing

- *Defense*: National customers can protect themselves by dealing more regionally
  - Dealing with a single national distributor is merely a preference
  - National customers often deal with multiple sources of supply
- *Court*: Rejected defense
  - Multiple sources for some national customers are often a "one-off" phenomenon—national customers still purchase the bulk of their products from national distributors (61% to 100%)
  - Regionalization available today, but national customers are not moving in that direction—the "clear trend" is to move toward centralization in a single supplier
  - Not merely a customer preference—driven by rational business considerations:
    - Management and supply chain costs increase
      - Multiple points of sales and logistics contact
      - Multiple, different order entry/communications/IT systems
      - Multiple billing systems
    - Consistency in products can suffer (especially private label)

3. Entry/expansion

- *Defense*:
  - No technological, legal or regulatory barriers to entry or expansion
  - New firms will enter or smaller incumbent firms will expand in the event of a postmerger price increase and compete prices back down to premerger levels

3. Entry/expansion

- *Court*: Rejected defense
  - Rule: To be a defense, entry must be—
    1. Timely
    2. Likely, *and*
    3. Sufficient to deter or counteract the anticompetitive effect
  - *Not likely*: There exist significant barriers to entry and expansion
    - Broadline extraordinarily capital- and labor-intensive
      - New distribution center: $35 million to build
      - + stock
      - + Delivery trucks (including expensive refrigerated trucks)
      - + People to sell the service, maintain and stock the warehouse, deliver the products, handle the back office
    - Reputation barriers
  - *Not timely*
    - Even if barriers could be overcome, it would take years to enter (especially in national market)
  - *Not sufficient*: Individual ability and incentive:
    - Incumbent distributors testified that they have no plans to expand to serve national customers—dissuaded by time, costs, and risk
    - If incumbent distributors will not expand, de novo entry even less likely

4. Efficiencies

- *Defense*:
  - Merger will result in at least $600 million and as much as $1 billion in annually recurring efficiencies
  - Rigorously derived:
    - Developed over 8 months involving over 100 employees at McKinsey and over 170 Sysco and USF employees

4. Efficiencies

- *Court*: Rejected defense
  - Adopted Merger Guidelines requirements:
    1. Merger specificity
    2. Verifiability
    3. Timeliness and sufficiency to negate the merger's anticompetitive effects
  - Did not question scale or rigor of analysis or accuracy of estimate
    - Not questioning verifiability
    - NOT the usual approach

4. Efficiencies

- *Court*: Rejected defense
  - *Question*: Have "Defendants have shown that the projected 'merger-specific' cost savings are substantial enough to overcome the presumption of harm arising from the increase in market concentration and other evidence of anticompetitive harm?"
  - *Court*: Not persuaded
    - Not merger-specific
      - McKinsey was not hired to evaluate merger-specific efficiencies
      - McKinsey witness could not say if any of the efficiencies it identified would have occurred in the absence of the merger
        - Sysco, for example, had some projects going to achieve some of the same types of synergies that McKinsey (e.g., savings from "category management")
      - Hausman (a defense expert) reduced number to $490 million, but performed no independent analysis of McKinsey results
      - → Failure of proof on which merging parties bore the burden
    - Not sufficient
      - Even crediting Hausman's estimate of $490 million, insufficient to offset anticompetitive effect
      - <1% merged company's annual revenue
      - So even assuming 100% was passed on to consumers, even a small increase in price could offset any cost savings (merged firm would have $66 billion in annual sales)
      - → Failure of proof on which merging parties bore the burden
  - *WDC*: Note that court did not rely on Israel's quantification of anticompetitive harm to find that efficiencies were insufficient

The District Court Opinion
3. Determining the Net Anticompetitive Effect

Determining the net anticompetitive effect

- Unnecessary to proceed to step 3 of *Baker Hughes* since the defendants failed to produce sufficient evidence to put the prima facie case in dispute

The District Court Opinion
4. Balancing the Equities

The FTC's alleged equities

1. Public interest in effectively enforcing antitrust laws
2. Public interest in ensuring that the FTC can order effective relief if it succeeds at the merits trial—Would have to confront:
   - Consolidation of Sysco's and USF's distribution centers and infrastructure and possible departure of significant personnel (e.g., management, sales, logistics) would make it difficult to restore both parties to premerger condition, AND
   - Sale of 11 distribution facilities to PF, which presumably could not be rolled back
   - PLUS inevitable disruption to the food service industry caused by a postmerger divestiture

The defendants' alleged equities

- Public interest in allowing customers to have the advantage of the efficiencies of the transaction
  - *Court*: Rejected for failure of proof (in the efficiencies defense)
  - *WDC*: Could add that this factor could at most count the harm from the *delay* in the realization of the efficiencies if the defendants succeeded on the merits
- The public and private harm merger that would result if the merger terminates as a result of injunction, even if the merger is not anticompetitive
  - *Court*: This is a "private equity" that does not outweigh the public equities in favor of the preliminary injunction
  - *WDC*: Could add that the election to terminate the transaction and not defend on the merits was made by the parties and was not compelled

The District Court Opinion
5. Conclusion

Conclusion

- Court:
  - FTC proved a prima facie case of anticompetitive effect in two markets:
    1. Broadline distribution to national customers
    2. Broadline distribution in local markets
  - Defendants failed to discharge their burden of production on any of their defenses:
    1. The PFG “fix”
    2. Protection through regional dealing (for national customers)
    3. Entry/expansion
    4. Efficiencies
  - FTC showed a likelihood of success on the merits at a full trial
  - Equities weighed in favor of entering a permanent injunction
  - Preliminary injunction entered June 23, 2015

- Aftermath
  - Parties terminated the merger agreement terminated June 29, 2015