MERGER ANTITRUST LAW

LAWJ/G-1469-05
Georgetown University Law Center
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Tuesdays and Thursdays, 3:30-5:30 pm
Dale Collins
wdc30@georgetown.edu
www.appliedantitrust.com

GRADED WRITTEN ASSIGNMENT

Instructions

Submit by email by 8:00 pm on Monday, November 21
Send to wdc30@georgetown.edu
Subject line: Merger Antitrust Law: Graded Homework Assignment

This is an untimed *graded* homework assignment. The assignment presents a hypothetical fact situation that you are asked to analyze from a particular perspective (e.g., a special assistant to the Assistant Attorney General making a recommendation on the disposition of an investigation, a private practitioner providing advice on the antitrust risks and likely outcome of a proposed transaction, a law clerk preparing an initial analysis of the application of the law to the evidence for a judge). Be sure to write from the assigned perspective *and* answer the question(s) asked.

You must submit the assignment no later than 8:00 pm ET on Monday, November 21, 2022. *Write your answer as a single Word document.* When you are ready to submit your assignment, please email it to me.

This homework assignment is final. Do not expect any clarifications or corrections. If you believe there is an error or inconsistency in the hypothetical, please state your assumptions about the issue in your answer. You may email me if you wish to point out the problem, but I will either not respond or respond to the class as a whole.

You may consult any written source, including the reading materials, class notes, cases, outlines (commercial or otherwise), books, treatises, the Internet, Westlaw, and Lexis-Nexis. You may use Ctrl-F or search engines on your computer. Citations to cases or other primary sources are not required or particularly desired, although you may find reference to a case that we covered helpful at times to make your analysis more compelling or to shorten the exposition. Citations to secondary sources will *not* be helpful or appreciated. You may use calculators or spreadsheets and any template you have prepared in advance. *You may not contact any person inside or outside of the class about the assignment (with the exception noted above that you may email me about any error or inconsistency).*

As we discussed in class, you may cut and paste short passages *from materials you have collected in a single document* to introduce a concept, a rule of law, a legal principle, or an economic proposition or formula ("boilerplate"). You may include quotes from cases in the materials you create for this purpose, but if you do so, prepare the quote and cite the case (in proper Blue Book form) as you would in a brief. You are prohibited from copying/cutting and pasting any other text into your take-home answer, regardless of who authored the text.[1]

The "facts" in the hypothetical should be complete in the sense that they present what is known at the time the analysis is requested. As in life, some information you would like to have may not be available. Analyze the facts as they are presented in the question. If you have to make an assumption to correct an error, inconsistency, or deficiency, be sure to state your assumption explicitly. To the extent possible, make sure your assumption fits "naturally" in the spirit of the facts stated in the hypothetical.

You should assume that all demand, inverse demand, and residual demand curves are linear, that marginal costs are constant, and that all firms maximize their profits given their residual demand curves and marginal costs. You also should assume that the requisite effect on interstate commerce is present and that the transaction involves the acquisition of stock or assets, so you do not have to address these elements in your analysis of a possible Section 7 violation.

Also, if the hypothetical gives prices or costs for a group of differentiated products as being "around" a given number, you may treat all products within that group as having prices or costs at that number. (This substitutes for the assumption, for example, that all prices have coincidentally converged to the same number, notwithstanding their differentiation.)

Present your analysis in a well-organized, linear, and concise manner. Think about your answers before writing. *Remember Pascal's apology*: "I am sorry that this was such a long letter, but I did not have the time to write you a short one." Clarity of thinking and exposition is much more important than throwing in the kitchen sink. Penalties will be levied for excessive length, verbosity, lack of organization, or the inclusion of irrelevant boilerplate.

Grading will be on the completeness, coherency, and persuasiveness of your answers to the questions presented and not on whether you reached the same conclusion as I did. Ideally, your answer to each question will persuade me that you have correctly identified the issues, properly analyzed them in the context of the prevailing legal standards and the facts presented, and advised a sensible course of action. I have no doubt that some of you will persuade me to go one way on a question, while others will equally persuade me to go a different direction on the same question.

It should go without saying that, outside of this assignment, you should not believe anything in the statement of any hypothetical fact situation. I have taken considerable liberties in fashioning the problem and have wholly ignored reality whenever it was convenient. It will be in your best interest to unlearn the "facts" in the hypothetical as soon as possible after you finish the assignment.

Since this is effectively an exam problem, I will not hold out hope that you find it enjoyable, but I do hope that you find it intellectually stimulating. I have sought to make the question challenging, but you should be well-prepared to tackle it.

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[1] To be clear, this restriction does not prohibit you from writing new language or copying and pasting new text into your boilerplate document and then copying that text from your boilerplate into your answer. Indeed, I encourage you to take the time during the graded homework assignment to "beef up" your boilerplate. You just cannot copy and paste any text into your answer except from your boilerplate document.

HONOR STATEMENT

BY SUBMITTING THIS GRADED ASSIGNMENT, I AFFIRM ON MY HONOR THAT I AM AWARE OF THE STUDENT DISCIPLINARY CODE, AND (I) HAVE NOT GIVEN NOR RECEIVED ANY UNAUTHORIZED AID TO/FROM ANY PERSON OR PERSONS, AND (II) HAVE NOT USED ANY UNAUTHORIZED MATERIALS IN COMPLETING MY ANSWERS TO THIS GRADED HOMEWORK PROBLEM.

SHAMPOO MERGER

You are an attorney at the FTC, and your group is reviewing Saul Michael's pending acquisition of Salon One, a family-owned company, for $162 million in cash. Both companies manufacture and sell shampoo. Elle Woods, your section chief, has asked you to prepare a memorandum analyzing whether she should recommend that the FTC seek a preliminary injunction blocking the transaction from a federal district court pending a resolution of the merits in an administrative trial. Ms. Woods is an aggressive antitrust enforcer with a history of recommending challenges in close cases. But she does not want to recommend a case that the FTC is likely to lose in court. From this perspective, Ms. Woods would like you to structure your analysis into five parts:

1. For each element of its prima facie case, determine the best case the FTC can make based on the facts determined in the staff's investigation, anticipate the merging parties' likely rebuttal to that element, and assess what the court is likely to find on the record presented.
2. Anticipate any downward pricing pressure and other offsetting procompetitive defenses the merging parties are likely to raise, determine the FTC's best response to those defenses, and assess what the court is likely to find.
3. Anticipate whether the merging parties may attempt to "litigate the fix," what fix they might propose, and how best the FTC should respond.
4. Apart from the technical legal analysis, assess whether the FTC or the merging parties have the better argument for appealing to the "heart" of the judge on which outcome at trial would better serve society and promote consumer welfare.
5. Given your overall analysis, assess the likelihood that a federal district judge in the District of Columbia would grant a preliminary injunction.

The staff's investigation revealed the following facts:

Shampoo is a hair care product, typically in the form of a viscous liquid, used to clean hair. Shampoo is typically used to remove the unwanted build-up of sebum, a waxy substance secreted by sebaceous glands into the hair, without stripping out so much as to make hair unmanageable. Most shampoos are formulas that contain roughly ten to thirty different ingredients. All shampoos are made by combining a surfactant and other ingredients with water. The *surfactant* traps oils and other contaminants, similar to soap. Some of the other ingredients can include *silicones*, to create slip and contain "frizz" in hair and are the key reason why hair feels smooth after washing; thickeners, to help make shampoo less "watery"; *carbopol*, to help keep the ingredients emulsified and eliminate the need for shaking the bottle before use; *fiber actives*, to help repair hair damaged within the hair cuticle; *pH regulators*, to help prevent film forming on hair; *preservatives*, to prevent bacteria formation; *color additives* to add color to the solution; and *fragrances* to provide an attractive smell. The water acts as a medium in which to combine the various ingredients.

Manufacturers use different ingredients to formulate their shampoos to differentiate them from their competitors in their ability to clean, manage, and repair or preserve hair and make them appealing to use. Consumers can develop strong personal preferences for a particular brand. The cost of ingredients can vary widely among formulations. Each manufacturer currently produces only one product, although some manufacturers have offered multiple shampoo products in the past.[2]

All brands of shampoo are made on the same types of machines. Manufacturing shampoo requires *mixers* to produce stable emulsions, *filling equipment* to fill shampoo bottles, *automatic sealing equipment* to secure the bottle cap, and *labeling equipment* to label the bottles. Switching between different formulations is gallon-for-gallon and involves negligible switching costs. The marginal costs of producing shampoo, however, differ because of the difference in the cost of ingredients, which can be significant.

Idustrial Shampoo Production Line

Manufacturers package their shampoo in plastic bottles and sell their products to wholesale customers directly in three distinct channels.[3]

- *Salon-only channel*. Some manufacturers market and sell their shampoo products exclusively to high-end hair salons. These shampoos have a wholesale price of around \$25.00, a marginal cost of around \$10.00, and a retail markup of about 120% for a retail price of \$55.00.
- *Mixed channel*. Other manufacturers market and sell their shampoos product to both hair salons and retail stores (online and brick-and-mortar). In both salon and retail, manufacturers have a wholesale price of around \$6.00, a marginal cost of around \$3.00, and a retail markup of about 80% for a retail price of \$10.80. The staff found that the prestige of salon use is essential to support the high retail price in the retail channel

2 In this hypothetical, all shampoo is regular shampoo. We are ignoring all other types of shampoo.
3 All prices and marginal costs are for 16-ounce containers.

compared to retail-only products. Consequently, although manufacturers could charge different wholesale prices to salons and retail stores, they said that it was important not to price discriminate and risk losing the goodwill of the salons or competitively disadvantaging either channel against the other. The staff found no evidence that the merged firm would price discriminate between channels postmerger.

- *Retail-only channel*. Finally, the remaining manufacturers market and sell their shampoo only to retail stores. These shampoos have a wholesale price of around $4.00, a marginal cost of around $1.40, and a retail markup of about 30% for a retail price of $5.20.

Transportation costs for shampoo are small relative to their value. Each manufacturer sells and promotes its shampoo brand nationwide at uniform wholesale prices without any geographic price discrimination. The parties agreed in the investigation that the relevant geographic market is the United States.

The following table gives some basic information about shampoo manufacturer sales in each of the three sales channels:

Table 1
Shampoo Manufacturer Sales
(units and revenues in millions)

		Manufacturer sales			Salon Channel		Retail Channel	
Company/Brand	Channel	Price	%Margin	$margin	Units	Revenues	Units	Revenues
Salon Professional	Salon	$25.00	60%	$15.00	3.00	$75	–	–
Salon One	Salon	$25.00	60%	$15.00	1.80	$45	–	–
Saul Michael	Salon, retail	$6.00	50%	$3.00	10.00	$60	20.00	$120
Mexxus	Salon, retail	$6.00	50%	$3.00	5.00	$30	15.00	$90
Fumble & Fumble	Salon, retail	$6.00	50%	$3.00	5.00	$30	5.00	$30
Fuave	Retail	$4.00	30%	$1.20	–	–	75.00	$300
Floral Essences	Retail	$4.00	30%	$1.20	–	–	45.00	$180
Cardinal	Retail	$4.00	30%	$1.20	–	–	30.00	$120
Fantene	Retail	$4.00	30%	$1.20	–	–	20.00	$80
WO5	Retail	$4.00	30%	$1.20	–	–	10.00	$40
Price is for 16 oz equivalent packages.					24.80	$240	220.00	$960

Wholesale customers contract with manufacturers to supply shampoo on a purchase order basis, that is, they agree on a wholesale price, but the manufacturer only supplies what the wholesale customer orders. These contracts are not exclusive and may be terminated at will by the wholesale customer.

All salons only carry one brand of shampoo. They try to convince their customers that the brand they carry is the best brand for the customer. In addition to using the shampoo on customers at the salon, salons also sell shampoo to customers to take home. High-end salons sell salon-only products for around $55 per 16-ounce container. Salons that use shampoos are also sold at retail—Saul Michael, Mexxus, and Fumble & Fumble—use an 80% markup over the wholesale price for a retail price of around $10.80 per 16-ounce container. Retailers sell mixed channel shampoo at similar prices.

If either of the two salon-only shampoo manufacturers were to increase its price by 5%, the manufacturer would lose 8.3% of its unit sales. In addition, customer loyalty runs primarily to the salon and not to the shampoo brand, so no customers would switch to another salon to obtain their preferred salon-only shampoo brand. If both salon-only shampoo manufacturers were to increase its price by 5%, each would lose 4.0% of its unit sales, all to mixed channel shampoo brands.

If any of the three mixed channel manufacturers were to increase its price by 5%, the manufacturer would lose 10% of its sales. Of these lost marginal sales, 90% would divert to the same shampoo brand sold in the retail channels, 10% to a different mixed channel or retail-only brand, and none to salon-only brands. If all three mixed channel manufacturers were to increase their price by 5%, they each would lose 5% of their sales, all to retail-only brands.

If any of the five retail-only channel manufacturers were to increase its price by 5%, the manufacturer would lose 16.7% of its sales. Of these lost marginal sales, 100% would divert to other retail-only shampoo brands and none to salon-only or mixed channel brands. If all five retail-only manufacturers were to increase their price by 5%, they each would lose 0.5% of their sales, all to non-shampoo products.

Market shares in all segments of shampoo have been relatively stable for many years except in the salon-only channel. Salon One has lost significant share to Salon Professional in the last five years. Between 2017 and today, Salon One's market share in salon-only products fell from 50% to 37.5%, while Salon Professional's share increased from 50% to 62.5%. In its investigation, the staff found that industry observers attribute this loss of share to an illness of the CEO—the family patriarch, who had to retire from the business—and tensions among other family members with ownership interests, resulting in a loss of strategic direction and focus for the company.

On the advice of their financial advisors, the family put the company up for sale. Saul Michael and two private equity firms were the only companies interested in buying the company. The family elected to sell to Saul Michael because it was an established shampoo manufacturer they believed could reinvigorate the Salon One brand. Saul Michael also offered the highest bid price. Saul Michael's bid price of $162 million is 3.6 times Salon One's most recent annual revenues of $45 million, less than the average 4.0 revenue multiple for health and beauty manufacturers. Both private equity firms bid under $150 million for Salon One.

Although there has been no entry or expansion into new shampoo segments in the last ten years, the staff found that two shampoo manufacturers have contemplated expanding into new segments in recent years. The staff found no evidence that any other firm would enter or expand into any shampoo segment, even if prices increased significantly in the segment.

The furthest along is Fauve, the largest shampoo in the United States by revenue. Today, Fauve sells in the retail-only channel, but over the last two years it has invested $3 million to develop and test market a new mixed channel shampoo brand called Fauve Pro to compete with Saul Michael, Mexxus, and Fumble & Fumble. Fauve has excess capacity in its plant to produce up to 10 million units of Fauve and has the space to add new lines if necessary. Last October, Fauve announced that it would begin to sell Fauve Pro at the beginning of January 2023 with an introductory wholesale price of $5.00 per unit. Fauve is conducting an aggressive marketing campaign in both the salon and retail channels. Although obtaining retail shelf space presents a high barrier to entry for a new retail shampoo producer, successful existing retail producers can often obtain shelf space for a new product through some combination of additional incremental space and reallocating some of their current space to the new product. Fauve has been able to contract with most of its major retail customers to carry the Fauve Pro brand. Fauve also has distributed 200,000 free units to salons to enable them to try the product and has already signed contracts with about 100 salons nationwide to carry the product. Fauve expects to reach annual sales of 5 million salon sales and 10 million units in retail sales within two years. Since both segments are already saturated, the Fauve Pro sales in each segment will have to come from its competitors. The staff's investigation confirmed that industry analysts believe Fauve can reach its projections. The staff's investigation also found that Fauve stock price has increased as its plans have become publicly known.

Saul Michael also has contemplated expansion into the salon-only segment to compete with Salon Profession and Salon One. Entry into the salon-only segment is difficult. For the most part, a new salon-only brand must displace the established salon-only brand the salon carries. This poses a high hurdle since each salon has invested significant time, effort, reputation, and goodwill to sell to its customers on the brand it currently carries as the best brand for them. Saul Michael began formulating a salon-only brand about two years ago. However, the board of directors remains skeptical that a new salon-only product could be profitable. As a result, the company has proceeded cautiously, investing only about $250,000 so far, and has yet to develop a commercial prototype to market test or commit significant additional funds to the project. At its current pace, Saul Michael would not enter the salon-only segment for at least four or five years, if ever. When Salon One—a salon-only brand with an established but weakening reputation—became available on the market, Saul Michael shelved its plans to develop its salon-only brand de novo and purchased Salon One instead.

Saul Michael believes the merged firm can save $5.3 million annually by merging the two companies. Saul Michael's production facility has an annual capacity of 33 million units but is running at only 30 million units with its current production. Salon One has an annual production of only 1.8 million units in a facility that can produce 5 million units annually. Saul Michael intends to close the Salon One plant and consolidate all production in Saul Michael's facility. Moreover, Saul Michael intends to reduce overhead costs by consolidating Salon One's management, back office, and logistics operations into Saul Michael. These consolidations will save the combined firm $3.5 million. The staff does not dispute these numbers. Moreover, Saul Michael believes that it can procure equally good and sometimes better ingredients at a lower cost, reducing Salon One's marginal cost from $10.00 to $9.00 per unit for annual savings on 1.8 million units of $1.8 million. During the investigation, Saul Michael presented a detailed analysis of how it would obtain these cost savings (including the name of the suppliers and the prices they would charge). The staff has confirmed the suppliers and the prices but questions whether the substitute ingredients would produce a product as good as Salon One is today.

Saul Michael believes it can reverse Salon One's decline and regain lost market share. Saul Michael plans on investing at least $3.0 million of its annual cost savings from the transaction, if not more, for the next three years in revitalizing Salon One by updating the product formulation, improving the brand image through a sustained advertising campaign in the trade magazines, and hiring more sales representatives to work with high-end salons, and promoting the product at trade shows. Although highly confidential, Saul Michael is also considering reducing the wholesale price from $25.00 per unit to $22.00 per unit. If the salons carrying Salon One continue to charge $55 per unit, they will increase their markup from 120% to 150% and earn $3.00 more on each sale.

The staff's investigation found wholesale customers to be indifferent to supportive of the acquisition. High-end salons carrying Salon One uniformly supported the transaction. They said that under existing management, Salon One seemed directionless and was falling behind Salon Professional in the prestige necessary to enable the salons to continue to charge a high price comparable to Salon Professional to their customers. Salon carrying Salon One knew about Saul Michael's plans for the product and said that the acquisition was their best hope for a revitalized product. They consistently oppose an acquisition of Salon One by a private equity firm.

Other salons were indifferent to the deal. These salons said that even if Saul Michael successfully revitalized Salon One, it would have little effect on their business. Customers choose a particular salon because they like the stylists, location, and price, not because of the particular shampoo the salon uses.

Retail customers, including the large chains that account for most of the retail shampoo volume, were also indifferent to the deal. They said salon-only products such as Salon One do not compete with the products retail stores carry because of the significant difference in retail prices: end-users pay almost ten times more for salon-only products than retail-only products and five times more than mixed channel products.