Class slides

Unit 15a: Fountain Pen Merger

Merger Antitrust Law

Georgetown University Law Center

Dale Collins

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Grading philosophy

- My approach
  1. I read all answers twice and blind grade them each time with a letter grade
  2. If the grades for an answer differ significantly between the first and second reads, I read the answer for a third time and reconcile the differences
  3. I rank order the exams by letter grade in descending order and apply the prescribed curve for the course
  4. UNLESS the quality of the exams do not break significantly at a change in the grading curve, in which case I include the exam in question in the group to which it is most comparable (and fight with the Dean if required)

I grade on the logic, completeness, and persuasiveness of an answer, not whether you approached the problem the same way I did or reach the same outcome

I do not expect anyone to spot and properly analyze all issues in the hypothetical

Suggestion: How to approaching the problem

1. Ask the setup questions
2. Read the hypothetical straight through quickly to spot the major issues
3. Read the hypothetical again more slowly
   Annotate the hypothetical in the margin
   Outline an answer—pay attention to you intuitions!
4. Start writing

Another suggestion:

SHOW YOUR WORK!!

Some of you simply assert that a particular test would or would not be satisfied and got it wrong. Unless you show your work, I will have to assume that this was a conceptual error rather than an arithmetical one.

1. Ask the setup questions

1. Who are you/what role are you being asked to play?
2. What is the transaction?
3. What is the form of the work product?
4. What questions are you being asked to addressed?
5. What statutes(s) apply?

1. Ask the setup questions

1. Who are you/what role are you being asked to play?
   - From the hypothetical:

> **You are an attorney in the Defense, Industrials, and Aerospace Section (DIA) of the Antitrust Division.** DIA is reviewing Tornado Pens' pending acquisition of Conway Writing Corporation, two fountain pen manufacturers, for $95 million in cash.

1. Ask the setup questions

2. What is the transaction?
   - From the hypothetical:

> You are an attorney in the Defense, Industrials, and Aerospace Section (DIA) of the Antitrust Division. **DIA is reviewing Tornado Pens' pending acquisition of Conway Writing Corporation, two fountain pen manufacturers, for $95 million in cash.**

1. Ask the setup questions

3. What is the form of the work product?
   - From the hypothetical:

> Joyce Davenport, your section chief, has asked you to **prepare a memorandum independently assessing whether DIA should recommend to the Assistant Attorney General that the Division challenge the transaction**. In particular, Ms. Davenport is seeking your analysis of how strong the Division's prima facie case of a Section 7 violation is likely to be and whether the Division can defeat the defenses the merging parties advanced during the investigation. Market definition is a central issue in this matter, and, in addition to analyzing the merits of the staff's and merging parties' position, Ms. Davenport invites your thoughts on any alternative market definition and competitive analysis that you believe should be considered. Finally, if you recommend a challenge, Ms. Davenport would like you to address what consent decree relief, if any, the Division should be willing to accept.

You are being asked to write a reasoned memorandum of law with a recommendation

1. Ask the setup questions

4. What questions are you being asked to addressed?
   - From the hypothetical:

Joyce Davenport, your section chief, has asked you to prepare a
memorandum independently assessing whether DIA should recommend
to the Assistant Attorney General that the Division challenge the
1 transaction. **In particular, Ms. Davenport is seeking your analysis of**
how strong the Division's prima facie case of a Section 7 violation
2 **is likely to be** and **whether the Division can defeat the defenses the**
merging parties advanced during the investigation. Market definition
is a central issue in this matter, and, in addition to analyzing the merits
of the staff's and merging parties' position, **Ms. Davenport invites your**
thoughts on any alternative market definition and competitive
3 **analysis** that you believe should be considered. Finally, **if you**
recommend a challenge, Ms. Davenport would like you to address
4 **what consent decree relief, if any, the Division should be willing to**
accept.

   - Four questions are presented
   - BE SURE THAT YOU ADDRESS EACH QUESTION!!

1. Ask the setup questions

5. What law(s) apply?
   - From the hypothetical:

> Joyce Davenport, your section chief, has asked you to prepare a memorandum independently assessing whether DIA should recommend to the Assistant Attorney General that the Division challenge the transaction. In particular, Ms. Davenport is seeking your analysis of how strong the Division's prima facie case of a **Section 7** violation is likely to be and whether the Division can defeat the defenses the merging parties advanced during the investigation. Market definition is a central issue in this matter, and, in addition to analyzing the merits of the staff's and merging parties' position, Ms. Davenport invites your thoughts on any alternative market definition and competitive analysis that you believe should be considered. Finally, if you recommend a challenge, Ms. Davenport would like you to address what consent decree relief, if any, the Division should be willing to accept.

   - Clayton Act § 7 for the elements of the substantive violation

2. Quick read to spot the issues

- The problem is likely to have multiple issues
- Some issues will be substantively more important than others
- DO NOT get hung up spending too much time on the small issues at the cost of not adequately addressing the major issues

So what do I need to spot?

3. Annotate/Outline

- Some facts to note:
  1. Acquisition by Tornado of Conway for $95 million cash
     - Not each other's closest competitors
  2. Differentiated products along a price/quality/image continuum—No clear breaks; no industry-accepted segmentation → Think gasoline stations along a road

Table 2
Diversion Ratios

To:	Visconti	Conklin	Tornado	QW	Conway	Nettuno	Accutron
Tornado	0.2	0.3	–	0.4	0.1	0.0	0.0
Conway		0.1	0.2	0.3	–	0.3	0.1

  3. Multiple competing market definitions
     - Conglomerate: Reject given meaningful diversion ratios
     - All fountain pen: No *PNB* presumption
     - Premium + luxury: Weak to no *PNB* presumption
     - Luxury: PNB presumption triggered—but looks gerrymandered

3. Annotate/Outline

- Some facts to note:

4. But there is a break at $100:
   - Type of advertising (price vs. image)
   - Amount of advertising (<10% vs. >10%)
   - Price discounting (some vs. none)
   - Sales channels (mass outlets vs. specialty stores)
5. Looks like nationwide market
   - Parties agree
   - Uniform wholesale pricing
   - Uniform advertising
6. Price transparency
7. Luxury Fountain Pen Association (5 members)—did nothing
8. Market shares for pens over $100 have been stable
9. Prices increase as the rate of inflation for jewelry
10. Entry and exit/new products
    - Some <$100
    - None >$100 (but possible entry in the future)
11. Threatened entry by Visconti and Conklin against tornado at $150 price point—but no commitment

3. Annotate/Outline

- Some facts to note:

12. Extensive advertising over a period of years to establish a “prestige” brand name
13. Benefits of deal
    - Tornado can grow business (become bigger)
    - $20 million in annual cost savings
    - Can launch new $180 pen
14. No adverse documents
15. No customer complaints → No customer testimony supporting anticompetitive effects
16. Relief: Tornado willing to accept price caps

3. Annotate/Outline

- Note some numbers and important facts:

high-end specialty shops.

Tornado, the tenth largest fountain pen manufacturer by revenues, produces and sells 360,000 fountain pens in the United States at a wholesale price of $150 with a margin of 40%. Tornado's closest competitors are Conklin ($110) and Quality Writing ($180). Conway, the twelfth largest fountain pen manufacturer, produces and sells 100,000 pens at a wholesale price of $220 with a margin of 50%. Conway's closest competitors are Quality Writing ($180) and Nettuno ($250). The staff also determined that the minimum margin for fountain pens is at least 30% and often much larger, especially for the more expensive pens.

For each manufacturer, wholesale prices are uniform throughout the United States. Although

$P_T = \$1\overset{5}{\cancel{0}}0$

$\%m_T = 40\%$

$P_C = \$220$

$\%m_C = 50\%$

$\%m_{MIN} = 30\%$

Table 2
Diversion Ratios

To:	Visconti	Conklin	Tornado	QW	Conway	Nettuno	Accutron
Tornado	0.2	0.3	–	0.4	0.1	0.0	0.0
Conway		0.1	0.2	0.3	–	0.3	0.1

4. Write: Introduction

- Opening paragraph to a memorandum: "You have asked me . . . ."

To: Joyce Davenport

From: Dale Collins

<u>Tornado/Conway Fountain Pen Merger</u>

You have asked me to assess whether DIA should recommend that to the Assistant Attorney General that the Division challenge Tornado Pens' pending acquisition of Conway Writing Corporation, two fountain pen manufacturers, for $95 million in cash. In particular, you asked that I assess how strong the Division's prima facie case of a Section 7 violation is likely to be and whether the Division can defeat the defenses the merging parties advanced during the investigation. If I recommend a challenge, you have also asked me to address consent decree relief, if any, the Division should be willing to accept.

You should be able to copy most of this from the exam pdf

4. Write: Introduction

- Short conclusion
  - Succinctly answer each question asked
  - You can write this last—but if you did a good outline you can do a first draft it now
  - Helpful to you and to me
    - Ensues that you answer all of the questions asked
    - Gives me a roadmap as to how to approach your answer

4. Write: Introduction

- Short conclusion—Instructor's outline
  - The Division should not bring the case
  - Product market
    - Reject conglomerate merger, all fountain pens, luxury fountain pens
    - Strongest support for seven-product symmetrical premium + luxury
      - Some *Brown Shoe* support to draw the line at $100
      - Symmetrical around substitutes for merging firm products
    - Possible five-product symmetrical market
  - Geographic market: Nationwide
  - *PNB* analysis
    - No presumption in seven-product market
    - Weak presumption in five-product market
    - Conclusion:
      - Will determine whether transaction violates Section 7 based on additional evidence
      - If evidence too weak, court will find a seven-product market
      - If evidence is strong, court will find a five-product market

4. Write: Introduction

- Short conclusion—Instructor's outline
  - Additional evidence
    - Unilateral price effects
      - Fails 1992 MG test (not each other's closest substitutes)
      - Weak on 2010 MG test (too many intervening better substitutes)
      - Brute force accounting shows profit-maximizing price increases to be small:
        - About 4.0% for Tornado ($180K additional profit)
        - About 2.5% for Conway ($32.5K additional profits)
      - "Limit pricing" incentive against Tornado price increase
        - Very small gain for Tornado
        - Significant margin increase for Visconti and Conklin
    - Coordinated effects
      - No material premerger susceptibility
        - Price transparency
        - BUT
          - Too many firms (5 or 7)
          - No price leadership
          - Suggestions of coordination in trade association gone nowhere
    - Elimination of a maverick: No suggestion in the investigation record
  - *Conclusion*: Prima facie case very likely to fail

4. Write: Introduction

- Short conclusion—Instructor's outline
  - Procompetitive benefits
    - Types
      - Cost-savings
      - New product introduction
    - Neither is a technical defense, but could be emotive factors for the court to decide for merging parties

4. Write: The prima facie case

- The relevant product market
  - Observations
    - Differentiated products market
    - Pens priced on a continuum with no clear breaking points
      - Looks like gasoline station problem
    - No industry-accepted segmentation of fountain pens
      - But some third-part market research reports divide between “writing instruments (<$100) and “prestige” pens (>$100)
    - Prices increase with—
      - more expensive inputs (materials and artisans)
      - perception as a “status” good

4. Write: The prima facie case

- The relevant product market
  - Product markets to be analyzed
    - Conglomerate merger
    - All fountain pens
    - Premium + luxury fountain pens ($100+)
    - Luxury only fountain pens ($130+)
    - Any alternative market

Do not get lost in the details. Think about what your intuitions tell you are the correct relevant markets. When you do the details (especially the HMT), if you are getting an answer different from your intuitions, double check your work!

4. Write: The prima facie case

- The relevant product market
  - **Conglomerate merger: Rejected**
    - Significant price differences but still meaningful (although not large) diversion ratios
      - 10% from Tornado to Conway
      - 20% from Conway to Tornado
    - Satisfies two-product SSNIP recapture test (formula):

$$R_{Critical}^{Tornado} = \frac{\$SSNIP_{Tornado}}{\$m_{Conway}} = \frac{7.5}{110} = 6.8\%$$

$$R_{Critical}^{Conway} = \frac{\$SSNIP_{Conway}}{\$m_{Tornado}} = \frac{11}{60} = 18.3\%.$$

.

    - Actual: Tornado 10%
      Conway 20%

4. Write: The prima facie case

- The relevant product market
  - **Conglomerate merger: Rejected**
    - Alternative, brute force accounting:

Brute force accounting: Tornado + Conway Market

	SSNIP imposed on:	
	Tornado	Conway
Gain on inframarginal sales		
Price	150	220
δ =	5.00%	5.00%
\$SSNIP = δp =	7.50	11.00
q =	360,000	100,000
ε = 1/m =	2.5	2
%Δq = $\delta\varepsilon$ =	0.125	0.1
Δq = %Δq × q =	45,000	10,000
q2 = q - Δq =	315,000	90,000
Gain =	2,362,500	990,000
Loss on marginal sales		
\$m = %m × p =	60	110
Δq =	45,000	10,000
Loss = \$m × Δq =	2,700,000	1,100,000
NET firm 1 =	-337,500	-110,000
Gain on recapture		
Δq =	45,000	10,000.00
D	0.1	0.2
Rec. units = DΔq =	4,500	2000
$\$m_{Recapture}$	110	60
Gain	495,000	120,000
NET GAIN HM	157,500	10,000

4. Write: The prima facie case

- The relevant product market
  - **Conglomerate merger: Rejected**
    - BUT unlikely a court would accept a the relevant product market
      - Excludes the first (QW) and second (Conklin) most competitive products with Tornado pens as shown by their diversion ratios
      - Excludes the two most competitive products with Conway pens (QW and Nettuno)
      - Almost surely, the court would insist that the relevant market include in addition at least the products more competitive with a merging product than the other merging product (Conklin, QW, and Nettuno).

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Diversion Ratios

To:	Visconti	Conklin	Tornado	QW	Conway	Nettuno	Accutron
Tornado	0.2	0.3	–	0.4	0.1	0.0	0.0
Conway		0.1	0.2	0.3	–	0.3	0.1

4. Write: The prima facie case

- The relevant product market
  - **All fountain pen market: Rejected**
    - Satisfies HMT profitability test
      - could rely on the "superset principle" if you had already shown that a subset of products was a relevant market.
      - Alternatively, could have used a one-product SSNIP recapture sufficiency test:
        - Impose the SSNIP on one of the products of the merging firms, say, Tornado. We know the minimum price ($32) and minimum percentage margin (30%) for the "other" products, so:

$$\overline{R}^{1}_{Critical} = \frac{\$SSNIP_1}{p_{R\min} m_{R\min}} = \frac{(0.05)(150)}{(32)(0.30)} = \frac{7.5}{9.6} = 78.125\%.$$

This is an upper bound of the critical recapture rate, so if the actual recapture rate is greater than this upper bound, it is necessarily greater than the critical recapture rate and so satisfies the HMT.

        - Here, the actual recapture rate of Tornado in the candidate all fountain pen market is 1. Therefore, all fountain pens satisfy the HMT.

4. Write: The prima facie case

- The relevant product market
  - **All fountain pen market: Rejected**
    - BUT fails to comport with the commercial realities
      - Includes too many products that do not compete with the products of the merging firms
        - These noncompeting products account for 63% of total market revenues → significant dilution of Tornado and Conway market shares and masks possible anticompetitive interactions between the merging products
      - *Brown Shoe* factors mitigate against: Internal differences—
        - Sales channels (department stores vs. high-end specialty)
        - Price discounting (some vs. none)
        - Advertising (price vs. "prestige" image)
        - Advertising spend (<10% vs. > 10%)
        - Some 3P market research ("writing instrument" vs. "prestige pen")

4. Write: The prima facie case

- The relevant product market
  - **Luxury pens: Rejected**
    - In favor
      - Satisfies HMT profitability test
      - Recaptures 50% of Tornado’s lost marginal sales
      - Recaptures 90% of Conway’s lost marginal sales
      - Five firms in this market comprise the Luxury Fountain Pen Trade Association
    - BUT fails to comport with the commercial realities
      - Appears gerrymandered—Looks “unbalanced”
      - Removes Conklin and Visconti, two high-volume manufacturers that compete with Tornado, from the market to increase the shares of the merging parties
      - Conklin is a closer competitor to Tornado than Conway
      - Contains Nettuno and Accutron, which do not compete with Tornado, while Accutron competes only weakly with Conway

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Diversion Ratios

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Conway		0.1	0.2	0.3	–	0.3	0.1

4. Write: The prima facie case

- The relevant product market
  - **Another alternative: Five-product symmetrical market**
    - In favor
      - Satisfies HMT profitability test
      - Retains “balance”—removes most distant competitor from each of Tornado and Conway
      - Recaptures 80% of Tornado’s lost marginal sales
      - Recaptures 90% of Conway’s lost marginal sales
      - Moves in the direction of the “smallest market” principle
    - BUT *Brown Shoe* factors may favor including Visconti

Table 2

Diversion Ratios

To:	~~Visconti~~	Conklin	Tornado	QW	Conway	Nettuno	~~Accutron~~
Tornado	~~0.2~~	0.3	–	0.4	0.1	0.0	~~0.0~~
Conway		0.1	0.2	0.3	–	0.3	~~0.1~~

4. Write: The prima facie case

- The relevant product market
  - **Conclusion**
    - Only two choices are likely to be accepted by the court:
      - Seven-product premium + luxury market
      - Five-product symmetrical market
    - But looking a HHIs
    - In practice, the court's choice between these two markets may depend on whether one market or the other better supports a finding consistent with the court's belief about the competitive effect of the transaction

Need to look at competitive effects

But first, the geographic relevant market

4. Write: The prima facie case

- The relevant geographic market
  - The United States
    - The “area of effective competition” test (test and application)
      - Nationwide sales
      - Uniform nationwide pricing
      - Nationwide advertising
    - Hypothetical monopolist test—performed above

Besides, the merging parties agree that
the relevant geographic market is nationwide

4. Write: The prima facie case

- The *PNB* presumption

HHI Statistics: Summary

Candidate market	Combined share	Delta	Postmerger HHI
Seven-product market	26.6%	292	2171
Five-product market	39.3%	635	2973
Staff's luxury market	50.6%	1052	3650

  - No presumption in seven-product market
  - Weak presumption in five-product market
  - *Conclusion*:
    - Court likely to determine whether transaction violates Section 7 based on additional evidence
    - If evidence too weak, court will find a seven-product market
    - If evidence is strong, court will find a five-product market

4. Write: The prima facie case

- Additional evidence supporting the prima facie case
  - Unilateral price effect
    - Fails the 1992 MG requirements
    - Weak on the 2020 MG requirements (too many intervening significant substitutes)
    - Brute force accounting shows profit-maximizing price increases to be small:
      - About 4.0% for Tornado ($180K additional profit)
      - About 2.5% for Conway ($32.5K additional profits)

Brute force accounting: Tornado + Conway

	SSNIP imposed on: Tornado	Conway
Gain on inframarginal sales		
Price	150	220
δ =	**4.00%**	**2.50%**
$SSNIP = δp =	6.00	5.50
q =	360,000	100,000
ε = 1/m =	2.5	2
%Δq = δε =	0.1	0.05
Δq = %Δq × q =	36,000	5,000
q2 = q - Δq =	324,000	95,000
Gain =	1,944,000.00	522,500
Loss on marginal sales		
$m = %m × p =	60	110
Δq =	36,000	5,000
Loss = $m × Δq =	2,160,000	550,000
NET for firm 1 =	-216,000	-27,500
Gain on recapture		
Δq =	36,000	5,000.00
D	0.1	0.2
Rec. units = DΔq =	3,600	1000
$\$m_{Recapture}$	110	60
Recapture gain	396,000	60,000
NET GAIN	180,000	32,500

4. Write: The prima facie case

- Additional evidence supporting the prima facie case
  - Unilateral price effect: Alternatively, could have used a formula
    - Recall the way to do this is to equate the actual recapture ratio with the critical recapture ratio in a "market" consisting only of the merging firms and solve for δ. The profit-maximizing price is then $\delta/2$.

Tornado

- From Table 2, the actual recapture ratio from Tornado to Conway is 0.1.
- The critical recapture ratio is:

$$R^1_{Critical} = \frac{\delta p_1}{\$m_{RAve}},$$

- Equate the actual recapture ratio with the critical recapture ratio:

$$0.10 = \frac{\delta(150)}{\$110},$$

- Solving, δ = 7.33% (use Mathpapa). So the profit-maximizing price increase for Tornado is $\delta/2$ or 3.67% (or about 4%).

4. Write: The prima facie case

- Additional evidence supporting the prima facie case
  - Unilateral price effect

Conway

- From Table 2, the actual recapture ratio from Conway to Tornado is 0.2.
- Equating the actual recapture ratio with the critical recapture ratio:

$$0.20 = \frac{\delta(220)}{\$60},$$

where the price of a Conway pen is $220 and the dollar margin of the "other" product (Tornado) is $60 (50% of $150 wholesale price).

- Solving, δ = 5.456% (use Mathpapa). So the profit-maximizing price increase for Conway is $\delta/2$ or 2.73% (or about 2.5%).

4. Write: The prima facie case

- Additional evidence supporting the prima facie case
  - Unilateral price effect
    - “Limit pricing” incentive against Tornado price increase
      - Threat of entry by Visconti and Conklin at $150 price point
      - Very small gain for Tornado from increasing price ($180,000)
      - Significant margin increase for Visconti and Conklin (10% increase in percentage margin)
      - *Bottom line*: Tornado reasonably should withhold a price increase for such a small gain if seriously concerned with threat of entry by Visconti or Conklin

4. Write: The prima facie case

- Additional evidence supporting the prima facie case
  - **Coordinated effects**
    - No material premerger susceptibility
      - Price transparency
      - BUT
        - Five to seven firms
        - No price leadership
        - Suggestions of coordination in trade association gone nowhere
  - **Elimination of a maverick:** No suggestion in the investigation record
  - **Customer testimony:**
    - No customer testimony supporting a likely anticompetitive effect
    - would be almost unique in modern Division to bring a case without supporting customer testimony

Conclusion: Prima facie case very likely to fail

Better put: Court is unlikely to be convinced that the merger threatens substantial anticompetitive harm

4. Write: Procompetitive benefits

1. Cost-savings: $2.0 million annually
   - Contents
     - Closing down Conway's headquarters and only production facility
     - Consolidating all back office, sales, and marketing operations into Tornado's existing infrastructure
     - Moving all production into Tornado's factory
   - Conclusion
     - All fixed cost savings → not cognizable efficiencies under the Merger Guidelines
     - BUT court might find them procompetitive (although not a technical defense)

2. New product introduction
   - Tornado to use merger profits to finance the introduction of a new $180 pen
   - Not a technical defense
     - Speculative whether it will occur
     - Years in the future
     - Even if entry occurs, competitive effect speculative
   - BUT court might find this procompetitive and favoring the merger (although not a technical defense)

4. Write: Consent decree relief

- General rule
  - Division requires divestiture relief to cure horizonal merger problems
  - Does not accept behavioral remedies
    - In particular, does not accept price caps
- Conclusion
  - No partial divestitures would cure any competitive problem
  - Tornado would reject divestiture relief
    - Divest Conway—Nothing to acquire
    - Divest Tornado—Not a "trade-up" merger, since Tornado significantly more profitable than Conway
  - Reject price caps as relief