CLASS 2 SLIDES

Unit 2. Predicting Antitrust Enforcement Challenges

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Thinking Systematically about Antitrust Risk

The setup

- You are counsel to TransDigm
  - Prior to signing the purchase agreement, TransDigm's management seeks your advice on—
    1. Whether the antitrust authorities will investigate the transaction?
    2. Whether the DOJ or FTC will challenge the transaction on the merits?
    3. Whether the merging parties can successfully defend on the merits?
    4. If unsuccessful, what will be the consequences?

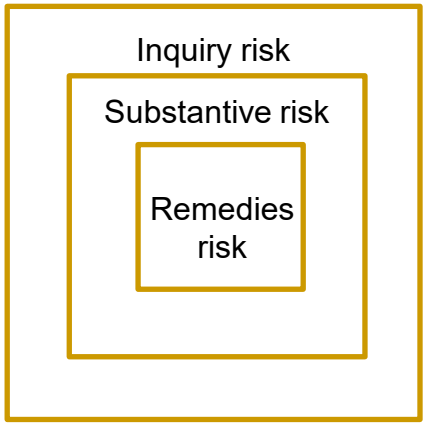
These are the fundamental questions every client asks at the beginning of a deal

These are questions about antitrust risk. How can we best explain to a client what is the antitrust risk in a deal?

Three types of antitrust risks

1. Inquiry risk
   - The risk that legality of the transaction will be put in issue
2. Substantive risk
   - The risk that the transaction is anticompetitive and hence unlawful
3. Remedies risk
   - The risk that the transaction will be blocked or restructured

Risks are nested



Assessing Substantive Risk

Focus first on substantive risk

- Inquiry risk comes first chronologically in a deal
  - Inquiry risk depends largely on—
    1. The *likelihood* that the challenger will prevail,
    2. The *reward* that the challenger will obtain from a successful challenge, *and*
    3. The *costs* to the challenger of raising the challenge

    all compared to doing nothing

In other words, inquiry risk depends on the expected value *to the challenger of raising the antitrust question*

- The first factor is a function of the substantive risk—so we need to study that first

Substantive risk

- Definition
  - The risk of being unable to successfully defend the transaction on the merits
- Can be defined in relation to either—
  - The outcome of a DOJ/FTC merger investigation, *or*
  - The outcome of litigation on the merits

Substantive risk: Costs

- There are costs associated with substantive risk incurred in defending a transaction regardless of the outcome—
  1. Delay/opportunity costs
  2. Expense of investigation/litigation and other out-of-pocket costs
  3. Management distraction costs
- But there is no reputational cost
  - Everyone views merger antitrust reviews as *regulatory*
  - *Not* as an indication that the merging parties may be breaking the law
    - Compare with an effort to engage in horizontal price fixing

Assessing probabilities of substantive risk

- Substantive risk depends on a *prediction* on whether the parties will be able to successfully defend their transaction on the merits

So how do we make that prediction?

First, an important distinction

- Basic distinction #1
  - *Decision making*: How the agencies ***decide*** a merger is anticompetitive
  - *Explanation*: How the agencies ***explain*** why they believe that the merger is anticompetitive
- Why is this distinction important?
  - How the agencies (or the courts) explain their decisions often does not reveal *why* they decided on that particular outcome
  - What you read in judicial opinions may only be the justification of an outcome that the judge reached for other (unexplained) reasons

A fundamental task in effective advocacy is recognizing this distinction and making your argument appeal simultaneously to the "heart" as well as the "mind" of the decision-maker

Overview: Theories of anticompetitive harm

- "Conventional" theories of anticompetitive harm
  1. Elimination of horizontal competition in output/downstream/seller markets
  2. Elimination of potential competition
     a. Actual potential competition
     b. Perceived potential competition (essentially a dormant theory)
  3. Vertical harm
     a. Input foreclosure
     b. Output foreclosure

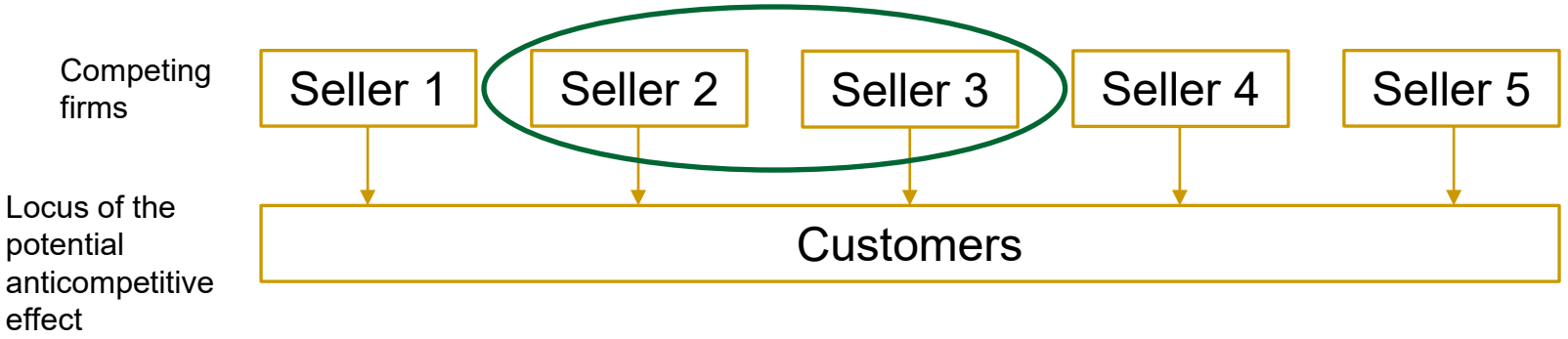
     } Generalized in "raising costs to rivals" (RRC)

     c. Anticompetitive information conduit
- "New" theories of anticompetitive harm being tested
  1. Elimination of horizontal competition in input/upstream/buyer markets
  2. Dominant firm entrenchment
     a. Elimination of nascent competition (an extension of actual potential competition)
     b. Modern entrenchment

See the Appendix for a little more detail

Overview: Theories of anticompetitive harm

- The vast bulk of challenges involve the *elimination of horizontal competition in output/downstream/seller markets*



  - In this example, Sellers 1 and 2 merge
    - Reduces the number of firms competing against each other in the sale of products from five to four (a "5-to-4 merger")
  - *Potential anticompetitive effect:* Will the decrease in the number of independent firms in the market reduce competition in the downstream market?

The vast bulk of merger antitrust challenges involve horizontal mergers. This class—and most of the course—will focus on this type of merger.

A predictive model for horizontal mergers

- We are going to look at a model that *predicts* merger antitrust outcomes for horizontal mergers in downstream markets
  - We will tweak the model as necessary to account for any DOJ or FTC challenges that depart from modern historical practice
- The model does *not purport to describe* how the investigating agency in fact decides merger outcomes
- The model's only purpose is to predict enforcement outcomes, not to describe the agency's decision-making process

Assessing substantive antitrust risk

- So how do the DOJ/FTC decide whether a merger is anticompetitive?
  - The purpose of merger antitrust law under the *consumer welfare standard* is to prevent harm to customers in the market through—
    - Increased prices
    - Reduced market output
    - Reduced product or service quality
    - Reduced rate of technological innovation or product improvement
    - [Maybe] reduced product variety

*Under the consumer welfare standard, modern antitrust law looks to effects on customers**

** Under an "expanded" consumer welfare theory, antitrust law also looks at effects on suppliers (i.e., anticompetitive effects in upstream markets).*

Assessing substantive antitrust risk

- The predictive model—Four important rules
  1. Absent compelling evidence of significant customer harm on other dimensions, only ***price increases*** count
  2. The merger is anticompetitive if it is likely to result in a price increase or other competitive harm to ***any identifiable customer group***
  3. The agencies believe that ***no customer group is too small*** to deserve antitrust protection
  4. *Corollary*: No deal is too small not to be challenged

The predictive model for horizontal mergers

Reduction in Bidders/Competitors*

5 → 4	Usually clears if no bad documents and no material customer complaints
4 → 3	Usually challenged unless there are no bad documents and there is a strong procompetitive business rationale, some customer support, *and* minimal customer complaints
3 → 2	Almost always challenged unless there are no bad documents, and there is a compelling business rational that is strongly supported by customers and no material customer complaints
2 → 1	Always challenged

* Critically, these must be ***meaningful*** and ***effective alternatives*** from the perspective of the customer; "fringe" firms that customers do not regard as feasible alternatives do not count

Historical note: Up until 2015, 5 → 4 deals almost always cleared without any review and the chart would be compressed to begin at 4 → 3

Prediction: In the Biden administration, it is likely we will see an attempt to further tighten the standards to begin at 6 → 5 (with 3 → 2 always being challenged)—BUT we have not seen this yet in practice

The predictive model for horizontal mergers

- Special cases inviting challenge
  1. Unilateral effects: Elimination of "local" competition
     - Two firms that compete very closely with one another but much less with other firms in the market
     - Often occurs with premium brands (think BMW and Mercedes Benz in an automobile market)
  2. Acquisition of a "maverick"
     - Elimination by an established firm of a typically smaller competitor that has been especially disruptive in the marketplace to the benefit of consumers
  3. Acquisition of an actual potential entrant
     - In a highly concentrated market, the acquisition by or of a firm that otherwise likely would have entered the market in the near future and thereby increased competition
  4. Acquisition of a "nascent competitor"
     - The acquisition by an entrenched "superfirm" (think Facebook) of a firm that has technology that objectively might be used by the seller or a third party in the future to compete against the buyer, whether or not anyone has a present intention of competing with the acquiring firm with the technology (think Instagram and WhatsApp)—Challenges, but no judicial decisions

New theory

The predictive model for horizontal mergers

- Special cases inviting challenge

"New" theory

5. Modern entrenchment
   - Entrenchment is a "conglomerate" merger theory, that is, a theory applying to transactions that are neither presently nor in the foreseeable future horizontal nor vertical
   - The idea is that somehow the combination of the products of the merging firms will "entrench" the dominant positions of the some of the products of the merging firms
   - The Biden FTC is attempting to revive the entrenchment theory in its challenge to Amgen's acquisition of Horizon Therapeutics[1]

Entrenchment emerged as a theory of merger antitrust in the 1960s. It never gained any meaningful transaction at the time. The courts almost surely will reject the theory today.

[1] *See* Complaint for a Temporary Restraining Order and Preliminary Injunction Pursuant to Section 13(b) of the Federal Trade Commission Act, FTC v. Amgen Inc., No. 23-CV-3053 (N.D. Ill. filed May 16, 2023).

The predictive model for horizontal mergers

- Special cases inviting challenge
  6. Any acquisition involving a dominant high-tech firm

Basic structural tests for horizontal mergers

- The chances of successfully defending a deal *improve* if—
  - There are demonstrable powerful forces that constrain price increases or other anticompetitive behavior beyond the mere number of incumbent competitors
  - Three major forces:
    1. *Entry, repositioning, or output expansion* by third-party competitors in response to anticompetitive behavior by the combined company
       - Requires low barriers to entry or repositioning
    2. *Powerful customers*, who can use their bargaining leverage to stop the combined firm from acting anticompetitively
       - Requires a detailed explanation of how the bargaining will work to constrain the combined firm
       - Defense only works firm-by-firm—the merger can still harm small firms that do not have the requisite bargaining power to protect themselves
    3. *Efficiencies*, where the procompetitive pressure of the efficiencies outweighs the anticompetitive pressure of the increased market power
       - More on this below
       - Agencies are very skeptical about efficiencies

Basic structural tests for horizontal mergers

- Defenses
  - These forces are *legal defenses* if they are sufficient in likelihood and magnitude to completely offset the likely customer-harming aspects of the transaction
  - Basic distinction #2
    - *Negative defense*: The merger is not anticompetitive in the first instance
    - *Affirmative defense*: Even if the merger is anticompetitive, it is nonetheless not unlawful
  - Technically—
    - A *negative defense* denies an element of the plaintiff's prima facie case
    - An *affirmative defense*
      - accepts the elements of the prima facie case as true, *but*
      - raises matters outside of the prima facie case that provide a justification or an excuse to absolve the defendant from liability

There are no affirmative defenses in modern antitrust law

Another basic distinction

- Basic distinction #3: Truth v. evidence
  - The agencies (and the courts) deal in ***evidence***
  - Having the ***truth*** but being unable to prove it will not win the day
    - True for the merging parties in a merger investigation
    - True for both parties in court
  - The investigating staff also needs evidence to be able to make its case to the agency decision makers and, if necessary, in litigation

So what are the sources of evidence?

Major sources of evidence

1. Company documents submitted with the original HSR filing
2. Company responses to second requests in an HSR Act review
   - Ordinary course of business documents
   - Responses to data and narrative interrogatories
3. Interviews/testimony/public statements of merging firm representatives
4. Interviews with knowledgeable customers
5. Interviews with competitors
6. Customer responses in staff interviews and to DOJ Civil Investigative Demands (CIDs) or FTC precomplaint subpoenas
7. Analysis of bidding or "win-loss" data
   - Including the ability of customers to play the merging firms off one another
8. "Natural" experiments
9. Expert economic analysis

Homework Assignment for Class 3

The problem

The general counsel of TransDigm has asked you to begin a merger antitrust analysis of an acquisition by TransDigm of SCHROTH from Takata. The GC wants to start with a “quick and dirty” view of the problems that might arise in the United States. To this end, the GC will try to find the answers within the company to up to six questions. What six questions would you like to ask?

Instructor's answer

1. Business rationale
   - What is TransDigm's business rationale for making the acquisition (i.e., how will TransDigm make money by acquiring SCHROTH)?
2. Customer benefits
   - How, if at all, will customers benefit from the transaction?
3. Complaints
   - Who, if anyone, is likely to complain about the transaction and, if so, what will they say? (Especially interested in customer reactions)
4. Power to harm customers
   - If someone (say a sophisticated customer) was hostile to the deal, how would it argue that the merger will give TransDigm the ability and incentive to raise prices, reduce product or service quality, reduce investment in innovation or product improvement, or cut off supplies to competitors?

Instructor's answer

5. Competitive overlaps
   - In what product lines do TransDigm and SCHROTH compete against each other in the United States?
6. Other competitors
   - In each overlapping product line, are there significant other competitors to whom customers can turn to protect themselves in the event that TransDigm increases its price, reduces its product or service quality, or reduces investment in innovation or product improvement following the acquisition?

Questions from homework submissions

1. What are the relevant markets that will be affected by this acquisition?
2. How would you define the market (products/services and geography) for your products?
3. Will this acquisition substantially decrease competition in the relevant markets?
4. How big a player is TransDigm within the market?
5. For each product TransDigm produces, please provide the names of all competitors and their respective market shares.

Questions from homework submissions

6. Will consumers be harmed by this acquisition by an increase in prices?
7. Do customers “play off” TransDigm and SCHROTH against each other to get better prices?
8. What would TransDigm’s new market share in an already highly concentrated market be after the acquisition?
9. Would the acquisition decrease innovation of future technologies, or would TransDigm remain motivated to innovate?

Questions from homework submissions

10. Will consumers benefit from or be harmed by differences in product quality after the acquisition?
11. Has TransDigm received any customer complaints about the transaction?
12. What documents do the merging parties have that might reveal the intent of the transaction?
13. Does TransDigm have any documents, or has it made any public statements, suggesting that postmerger it will raise prices, reduce production, or decrease R&D investment?

Appendix

Overview: Theories of anticompetitive harm

- "Conventional" theories of anticompetitive harm
  1. Elimination of horizontal competition in output/downstream/seller markets
     - Where competing sellers merge to the harm of customers
     - The vast bulk of merger antitrust challenges invoke this theory
  2. Elimination of potential competition
     a. Actual potential competition:
        - Where the merger involves one of the few firms (the actual potential entrant) that likely would have entered the market in the near future but for the merger and whose entry would have substantially increased competition in the market
        - The idea is that, on a going-forward basis, the market would be more competitive without the merger than with it
     b. Perceived potential competition (essentially a dormant theory)
        - Where the merger involves one of a few firms (the perceived potential entrant) that incumbent firms in the market perceive is on the verge of entering the market and whose presence causes the incumbent firms in the market to act more competitively than they would in the absence of the perceived potential entrant

Overview: Theories of anticompetitive harm

- "Conventional" theories of anticompetitive harm
  3. Vertical harm
     a. Input foreclosure
        - Where the merger involves a firm and a supplier, and postmerger the combined firm can competitively disadvantage its downstream rivals by refusing to sell (foreclose) them supplies or raising their supply prices[1]
     b. Output foreclosure
        - Where the merger involves a firm and a customer/distributor, and postmerger the combined firm can competitively disadvantage its upstream rivals by refusing to buy or distribute their products or paying less than competitive prices
     c. Anticompetitive information conduits
        - Where the merger involves a firm (usually a downstream firm) that deals with the other merging firm's rivals and obtains sensitive information from them that postmerger the combined firm can use to competitively disadvantage those rivals and reduce competition in the market

Overview: Theories of anticompetitive harm

- "New" theories of anticompetitive harm being tested
  1. Elimination of horizontal competition in input/upstream/buyer markets
     - Where competing buyers merge to the harm of suppliers (including labor)
     - Invoked on occasion in the past (usually in agricultural markets)
     - A major focus for the Biden administration (especially for anticompetitive effects in labor markets)
     - *Test case*: United States v. Bertelsmann SE & Co. KGaA, No. 1:21-cv-02886 (D.D.C. filed Nov. 2, 2021)
       - Alleges a merger between two major book publishers violates Section 7 because it is likely to reduce the advances paid to authors
       - Tried in August 2022—decision expected in the fall

Overview: Theories of anticompetitive harm

- "New" theories of anticompetitive harm being tested
  2. Dominant firm entrenchment
     a. Elimination of nascent competition
        - Entrenched dominant firms should not e allowed to acquire firms or assets that, absent the acquisition, could potentially be used by the seller or a third party to undermine the entrenched firm's dominant position
          - Usually involves the acquisition of a new product or a new technology
          - The idea: An entrenched dominant firm should be prohibited from acquiring any firms or assets with the potential—even if the probability is low—of undermining the firm's dominant position
        - Introduced in the Trump administration
        - *Test cases*:
          - FTC v. Facebook, Inc., No. CV 20-3590 (JEB) (D.D.C. filed Dec. 9, 2020) (challenging Facebook's acquisitions of WhatsApp and Instagram) (trial to be held in 2024)
          - United States v. Visa, No. 3:20-cv-07810 (N.D. Cal. filed Nov. 5, 2020) (challenging Visa's proposed acquisition of Plaid Inc.) (transaction abandoned)

Overview: Theories of anticompetitive harm

- "New" theories of anticompetitive harm being tested
  2. Dominant firm entrenchment
     b. Modern entrenchment
        - Entrenched dominant firms should not be allowed to acquire firms or assets that could further entrench them
        - *Test case*: FTC v. Amgen Inc., No. 23-CV-3053 (N.D. Ill. filed May 16, 2023)
          - The FTC alleges that the deal would allow Amgen to leverage its portfolio of blockbuster drugs to entrench the monopoly positions of Horizon medications used to treat two serious conditions, thyroid eye disease and chronic refractory gout
          - The FTC alleges that Amgen to use rebates on its existing blockbuster drugs to pressure insurance companies and pharmacy benefit managers (PBMs) into favoring Horizon's two monopoly products, thereby reducing demand for alternative drugs and reducing the incentives of other drug companies to develop them.
        - *Note*: The FTC filed an earlier case, FTC v. Meta Platforms, Inc., No. 3:22-cv-04325 (N.D. Cal. filed July 27, 2022), that alleged a modern entrenchment theory, but the FTC amended the complaint to drop the entrenchment claim
          - The FTC proceeded solely on an actual potential competition claim and lost in the district court. The case in now on appeal to the Ninth Circuit