

Class 26 slides

Unit 18: Penguin/Simon & Schuster

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Merger Antitrust Law
Georgetown University Law Center

December 1, 2022



Penguin
Random
House



Simon &
Schuster

What was the gravamen of the complaint?

- The acquisition was reasonably probable to substantially lessen competition in the acquisition of publishing rights to anticipated best-selling books
 - “Anticipated best-selling books” identified as books with advances over \$250K

What was the result of the case?

- The DOJ won
- Simon & Schuster unilaterally terminated the merger agreement on the drop-dead date

Why did the winning party win?

Government wins

| | |
|------------------------------|--------|
| H&R Block/ TaxACT | Step 2 |
| Sysco/ U.S. Foods | Step 2 |
| Staples/ Office Depot | Step 2 |
| Penguin/ Simon & Schuster | Step 2 |

Merging parties win

| | |
|-------------------------------|--------|
| U.S. Sugar/ Imperial Sugar | Step 1 |
| AT&T/ Time Warner | Step 1 |
| UnitedHealth/ Change | Step 1 |

The complaint

- The complaint
 - Filed November 2, 2021
 - After investigating the proposed transaction for a little less than a year
 - *Venue*: District of Columbia
 - *Relief*: Permanent injunction blocking the transaction

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA
U.S. Department of Justice
Antitrust Division
450 Fifth Street, NW, Suite 4000
Washington, DC 20530,

Plaintiff,

v.

BERTELSMANN SE & CO. KGaA
Carl-Bertelsmann-Strasse 270
33311 Gütersloh, Germany,

PENGUIN RANDOM HOUSE, LLC
1745 Broadway
New York, NY 10019,

VIACOMCBS, INC.
1515 Broadway
New York, NY 10036,
and

SIMON & SCHUSTER, INC.
1230 Avenue of the Americas
New York, NY 10020

Defendants.

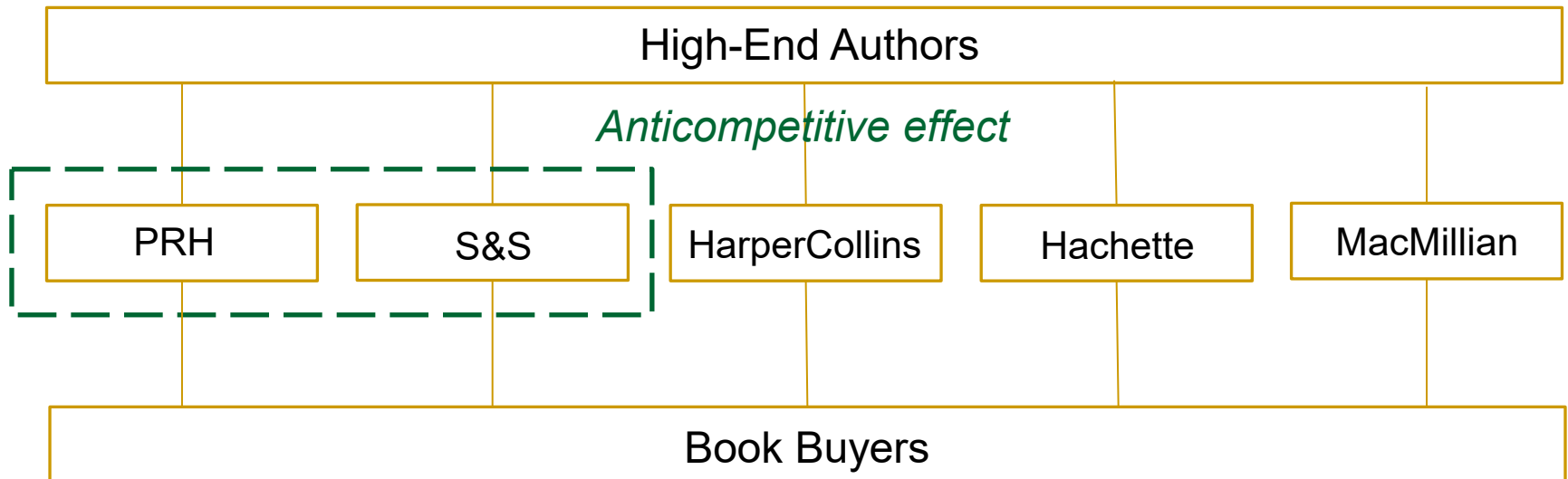
COMPLAINT

The United States of America brings this civil action to stop Penguin Random House, LLC—the world’s largest book publisher—from buying its publishing rival, Simon & Schuster, Inc. If Defendants’ proposed merger is allowed to proceed, Penguin Random

1

Claim

- Horizontal
 - Transaction may substantially lessen competition in the acquisition of publishing rights to anticipated best-selling books
 - Defined to be books with advances over \$250K
- The anticompetitive effect is located in an upstream (buyer) market
 - No claim of any anticompetitive in the downstream (seller) market



The trial

■ Judge Florence Y. Pan

- Former associate judge of the Superior Court of the District of Columbia
- Nominated by President Joe Biden
- Sworn in: September 23, 2021
- Elevated to the D.C. Circuit: September 26, 2022



■ Trial

- Parties stipulated to a TRO—proceeded to trial on the merits
 - Court consolidated proceedings under Rule 65(a)(2)
- Trial began on August 1, 2022 (12 days)—8 months after the complaint was filed
 - Testimony from authors, publishers, literary agents, and industry executives
 - One expert witnesses from each side
 - 230 exhibits
- Decision: Permanent injunction granted on October 31, 2022
 - Twelve months after the complaint was filed
- Deal abandoned by S&S on November 21, 2022 (the drop-dead date)
 - Bertelsmann pays \$200 million break-up fee



Experts:

■ DOJ: Dr. Nicholas Hill

- Partner at Bates-White
- Ph.D in economics, Johns Hopkins University
- Joined Bates-White in 2017
- Prior 12 years as a government antitrust economist
 - 2014-2017: ATD Assistant section chief
 - 2013-2014: FTC staff economist
 - 2006-2013: ATD staff economist
- Testified in several antitrust cases



■ Merging parties: Dr. Edward A. (“Ted”) Snyder

- Professor of Economics and Management, SOM, Yale
 - Dean (2011 - 2019)
- Former Dean, Booth School of Business, University of Chicago
- Ph.D in economics, University of Chicago
- Academic affiliate, Analysis Group
- Testified in multiple antitrust cases
 - But this may be his first merger antitrust case

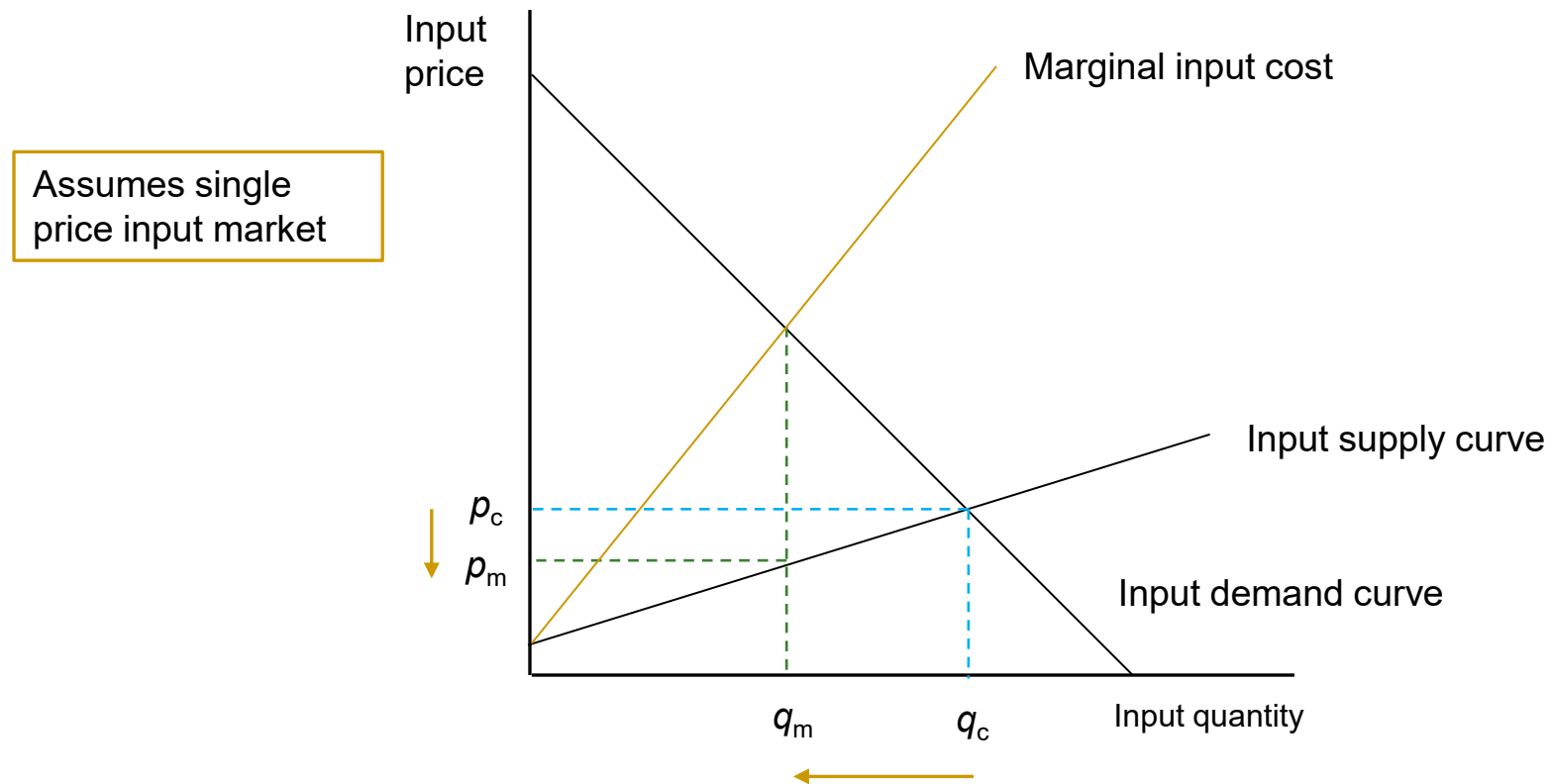


Court: Legal standard

- Recognized that competition could be harmed in input markets as well as output markets
- Treated harm to sellers in input markets as the same as harm to buyers in output markets
- Did NOT consider the effect—or lack of effect—on downstream consumers from harm in upstream markets
 - This was a major theme for the merging parties
 - The court ignored it in its opinion

Monopsony

- The monopsonist reduces input demand to create a demand scarcity
- Inframarginal suppliers bid down the input price to clear the market



Monopsony

- Consider three scenarios as a result of a monopsony power-increasing merger

| Scenario | Inputs | Market Output | Consumer Effect |
|---------------------|---------|--|-----------------|
| Classical monopsony | Decline | Declines (merged firm large enough to affect market output) | Consumer harm |

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| Local input market; Larger competitive output market | Decline | Increases (merged firm passes input cost savings to consumers in whole or in part by reducing output price) | Consumer benefit |

What is the antitrust outcome in each case for the merger?

In what scenario did the merging place attempt to place the Penguin/S&S merger?

The District Court's Analysis

What was the relevant product market?

- Court: Adopts DOJ definition
 - The acquisition of publishing rights to anticipated best-selling books
 - “Anticipated best-selling books” identified as books with advances over \$250K
 - Looks to—
 - *Brown Shoe* factors
 - Hypothetical monopolist test

What was the relevant product market?

■ *Brown Shoe* factors

□ *Court*: Looks at the characteristics of the products

- Distinct prices (advances, higher royalty rates, customized terms)
- Authors are “distinct sellers” with distinct demands for distribution, marketing support, and editorial assistance

Really more indicative of “target suppliers” in the broader market of all book rights

□ *Query*: Why look at these characteristics?

- In output markets, it is to test substitutability by customers of products inside the candidate market
- What about in input markets?
 - Should be to test substitutability by input suppliers of input purchasers
 - Did the court consider that here or did the court just apply the *Brown Shoe* factors mechanically?

□ Defendants: Argue that the \$250K threshold is arbitrary

- Δ s: Either set—
 - Too high (\$50K when Big Five begin to dominate acquisitions of book rights), or
 - Too low (\$1 million for celebrity authors)
- Court: Rejected
 - *Query*: What do you think the judge have in mind when she repeatedly spoke (repeatedly) of the \$250K threshold as an “analytical tool”? What do you think of this?

What was the relevant product market?

- Hypothetical monopolist test

- Idea: To test supply-side response—

If a hypothetical monopsonist of purchasers in the candidate market attempted to suppress input prices, would enough suppliers be to turn to alternative purchasers to make the hypothetical monopsonist's input price decrease unprofitable?

- Defendants: Do not dispute that the candidate market passes the HMT
- Query: Was the implementation of the HMT in this class correct?
 - Setup
 - Initial candidate market: All publishers
 - The alternatives are self-publishing and new entry
 - Is this the right starting point?
 - Where all publishing houses market participants in the candidate market?
 - Would the result differ if the HMT was conducted correctly?

What was the relevant geographic market?

- Global market for the acquisition of U.S. publishing rights
 - Actually, the qualification of “U.S.” publishing rights belongs in the relevant product market
- No dispute

Does the *PNB* presumption apply?

- Who were the market participants?
 - Hill used 60 firms
- What was the measure of market share?
 - Hill used the share of titles acquired (of books with advances over \$250K)
 - Was this the right measure?
 - Two alternatives—
 - Aggregate advances paid
 - $1/n$, where n is the number of purchasers in the market (since this is a bidding market

Does the *PNB* presumption apply?

- What were the concentration statistics (WDC calculations)?

| | Share | HHI |
|---------------|-------------|-------------|
| PRH | 37% | 1369 |
| HarperCollins | 24% | 576 |
| S&S | 12% | 144 |
| Hachette | 10% | 100 |
| MacMillian | 9% | 81 |
| Others | 8% | |
| | <u>100%</u> | <u>2270</u> |

| | | Court |
|----------------|-----|-------|
| Combined | 49% | 49% |
| Premerger HHI | | 2270 |
| Delta | | 888 |
| Postmerger HHI | | 3158 |
| | | 2220 |
| | | 891 |
| | | 3111 |

Differences probably result from rounding errors

Defendants did not dispute calculations

- Presumptively anticompetitive under the Merger Guidelines
- Supported by *PNB* (combined firm over 30%; 4FCR over 78%)
- Support by modern judicial precedent
 - Hospital Corp. of Am. v. FTC, 807 F.2d 1381, 1384 (7th Cir. 1986) (combined 26%; 4CFR 91%)
 - FTC v. H.J. Heinz Co., 246 F.3d 708, 715-17 (D.C. Cir. 2001) (combined 32.8%)

Does the *PNB* presumption apply?

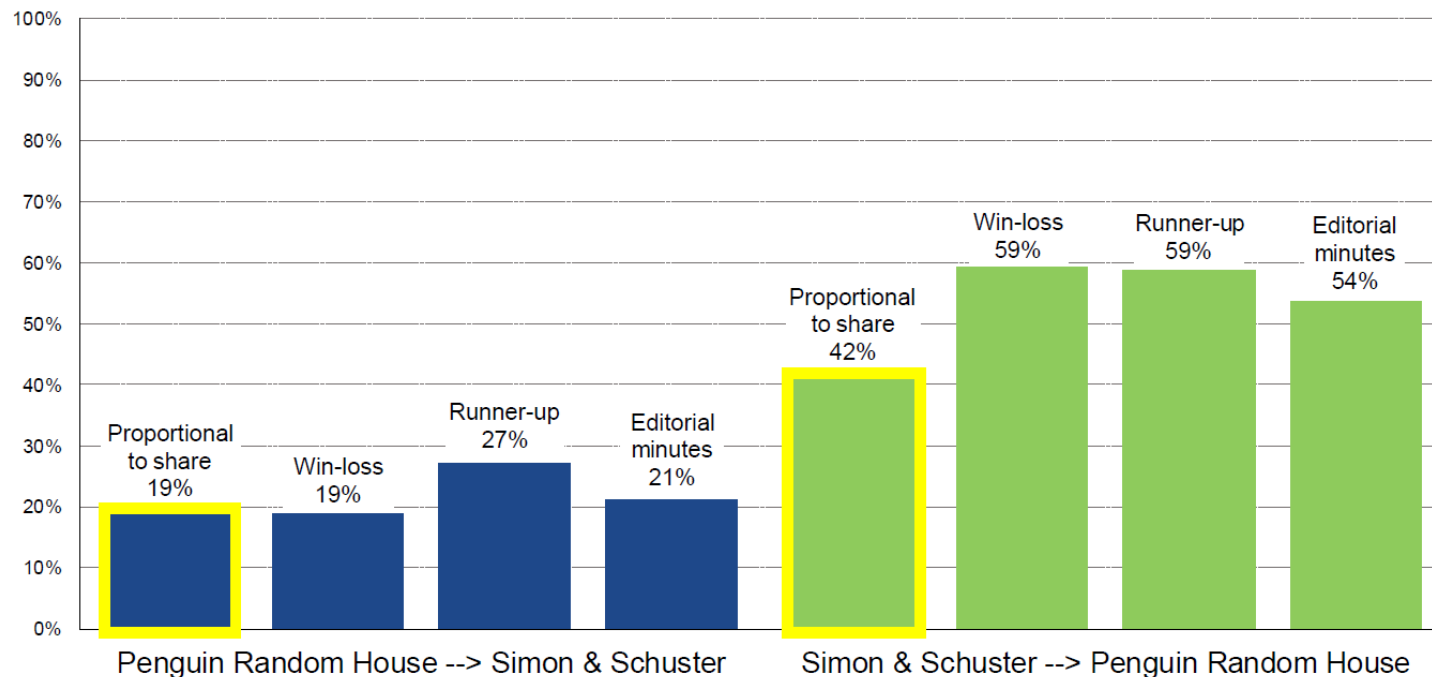
- Stability of market shares
 - Market shares of Big 5 stable over past three years
 - Court:
 - “The Agencies give more weight to market concentration when market shares have been stable over time. . . .” Merger Guidelines § 5.3
 - This “reinforces the presumption of anticompetitive effects based on market concentration.”
- Other evidence
 - Unilateral effects
 - Coordinated effects

What was the evidence of unilateral effects?

- Diversion ratio: Court's definition—
 - “If one merging party lowered advance levels, what percentage of its authors would ‘divert’ their business to the other merging party, as opposed to diverting to other firms in the industry?”
 - WDC: Not the usual definition of diversion ratio (which would look to the percentage of lost authors that divert)
 - But very likely the court may have misunderstood the concept or just misspoken
- Hill's four methods of calculating diversion ratios
 1. Diversion proportional to market shares, which is the largest data set (relative market shares)
 2. Win/loss data, which examines which publishers the merging parties lose to the most often
 3. Runner-up data, which shows how often the other party was the "runner-up" when one of the merging parties won an acquisition
 4. Minutes from the parties' editorial meetings, which provide a window into how frequently one merging party bid on a book and lost to the other party

What was the evidence of unilateral effects?

Estimates of diversion using four methodologies



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46

What was the evidence of unilateral effects?

■ Other evidence

- Snyder's diversion ratios (Δ s)—Was this helpful?
 - PRH → S&S: 20%
 - S&S → PRH: 27%
- Industry testimony
 - Expect advances would go down with competition lost between PRH and S&S
- “Top two” competition between PRH and S&S
 - Hill: About 12% of the time (based on relative market share)

| Highest Bidder | | Second Highest Bidder | | %total bids |
|----------------|-----|-----------------------|-------|-------------|
| Market share | | Relative market share | | |
| PRN | 37% | S&S | 19.0% | 7% |
| S&S | 12% | PRH | 42.0% | 5% |
| | | | | 12% |

- Snyder: 6-7%
- DOJ evidence: 27 summaries of head-to-head competition over last 3.5 years in which competition drove up advance amounts

What was the evidence of unilateral effects?

■ Other evidence

□ Number of bidders

- Court: As the number of bidder increase, the likelihood of a higher winning bid go up (and conversely)—with support expert and industry testimony
- WDC: This is an order statistic phenomenon
 - *The idea*: For example, if S&S is the highest bidder 12% of the time, then if S&S was eliminated as an independent bidder those bids that S&S won would have gone to the second highest bidder as a lower advance level
 - The court appears to have been very impressed with this argument
 - BUT assumes no adjustment by the other firms in the market

□ Acquisition will reduce PRH's incentive to bid aggressively to gain market share

- Dohle (PRH CEO):
Q: "After this merger, Penguin Random House will not have as strong a need to grow its share?"
Dohle: "Yes."

□ Hill's quantification model

- Advances to PRH authors would decrease about 4% (\$44,000)
Advances to S&S authors would decrease by 11.5% (or \$105,000)
- Used "second-score auction model" (what we called "second price auction model in Sysco)

What was the evidence of coordinated effects?

- Premerger susceptibility
 - History of collusion
 - Five of the then-Big Six colluded in attempting to raise ebook prices on Amazon
 - This was the Amazon eBook case
 - Random House did not participate
 - Big Five are tacitly coordinating now in acquiring books: Three examples—
 - *Advances*: Used to be paid in two installments, then publishers uniformly moved to three installments, and then to four installments
 - *Audiobooks*: Rights to audiobooks were originally sold separately from book publishing rights; now book publishers uniformly refuse to bid for book rights without audiobook rights
 - eBooks: During the early years of ebooks, publishers uniformly shifted royalty rates from 50% to 25% (reducing author's compensation)
- Postmerger increase in likelihood and effectiveness
 - Merger reduces the number of major publishers from five to four
 - Creates a dominant firm controlling 49% and top two firms controlling 74%

What was the defendants' rebuttal

■ Six lines of rebuttal

1. Existing competition is sufficient to preserve competition
 - Other Big Five publishers
 - Non-Big Five publishers
 - Internal competition among imprints
 - PRH's promise to allow imprints to compete not contractually enforceable
 - Self-publishing
2. Ease of entry and expansion
 - Substantial barriers to entry and expansion
3. Power of literary agents to constrain anticompetitive behavior by publishers
 - Their power remains the same but with one less major player to play off the others
4. Efficiencies from the merger will offset anticompetitive effects
 - Not considered—Testimony excluded for failing to verify
5. Lack of negative effects from the last major merger in the publishing industry
 - Evidence on both sides—Inconclusive
6. The parties' interest in finding the "best home" for S&S
 - Speculative as to the effect if S&S was acquired by a private equity firm
 - Parties' concerns not cognizable as a defense in any event
 - Only focus is the effect of this acquisition
 - *WDC*: Is this always right?

