Unit 1: TransDigm/Takata

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TRANSDIGM GROUP INC.

SCHROTH

The Parties

Who was the buyer?

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

Who was the buyer?

- TransDigm's AmSafe subsidiary
  - World's dominant supplier of restraint systems (seatbelts) used on commercial airplanes



  - Global revenues (2016): $198 million
  - Headquarters: Phoenix, AZ

Who was the seller?

- Takata Corporation
  - Global manufacturer of automotive safety systems and products for automakers worldwide
    - Also diversified into aviation systems
  - Headquartered in Japan
  - Production facilities on four continents
  - Manufacturer of the airbags subject to the massive recalls
    - U.S. recall of more than 42 million cars (Nov. 2014)
  - Bankruptcy
    - June 2017: Filed for bankruptcy protection in Japan
    - April 2018: Takata was acquired by Key Safety System

What was the seller going to sell?

- The SCHROTH passenger restraint systems business
  - Designs and manufactures advanced safety systems for aviation, racing, and military ground vehicles throughout the world
  - History
    - Founded in 1946
    - Built the world's first seat-belt in 1954
    - Entered the aviation business in 1991
    - Acquired by Takata in 2012
  - Facilities in three locations
    - Arnsberg, Germany
    - Pompano Beach, Florida
    - Orlando, Florida
  - Operations
    - Employees: 260
    - Revenues (2016): $37 million
    - Profits: Don't know, but probably between $5 - $10 million annually

SCHROTH®
Safety Through Technology

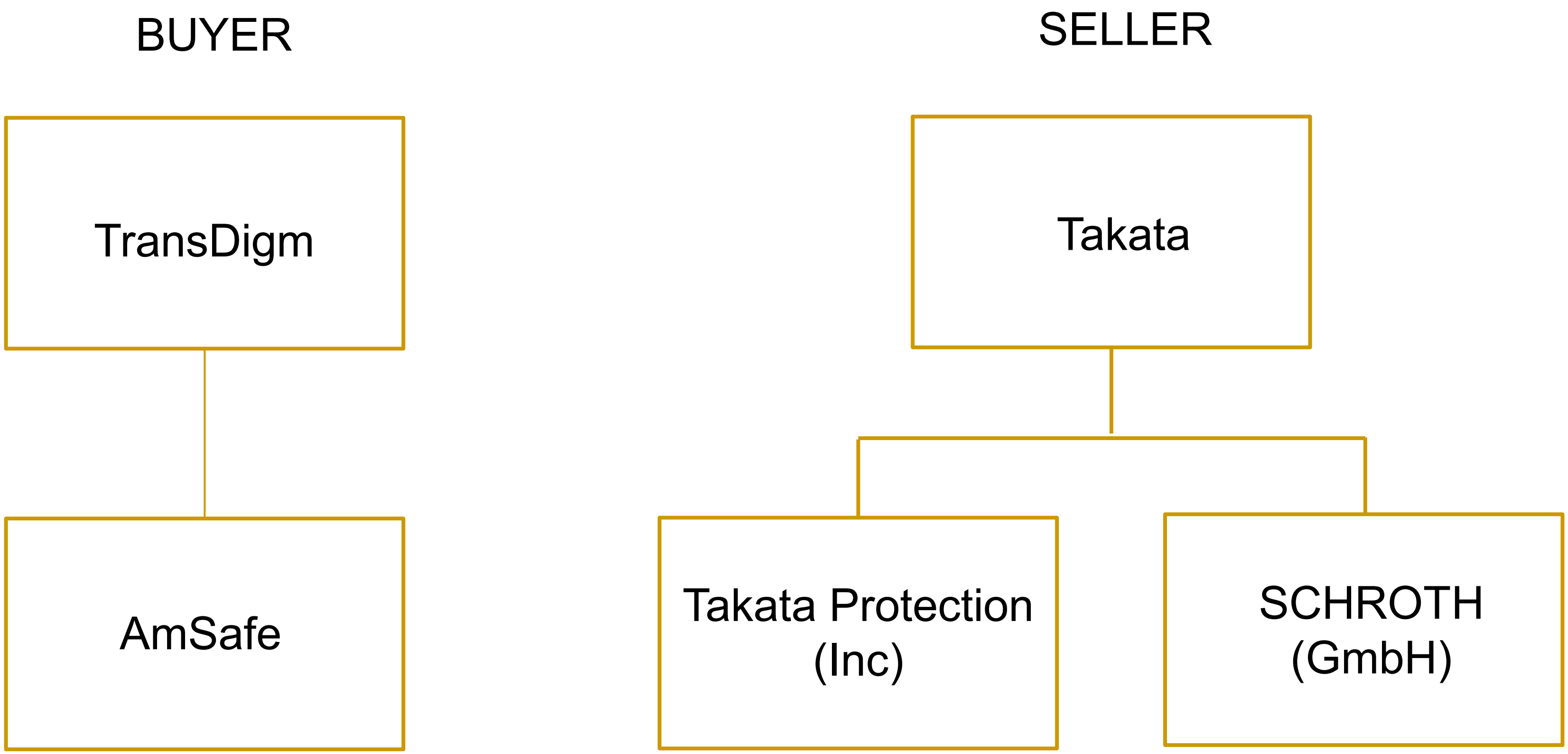
The Transaction

What was the transaction?

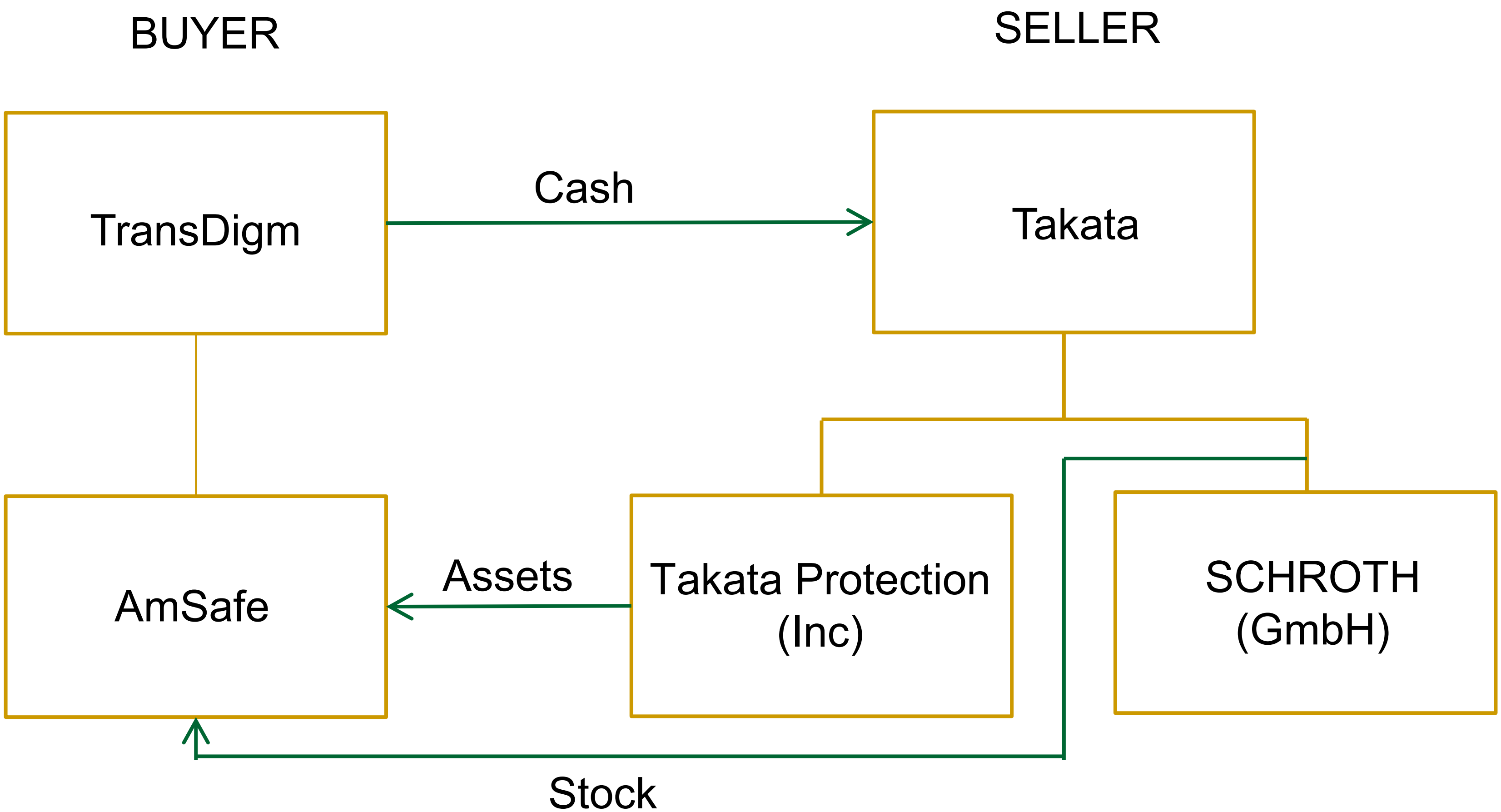
- TransDigm Group to acquire—
  1. Stock of SCHROTH Safety Products GmbH, *and*
  2. Assets of Takata Protection Systems, Inc.

  from Takata Corporation
- Purchase price: $90 million
- Transaction closed: February 22, 2017
  - Five years after being acquired by Takata

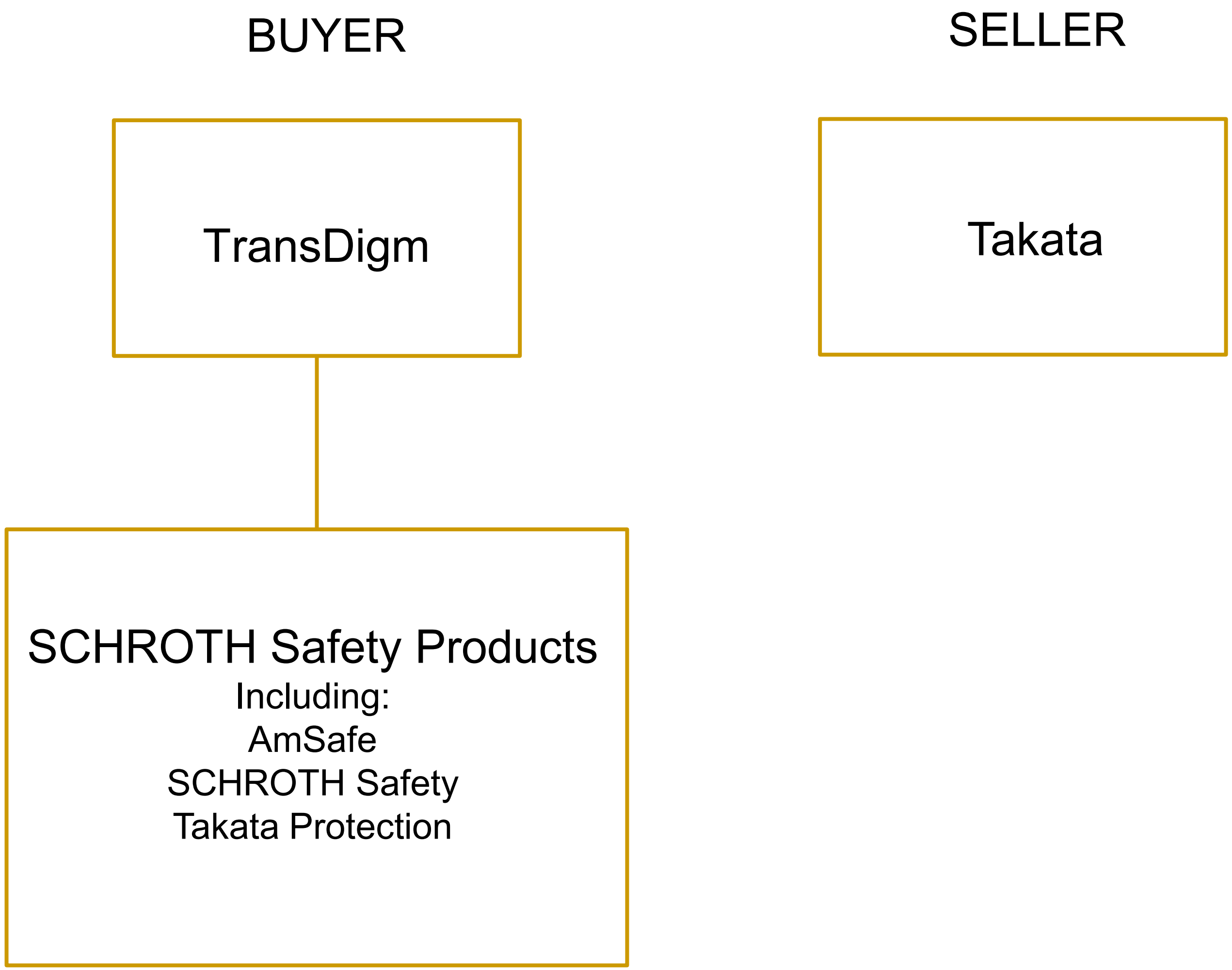
Summary of the deal structure: Before



Summary of the deal structure: Deal

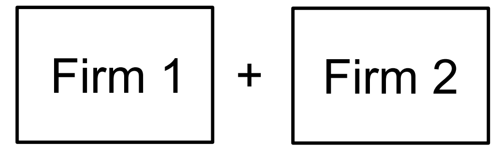


Summary of the deal structure: After

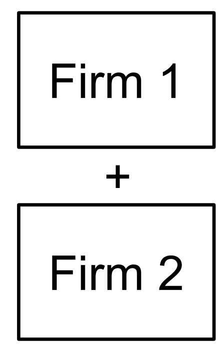


Is this a horizontal transaction?

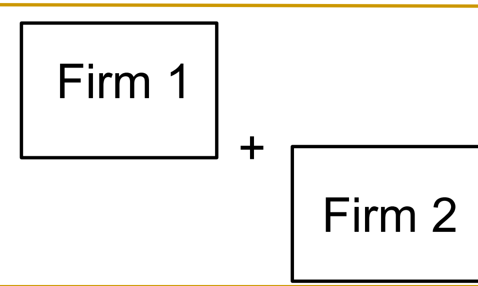
- Yes
- Horizontal transactions:
  - Combine two competitors
  - Sell *substitute* products



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



- Conglomerate transactions
  - Mergers that are neither horizontal nor vertical



The Business Rationale

Why did the parties do the transaction?

- TO MAKE MONEY

Parties do not do deals out of the goodness of their heart

Firms act with the goal of maximizing profit

To make money, the buyer must value the target at more than the target's going concern value

To make money, the seller must value the purchase price at more than the target's going concern value

- Some definitions
  - *Synergies* (a business term)
    - Benefits to the company from the transaction that lower the combined firms' costs or increase its revenues
  - *Efficiencies*
    - The term used in antitrust analysis for synergies that benefit consumers

How can buyers profit from a horizontal deal?

- Cost-saving efficiencies
  - Eliminate duplicative facilities
  - Consolidate corporate functions
  - Rationalize workforce
  - Run the business more efficiently
- Customer value-enhancing efficiencies
    - "Shift the demand curve to the right"
    - Improve the *customer value proposition*
  - Make existing products better or cheaper
  - Create new or improved products better, cheaper, or faster
  - Enhance customer service or support quality

These synergies are procompetitive *because they tend to improve consumer welfare*

How can buyers profit from a horizontal deal?

- Exploit customers
  - Increase prices by reducing competition on price, quality, or service
  - Reduce costs by degrading product quality, service, or other aspects of customer value
- Harm competitors (primarily vertical deals)
  - Gain the incentive and ability to withhold essential products or services from competitors, thereby weakening or excluding rivals and enabling higher prices

These synergies are anticompetitive *because they tend to harm consumer welfare*

Why did Takata buy SCHROTH in 2012?

- TO MAKE MONEY
- How?
  - Conglomerate transaction ("product extension" merger)
    - Saw AmSafe as essentially a monopolist
    - Only SCHROTH and one other company—both small—were in the market for restraint systems
    - Probably making significant profit margins
  - Takata probably thought it could capture more share and make more profits with SCHROTH than had SCHROTH's current owner
  - BUT Takata's strategy required some initial investment in—
    - Aggressive pricing
    - Innovation

  to gain reputation and market share

Why did TransDigm want to buy SCHROTH?

- TO MAKE MONEY
- How?
  1. Could eliminate competition from an aggressive “new” competitor
  2. Could reduce innovation competition and R&D expenditures
  3. Perhaps achieve cost savings

Why did Takata want to sell SCHROTH?

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

The Law

Statutes

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

Clayton Act § 7

- Provides the U.S. antitrust standard for mergers

> **No person** engaged in commerce or in any activity affecting commerce **shall acquire**, directly or indirectly, the whole or any part of the **stock** or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the **assets** of another person engaged also in commerce or in any activity affecting commerce, **where in any line of commerce** or in any activity affecting commerce **in any section of the country**, the **effect** of such acquisition **may be substantially to lessen competition, or to tend to create a monopoly.**[1]

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

Called the *anticompetitive effects test*

Called the *relevant market*

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

Section 7 is the binding constraint

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

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

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

- Consequently:
  - Invocation of the Sherman Act or the FTC Act is usually superfluous
  - Plaintiffs—including the DOJ and FTC—typically allege only a Section 7 violation in connection with the transaction
    - BUT the FTC alleges that the *signing* of the merger agreement violates Section 5
- State antitrust law
  - Not preempted by federal law
  - But no state has enacted a statute stricter than Section 7

Section 7 and
the Consumer Welfare Standard

Some history

- Until recently, modern antitrust law has focused on anticompetitive effects in downstream markets
  - *Downstream markets* are markets in which the firms of interest sell their products or services
  - *Upstream markets* are markets in which the firms of interest buy the inputs to manufacture their products or create their services

In TransDigm, only competitive effects in downstream markets were in issue

Downstream anticompetitive effects

- How do the DOJ/FTC decide whether a merger is anticompetitive in a downstream market?
  - *Rule*: Modern antitrust law looks to the *consumer welfare standard* to determine whether a merger is likely to substantially lessen competition
  - *Rule*: A merger will have a Section 7 anticompetitive effect if, when compared to the "but for" world without the merger, the world with the merger is likely to harm 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[1]

These are called *anticompetitive effects*

A firm that has the power to produce or strengthen an anticompetitive effect is said to have *market power*

[1] Reduced product variety may or may not have an anticompetitive effect. It can lower costs and benefit consumers if the savings result in lower prices or better products. But it may harm consumers if it limits meaningful choices without offsetting gains. The impact depends on whether consumers are better or worse off after considering both.

Downstream anticompetitive effects

- The anticompetitive effects analysis is *forward looking*
  - Compares the postmerger outcomes with and without the deal
    - Does NOT compare premerger outcomes with postmerger outcomes
    - Requires the investigating agency and the courts to do a *predictive analysis*
      - In the most common situation where the merger has not yet been consummated, the agencies and the courts will have to predict future market outcomes in BOTH the world with the merger and the "but for" world without the merger
  - *Example*: Suppose a merger occurs in a market where prices are decreasing over time
    - The merger is anticompetitive if reduces how fast prices will decrease in the future with the merger compared to what would have happened in the "but for" world without the merger
    - The fact the postmerger prices will be lower than premerger prices is irrelevant to the Section 7 anticompetitive effects analysis
  - Can view potential competitors today as future competitors tomorrow

Downstream anticompetitive effects

- Some observations
  - Economic models to predict product quality or the rate and direction of technological innovation—
    - Have found little traction in the economics profession, and
    - Are not credited with any material probative value by the agencies or the courts

The result is that merger antitrust analysis focuses primarily on the merger's effects on prices and output

    - It is not, as some critics maintain, that the consumer welfare standard focuses narrowly on price
      - The consumer welfare standard recognizes all dimensions on which consumers can be harmed
      - So evidence of anticompetitive harm on nonprice dimensions must come from admissions in the merging parties' documents or statements by executives—evidence that rarely exists (especially in well-counselled companies)

The upshot is that the agencies rarely, if ever, have challenged a merger primarily on nonprice grounds

Downstream anticompetitive effects

- 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*** to be challenged

The DOJ Investigation

Timing

- Did the DOJ investigation start before or after consummation?
  - After
    - Transaction closed Feb. 22, 2017
    - Complaint filed ten months later on December 21, 2017
- Important distinction
  - Mergers challenged after closing (postconsummation mergers)
  - Merger challenged before closing (preconsummation mergers)

Why is this distinction important?

Timing

- Why didn't the DOJ investigate and challenge the transaction before closing?
  - Probably did not know about it, *or*
  - Was aware of the transaction but not aware of its likely effect on competition
- Didn't the HSR Act filings alert the DOJ to the transaction before closing?
  - No. Apparently not reportable under the Hart-Scott-Rodino Act[1]

[1] Clayton Act § 7A, 15 U.S.C. § 18a.

Hart-Scott-Rodino Act

- Mergers and acquisitions that—
  1. Meet certain size thresholds *and*
  2. Are not exempt

  Must—
  1. File a *premerger notification report* with the DOJ and FTC, *and*
  2. Observe a *statutorily prescribed waiting period* before closing the transaction

  This permits the agencies to investigate and challenge the deal before closing

  - Much more effective and efficient to block or fix an anticompetitive deal before closing than to try to remediate it after closing

- Not jurisdictional
  - Not a prerequisite to a Section 7 investigation or challenge

We will cover the HSR Act in detail in Class 3

DOJ investigation

- How did the DOJ find out about this transaction?
  - Someone probably called the agencies and complained
  - Maybe Boeing complained
    - Largest U.S. passenger airline manufacturer
    - Probably the biggest beneficiary of SCHROTH's competition with AmSafe

    But why would Boeing wait until after the acquisition to complain?

  - Maybe it was a Tier 1 seat manufacturer supplying Boeing (e.g., Safran, RECARO, Zodiac Aerospace, and Adient Aerospace)

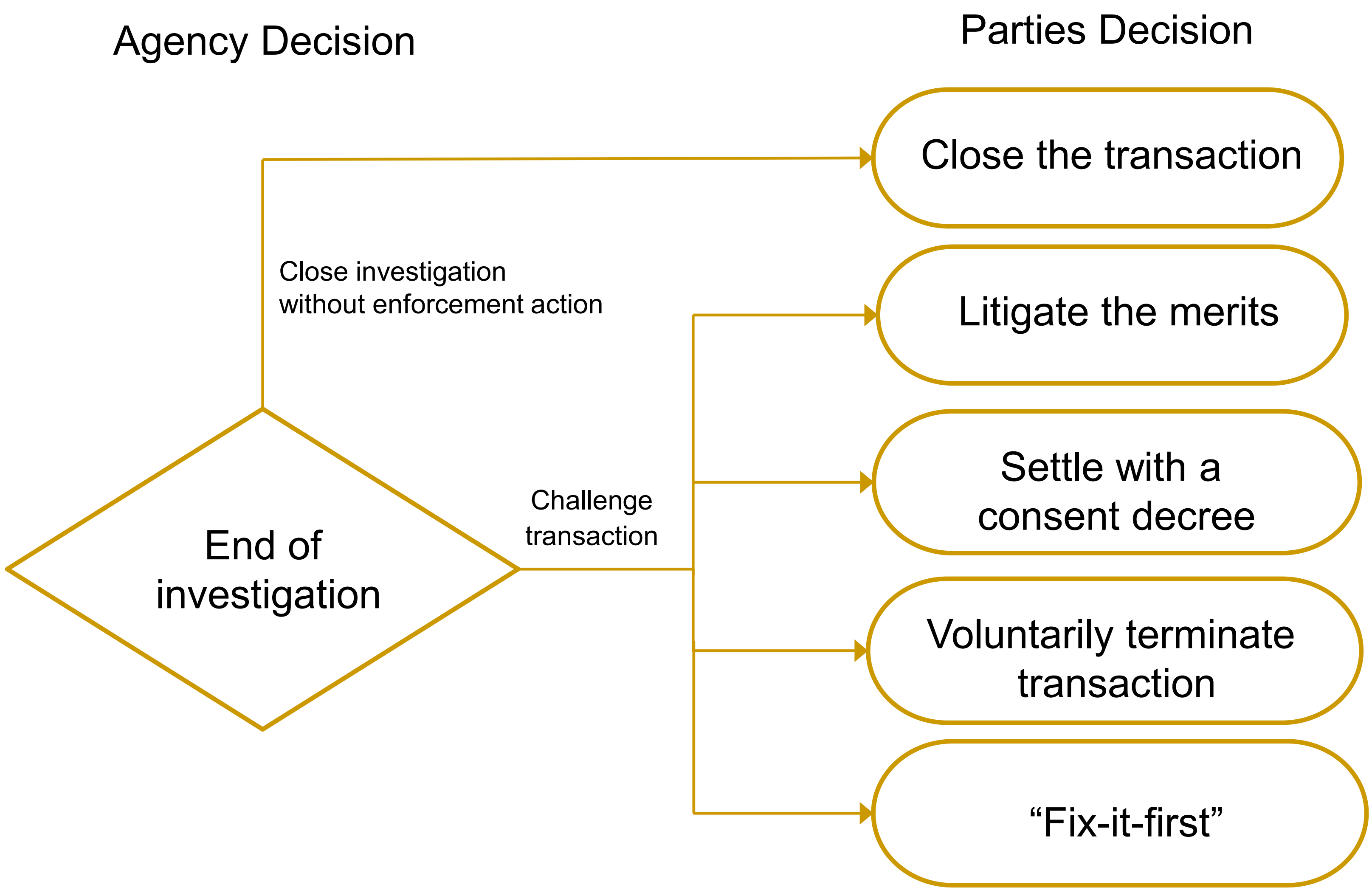
    But why would they wait until after the acquisition to complain?

  - Maybe it was a disgruntled current or former TransDigm or Schroth employee
  - But probably not a third-party competitor (WHY NOT?)

DOJ investigation

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

What were the possible investigation outcomes?



What happened here?

- What did the DOJ do?
  1. Decided that TransDigm's acquisition of SCHROTH violated Section 7 of the Clayton Act, *and*
  2. Told TransDigm that absent an acceptable settlement, the DOJ would file a Section 7 complaint against TransDigm seeking divestiture of the SCHROTH business to a third party

If the FTC had investigated and challenged the acquisition in 2017, the procedure would have been different (but the outcome would have been the same)

What Was the Problem?

Anticompetitive Effects

All downstream

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

Two-point lapbelts

1. Two-point lapbelts used on commercial airlines

- Only three competitors premerger (Compl. ¶ 24)
    1. AmSafe was by far the largest
    2. Small, privately held firm that had been in the market for years but had gained little share → little or no competitive significance
    3. SCHROTH, which entered the market with a new, innovative lightweight two-point lapbelt ("Airlite"), which it aggressively marketed to the major international airlines
- *Competitive effects implications*:
    - When three competitors are reduced to two, the remaining competitors are more likely to engage in oligopolistic coordination, which would result in a higher equilibrium market price and reduced rates of innovation
    - If the smallest firm is ignored → "Merger to monopoly" → higher prices

Three-point shoulder belts

2. Three-point shoulder belts used on commercial airlines

- Factual allegations
    1. Only two meaningful competitors premerger (Compl. ¶ 26)
    2. AmSafe was by far the largest
    3. “SCHROTH was aggressively seeking to grow its business at AmSafe’s expense”
    4. May indicate that SCHROTH’s current share remained limited but that its expansion efforts already constrained AmSafe’s pricing
- *Competitive effects implications*:
    - “Merger to monopoly” → higher prices

Technical restraints

3. Technical restraints used on commercial airlines

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

Inflatable restraint systems

4. Inflatable restraint systems used on commercial airplanes

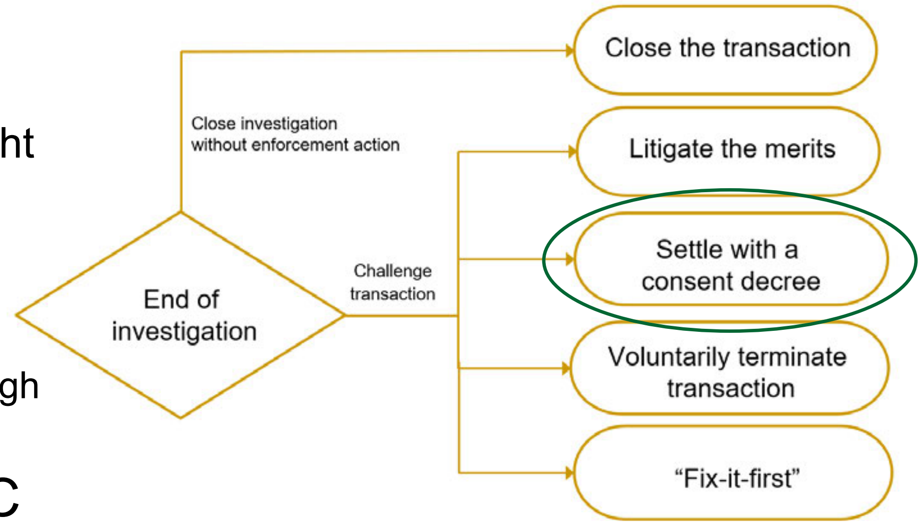
- Only two competitors premerger (Compl. ¶ 30)
  1. AmSafe (which developed technology—offers both inflatable lapbelts and structural mounted airbags)
  2. SCHROTH (offers only structural mounted airbags)
  3. “In recent years, SCHROTH had emerged as a strong competitor to AmSafe in the *development* of inflatable restraint technologies”
     - Only allegation of innovation competition—Not sales competition

Why did the DOJ include this claim?

What Did TransDigm Do?

What happened here?

- What did TransDigm do?
  - Agreed to divest SCHROTH pursuant to a consent decree
    - To get the DOJ's agreement, TransDigm agreed to give the DOJ essentially the relief it sought from a litigation of the merits
      - To obtain the DOJ's agreement, TransDigm accepted relief that the DOJ concluded would fully restore the competition lost through the acquisition
  - Historically, the DOJ and FTC have always required divestiture relief in horizontal merger cases



What is a consent decree?

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

What did the consent settlement require?

- Divestiture requirements
  1. Within 30 days after regulatory clearances or entry of the Hold-Separate Order,
  2. TransDigm *must divest the entire acquired SCHROTH business* (including the Takata Protection assets) to—
     - Perusa Partners Fund 2 and SSP MEP Beteiligungs KG *or*
     - another buyer acceptable to DOJ

These are *upfront buyers*—divestiture buyers that, prior to the agency's agreement to the consent decree, have signed a definitive divestiture acquisition agreement, and are acceptable to the investigating agency

What did the consent settlement require?

- What assets must be divested?
  1. All tangible and intangible assets necessary to operate the divested business as an independent and effective competitor
     - Facilities and equipment
     - Intellectual property and know-how
     - Contracts, customer relationships, and business records
     - Personnel and organizational capabilities
  2. The divestiture must preserve the business as a viable going concern, without material interruption in—
     - Production
     - Customer service and relationships
     - Product development
     - Competitive operations
  3. Any transition services supplied by TransDigm must—
     - be limited in duration and scope and
     - must not leave the divestiture buyer dependent on TransDigm for competitively significant capabilities

What did the consent settlement require?

- What makes an acceptable divestiture buyer?
  1. The buyer must have the incentive and ability to operate the divested business as an effective, independent competitor
  2. The buyer must possess, or credibly be able to obtain—
     - Operational and managerial capabilities
     - Technical and industry expertise
     - Adequate financial resources
     - Personnel and other capabilities necessary to execute its business plan
  3. The acquisition by the divestiture buyer must not itself create a competitive problem
  4. The buyer must present a credible plan for operating and developing the divested business on a long-term basis

Today, the agencies demand that the divestiture buyer be able to "step into the shoes" of the divestiture seller on Day 1 and operate immediately with the same competitive force postmerger as the divestiture seller did premerger

What did the consent settlement require?

- Agency approval and preservation of the remedy

1. The DOJ must approve—
   - The divestiture buyer
   - The divestiture agreement
   - Any transition-services or related agreements
2. The DOJ and FTC ordinarily require a buyer upfront
   - The buyer is identified before the agency accepts the settlement
   - The parties have signed a definitive divestiture agreement
   - The buyer and agreement have been reviewed by the agency
3. Until the divestiture closes, TransDigm must—
   - Hold the SCHROTH business separate
   - Preserve its assets, personnel, viability, and competitiveness
   - Prevent integration or deterioration that could impair the remedy

Business rationale for divestiture

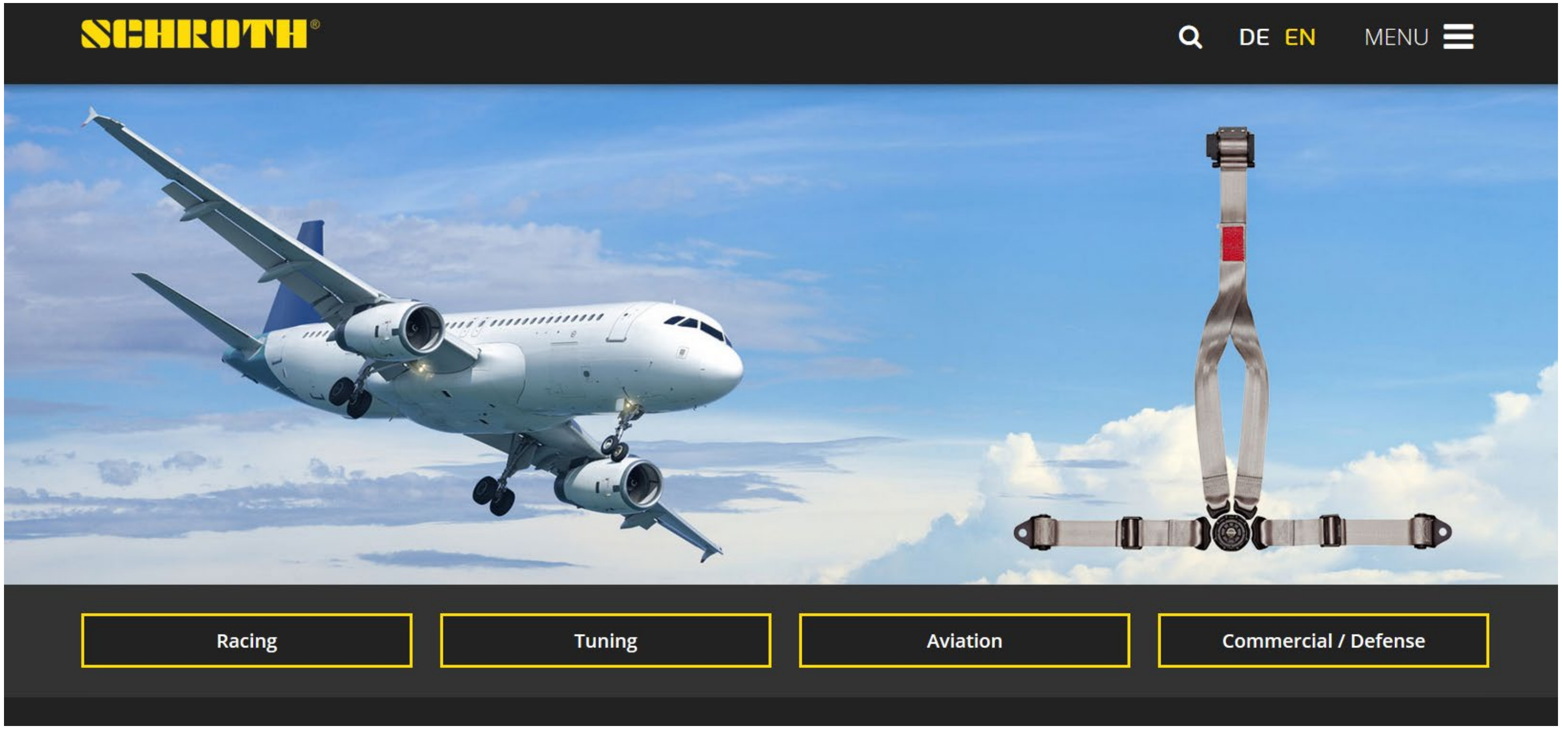
- Why did TransDigm agree to divest SCHROTH?
  - What were TransDigm's alternatives?
    1. Continue the litigation
    2. Settle with a consent decree acceptable to the DOJ
  - Why did TransDigm agree to settle?
    - Almost surely the least costly alternative
    - DOJ had a strong case: TransDigm was very likely to lose the litigation, and the DOJ would have obtained a litigated permanent injunction ordering the same divestiture
  - When did TransDigm agree to settle?
    - In the course of the investigation—Prior to litigation
    - Complaint and proposed consent decree were filed simultaneously with the court
      - Has the advantage that the consent decree can be drafted after the terms of the settlement have been reached
      - Means that the theories that appear in the complaint can all be negated by the negotiated settlment

The divestiture buyer

- To whom did TransDigm sell SCHROTH?
  - A management buyout (MBO)
    - Business unit's management + a private equity investor (Perusa GmbH)
  - Why sell to management?
    - The DOJ almost surely wanted a "buyer upfront"
    - An MBO was probably both—
      - The quickest solution, *and*
      - Offered the greatest return
  - Did the MBO get a good purchase price?
    - Almost certainly
    - Consent decree solutions almost always involve a "fire sale" of the divestiture assets
      - TransDigm paid $90 million to acquire SCHROTH (February 22, 2017)
      - The MBO paid $61.4 million[1] (proposed consent judgment filed December 21, 2017)
      - For a loss of $38.6 million (over 43% of the original purchase price 10 months later)

[1] TransDigm Form 8-K, Jan. 26, 2018, at 3.

SCHROTH today



- Reportedly:
  - Approximately 250 employees globally
  - Sales volume around $50-55 million

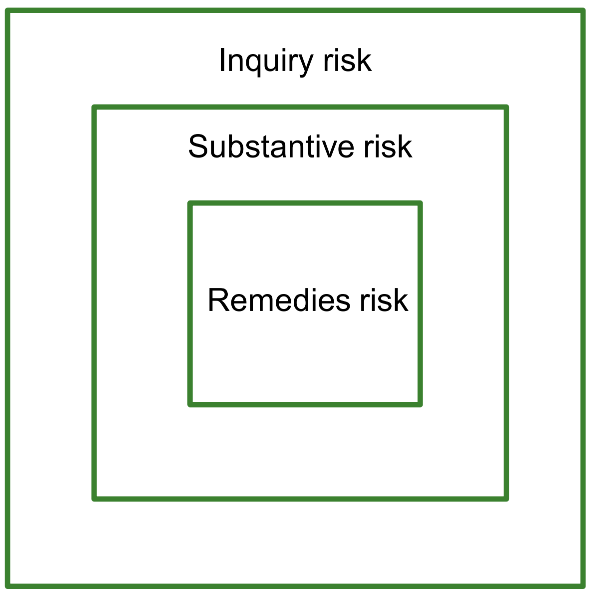
Thinking Systematically about Antitrust Risk

Three types of antitrust risks

- *Inquiry risk*: The risk that the legality of the transaction will be put in issue
  - Who has standing to investigate or challenge the transaction?
  - What is the probability that one of these entities will act?
- *Substantive risk*: The risk that the transaction is anticompetitive and hence unlawful
  - When is a merger anticompetitive?
  - How can we practically assess antitrust risk?
- *Remedies risk*: The risk that the transaction will be blocked or restructured
  - What are the outcomes of an antitrust challenge?
  - Will the transaction be blocked in its entirety?
  - Can the transaction be “fixed” to alleviate the agency’s concerns and if so how?

Three types of antitrust risks

- The three risks are nested
  - The substantive risk does not arise unless there is an inquiry
  - The remedies risk does not arise unless the transaction is found to be anticompetitive



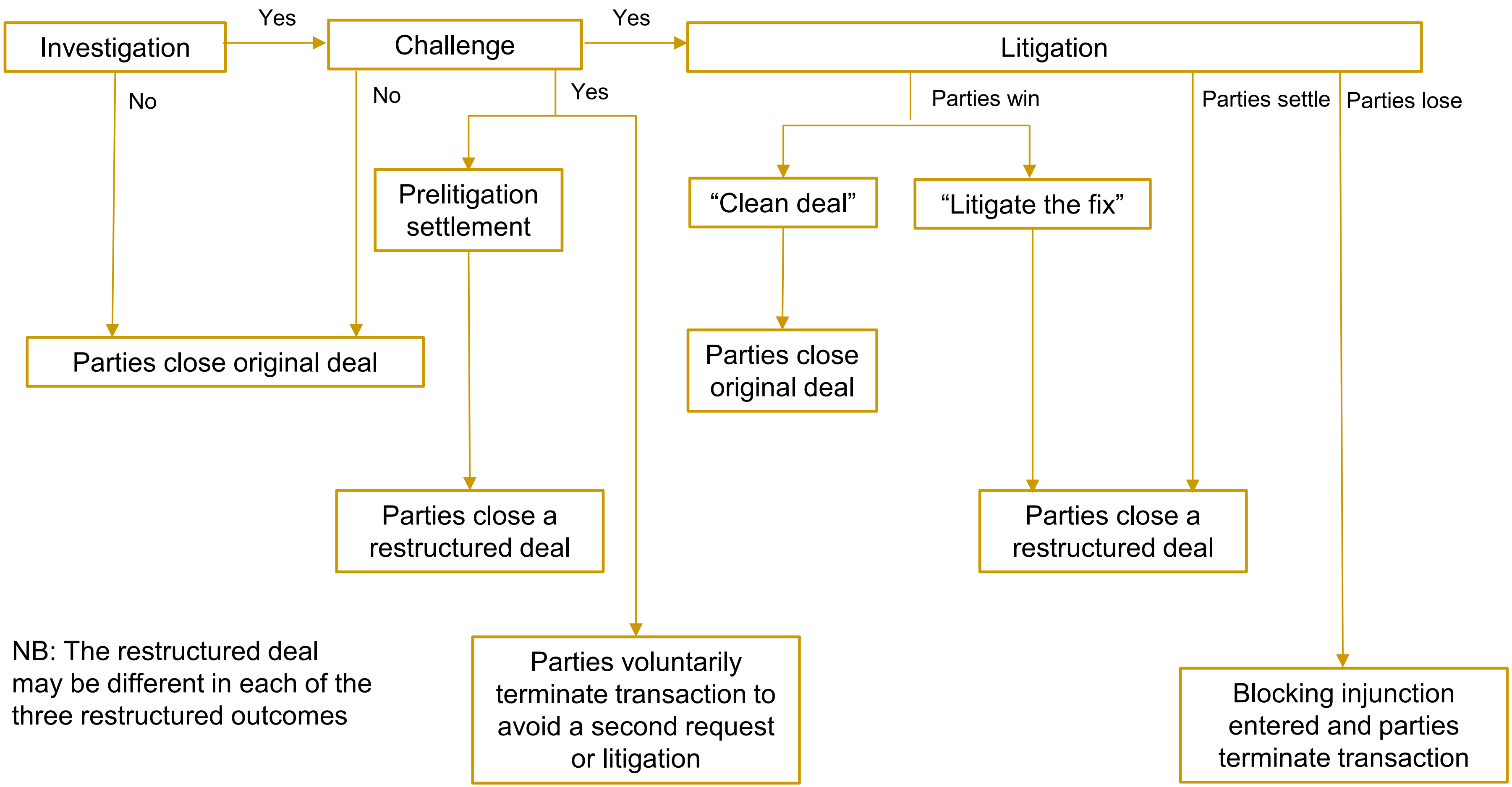
Because the inquiry risk is dependent on the likelihood that the transaction violates the antitrust law, we will examine substantive risk first

Possible outcomes of merger investigations

- Four possible ultimate outcomes:
  1. "*Clearance*": The investigating agency clears transaction on the merits without taking enforcement action
  2. *Fix*: The parties restructure ("fix") the deal to eliminate the substantive antitrust concern, typically through a divestiture of a line of business
     a. Post-closing "fix" under a judicial consent decree (DOJ) or an FTC consent order
     b. Restructure the deal preclosing to avoid a consent decree ("fix-it-first")
  3. *Litigate*: The investigating agency initiates litigation and either—
     a. The agency wins on the merits, the court issues an injunction blocking the closing, and the parties subsequently terminate their purchase agreement;
     b. The termination ("drop dead") date in the merger agreement occurs during the pendency of the litigation and one of the merging parties exercises its unilateral right to terminate the transaction;
     c. The agency and the parties settle the litigation through a consent decree; *or*
     d. The parties win on the merits and subsequently close their deal
  4. *Terminate*: The parties voluntarily terminate the deal rather than settle or litigate

Merger antitrust risk analysis

- Antitrust risk and outcomes from a process perspective in a preclosing transaction



NB: The restructured deal may be different in each of the three restructured outcomes

Pre-Signing Counseling

It is September 2016. Nicholas Howley, the CEO of TransDigm, is considering making an acquisition of the SCHROTH commercial airlines safety restraint business. He is asking you for a preliminary antitrust risk analysis of this deal. You know no facts, but Mr. Howley is happy to answer your questions at the meeting. He is also skeptical that the deal presents any material antitrust risk.

The setup

- You are counsel to TransDigm
  - Prior to signing the purchase agreement, TransDigm's management seeks your advice on—
    1. *Inquiry risk*: Whether the antitrust authorities will investigate the transaction
    2. *Substantive risk*:
       a. Whether the DOJ or FTC is likely to conclude that the transaction is anticompetitive and challenge it?
       b. If challenged, whether the merging parties can successfully defend the transaction on the merits?
    3. *Remedies risk*: If the agency challenges the transaction—
       a. What are our options?
       b. What are the likely outcomes under each option?
       c. What, if anything, can we do to improve our chances of closing the deal?

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

Before the meeting: Learn what you can

1. Look at the websites of both companies
   - Learn about their businesses
   - Try to determine whether there are any product overlaps
2. Search the Internet and newspaper archives using “TransDigm and SCHROTH” as the search request

Assume that you find from this research that—

- *The deal involves a horizontal overlap in safety restraints for commercial airlines*
- *TransDigm is the dominant firm in the business*
- *SCHROTH is a small but aggressively expanding competitor*
- *There are few if any other firms in the business*

But no other meaningful information

Goals of the meeting

1. *Teach* the client the operational test for Section 7 illegality
2. *Ask* the client the most important factual questions
3. *Communicate* your view of the antitrust risk in a way that the client understands
4. *Provide* any strategic advice as to how the client might minimize antitrust risk

We will go through each goal in detail

Teach the client the operational test

- Why begin with the operational test?
  - The client must understand how the antitrust agency will analyze the transaction
  - Understanding the test will help the client provide more complete and meaningful answers to counsel’s factual questions
  - The client can continue to identify and communicate additional relevant facts after the meeting
  - The client must understand the antitrust implications of—
    - internal documents
    - public and customer communications
    - presentations and testimony to the investigating agency
  - Legal advice is useful only if the client understands—and is persuaded by—the reasoning supporting it

Teach the client the operational test

- Start with Clayton Act § 7
  - Governing merger antitrust statute
  - Other statutes may apply, but they will not be more restrictive than Section 7
  - Section 7 prohibits transactions that “may substantially lessen competition”
- But what does this mean *operationally*?
  - A transaction “may substantially lessen competition” when it is likely to harm an identifiable group of customers by—
    1. Increasing prices
    2. Reducing market output
    3. Reducing product or service quality
    4. Reducing the rate of technological innovation or product improvement
    5. [Maybe] reducing product variety

Clients can grasp the operational test immediately

Teach the client the operational test

- Tell the client how the investigating agency is going to find the facts about the likely competitive effect
  - HSR reportability and merger review process
    - Time to ask questions to find out if the deal is likely to be reportable
  - If the investigating agency opens an investigation, it will—
    1. Entertain a presentation from the parties on the deal
    2. Interview relevant executives and employees
       - Can also obtain testimony under oath in formal depositions
    3. Obtain massive amounts of the documents and data from both companies
    4. Interview customers and competitors (and maybe obtain documents and data from them)
       - Can also obtain testimony under oath in formal depositions and compel the production of documents
    5. Analyze win-loss records of the companies in bidding for projects
    6. Use economists to assist in analyzing the likely competitive effects of the transaction
    7. Ask questions of the parties throughout the investigation

Teach the client the operational test

- Bottom line
  - The agency's conclusion on the likely effect on customers will determine the outcome of the investigation
    - NB: It is the *agency's conclusion*, not necessarily the truth, that counts
  - The best defense is a good offense
    - Can we argue that the deal is a "win-win" for the merging parties *and* the customers?
    - Companies do not do deals out of the goodness of their heart—*they do deals to make money*
    - Do we have a story consistent with the business model for the transaction, the documents and other company evidence, and the likely customer responses in staff interviews that the deal will be good for customers?

Best story*: The transaction will enable the combined company to reduce costs and make better products faster in ways that benefit customers while creating value for shareholders*

Ask the client questions

- Deal rationale and documents
  - What is the deal rationale?
  - How will TransDigm make money from the transaction?
  - What synergies or efficiencies does management expect?
  - What do the board materials, valuation analyses, and other transaction documents say?
  - Are those documents consistent with management's explanation of the source of gains from the merger?
  - What are the implications of the business model for customers and consumer welfare?

Ask the client questions

- Competition and customers
  - Where do AmSafe and SCHROTH compete?
  - How close are they as competitors?
  - What will company documents say about competition between the two companies?
  - Who are the customers, and what will they say when interviewed by the agency?
  - Do customers have practical alternatives?
  - Do we have a credible customer value proposition?
  - Will customers accept it?
  - If a customer wanted to torpedo the deal, what would it tell the agency about the likely effects of the merger?

Ask the client questions

- Defenses and remedies
  - Could entry, expansion, or repositioning replace the competition lost?
    - Can we identify firms that we believe would be likely to enter?
    - If asked by the agency, will they say that they would enter the market if prices increased by, say, 5%, as a result of the merger?
    - How long will these companies say it would take to enter the market and become an effective competitor after the merger
  - What synergies from the deal will benefit customers?
    - What is the profit-maximizing incentive of the merged firm to pass on any synergies to customers as opposed to keeping them for shareholders?
  - Can the problematic overlap be separated from the remainder of the transaction?
  - What would the agency likely require TransDigm to divest?
  - Would the transaction remain economically attractive after the likely remedy?

Communicate the antitrust risk

- *Answer the client's question*: Based on what you learned in the meeting, what is the antitrust risk presented by the deal?
  - Forming a view of the risk is not enough
  - Counsel must communicate both—
    - the bottom-line assessment, and
    - the reasoning supporting it
  - The advice must be presented in a form the client can understand and use in making business decisions
    - If the client does not understand the advice, the client cannot act on it
    - If the client is not persuaded by the analysis, the client is unlikely to act on it

What should counsel communicate?

- Inquiry risk
  - Likelihood and likely scope of an investigation
- Substantive risk
  - Likelihood the agency will challenge
  - Likelihood the parties can prevail if challenged
- Remedies risk
  - Available options
  - Likely outcome under each option
  - Effect on the ability to close and on the value of the transaction
- Basis for the assessment
  - Key facts and assumptions
  - Important unknowns or uncertainties
  - Recommended next steps

Provide strategic advice: Documents

1. Emphasize the need for care in drafting documents
   - "Bad" documents alone can kill a deal
   - Avoid careless, exaggerated, or inaccurate language suggesting that the transaction will reduce competition or harm customers
   - Do not omit or conceal material adverse facts when the omission would make the document inaccurate or misleading
2. State the genuine business rationale accurately and consistently
   - Where relevant, explain the expected efficiencies and customer benefits
   - Make sure those statements are supported by the actual business plan
   - Do not manufacture a business rationale or claim benefits that the business does not genuinely expect to achieve and cannot support

Provide strategic advice: Documents

3. If there is a genuine and supportable procompetitive business rationale, include it accurately and consistently in as many relevant transaction and business documents as possible
   - Counsel cannot know which documents agency staff ultimately will select and emphasize—or which documents will become evidence in litigation
   - Repetition increases the likelihood that the procompetitive rationale will appear in documents the agency reviews or that become evidence in court
   - Consistent articulation helps business personnel understand and internalize the rationale, making their later interviews, investigational testimony, and depositions more accurate and persuasive
   - BUT do not exaggerate anticipated benefits or state propositions that the business does not genuinely believe and cannot support

Provide strategic advice: Customer outreach

1. Develop a compelling and supportable sales pitch for the transaction to customers of both companies
   - Explain concretely how the transaction is expected to benefit customers
   - Ensure that the customer case is consistent with the genuine business rationale, the business plan, and the expected postmerger conduct
   - Help the relevant business personnel decide when and how to communicate that case
   - Think about mocking up a company website focus on the benefits the deal will produce for customers

Provide strategic advice: Customer outreach

2. Focus especially on the target company’s customers
   - They are often the most difficult customers to persuade
   - They may fear losing the target as an independent competitive alternative
   - Work with the target company to understand and address their concerns
   - Do not assume that customers will accept management’s assessment of the transaction

Provide strategic advice: HSR reportability

3. Consider whether the transaction can lawfully be structured to make it not HSR-reportable and thereby reduce inquiry risk
   - Nonreportability reduces—but does eliminate—the likelihood that the transaction will come to the agencies' attention before closing
   - It may also permit the parties to close without an HSR waiting period
   - But nonreportability does not reduce the transaction's substantive Section 7 risk
   - Nor does it prevent a postclosing investigation or challenge—as TransDigm itself illustrates

Final thoughts

1. Caution the client that this advice is only preliminary and depends on what the client has told you in the meeting

2. Explain that additional factual development is necessary
   - Would like to send the client a *preliminary information request* for easily obtainable documents and data
   - When confidentiality considerations permit, would like to set up a *meeting with knowledgeable employees* to develop the facts and potential arguments further

Final thoughts

3. Tell the client that documents prepared at counsel's request for the purpose of seeking or providing legal advice should carry the following prominent legend:

PRIVILEGED AND CONFIDENTIAL
Prepared at the request of counsel

- Whenever possible, make this legend *machine readable*
- The legend facilitates privilege review but does not itself make an otherwise unprivileged document privileged

Do NOT forget this!!!

Aggressively labeling nonprivileged documents as privileged can cost the parties significant goodwill loss at the agency and the court

Final thoughts

4. Bring the target company into the antitrust planning and defense effort
   - The target’s evidence and customer-outreach program may be equally or more important to the outcome of the merger review than the client’s
   - Enter into appropriate common-interest and confidentiality arrangements before sharing privileged legal advice
   - The common interest doctrine preserves the privileged status of otherwise privileged communications shared to advance the parties’ common legal interest; it does not independently make ordinary business communications privileged
   - The parties must continue to operate as independent competitors before closing and should use appropriate safeguards when sharing competitively sensitive information

Final thoughts

5. Expect the target to negotiate contractual protections against antitrust risk
   - Provisions designed to reduce the risk of deal failure
   - Provisions allocating responsibility for obtaining regulatory approval and accepting remedies
   - Compensation to the target for closing risk that cannot be eliminated