Updates
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2018 ABA Antitrust Law Spring Meeting: Merger Analysis Takeaways

The American Bar Association's recent 2018 Antitrust Law Spring Meeting included many sessions and discussion on merger enforcement. Among the most interesting of them are the following:

"Failing Firm Defense: Shop 'Till You Drop?"

A group of law enforcement attorneys, defense counsel and an economist discussed key aspects of the "failing firm defense." The three elements of the defense are (1) a target in imminent danger of failure, (2) with no realistic prospect of successful reorganization through bankruptcy or otherwise, and (3) no viable alternative buyer that poses less antitrust risk.

The panelists began by contrasting the "failing company defense" with the "flailing company" (or "weakened competitor") doctrine. Because the failing company defense is a complete defense to liability, it has been strictly construed.

The "flailing company" doctrine posits that because of weaknesses underlying one of the merging parties' operations, its historical performance substantially overstates its likely future role in the market. Status as a "flailing company" is not a defense to a merger challenge; rather, it serves to rebut any inference of future anticompetitive effect based on the firm's past performance. *United States v. General Dynamics*, the 1974 U.S. Supreme Court case that established the doctrine, is a classic example. There, because the buyer, a substantial seller of coal, had limited remaining coal reserves, its historical revenue was not indicative of its likely future sales.

Recent litigation surrounding the "failing company defense" has focused largely on (1) whether failure is imminent; and (2) the scope and duration of the target's efforts to find alternative buyers. The panelists agreed the strongest evidence of imminent failure is loss of credit lines. Recent auditor reports predicting failure are also persuasive, as are financial analyses indicating that, if bankruptcy becomes necessary, the firm is likely to be liquidated, rather than successfully reorganized.

Prevailing on the defense is difficult, however, if the target's investors (or corporate parent) are solvent and have historically supported the target financially. Also troublesome are recent statements by the target's officers to securities markets or state regulators describing the firm as financially healthy.

On the scope and duration of the search, the government strongly prefers a public auction-like process, which attracts the largest number of buyers. Nonpublic deals, especially those with "no shop" provisions prohibiting the target from considering other buyers, will count for little.

Narrow-Minded: Current State of Market Definition

The panelists generally agreed that although some Sherman Act section 1 caselaw suggests determining a relevant market may not always be necessary to determine whether specific conduct violates the rule of reason, relevant market analysis continues to be essential in merger challenges, even where government believes it has direct evidence of likely anticompetitive effects.

Recent market definition cases have focused on "price discrimination markets," which consist of a set of customers who for reasons other than differences in vendor cost, are charged prices different from those charged typical customers. In these cases, the merger parties were vendors to large "national footprint" customers (like hotel and restaurant chains) that purchase goods and services on a centralized basis. Such customers typically prefer dealing with a single vendor who is able to service all of the customer's units. Because sales to such customers require delivery and service on a national scale, few vendors may be able to compete. Ironically, because the alleged "victims" in such cases are typically power buyers, they already enjoy prices lower than the vendor's typical customers.

The panelists observed that focusing on price discrimination obscures the real question: whether there are sets of customers, who, because of their purchasing requirements, have fewer vendor options than other customers. The best evidence will be found in the customer's own purchasing records, which presumably identify the firms that have submitted bids. Second best evidence may consist of the competing vendors' win/loss bid records. Do they suggest the merging companies are among a very small number of vendors for such national contracts?

Panelists agreed that, in such cases, a critical factor in determining whether a merger is challenged is the extent to which customers complain about it, either on their own or in response to inquiries from government investigators. For this reason, from a defense perspective, parties planning a merger must develop a plan for the care and feeding of the parties' customers. Following announcement of the deal, the parties should affirmatively reach out to key customers, explaining the reasons for the deal and the benefits it will provide customers.

This "missionary work" should not be limited to the individual customer representative with whom the vendor typically deals, who may be a mid-level manager who reflexively believes that "having fewer competing vendors is always worse than more." Employees higher in the customer organization may take a different and more nuanced view of the deal's likely effect on the customer.

Innovation and Merger Control

The panelists, who consisted of U.S. and EU enforcement officials, defense counsel and an economist, agreed the potential loss of competition in innovation/R&D is a legitimate concern in merger review but one that may raise especially difficult issues regarding proof. They also noted that virtually all of the enforcement actions to date have alleged likely losses of competition in both products and innovation. In many investigations, the loss of innovation did not focus on the development of specific future products. Instead, customer complaints addressed the potential loss of competing capabilities to address the problems (and potential problems) found in challenging operating environments (for example, offshore oil drilling).

There is an economic debate about whether firms with large market shares are more or less likely to engage in innovation. The difference between product and process innovation may play a role. A firm with a large market share may be less likely to pursue product innovation, which may (especially if is appropriated by smaller competitors) erode its existing market share. Such a firm should be more likely, however, to pursue process innovations because the benefits can be spread across a larger number of product units.

The panelists agreed enforcers should consider forces other than competition that may promote (or mandate) innovation. These could include product obsolescence (for example, insecticides to which the target insects have developed resistance), changing government performance standards (like the federal fuel efficiency standards) and expiration of important patents.

A special problem is measuring market shares. The agencies may consider competitors' history of new product introductions, R&D expenditures, the number of patents awarded and/or the quality of patents. In many cases, the best evidence will consist of the parties' internal R&D budgets and product roadmaps that identify the firm's key innovation competitors.

The panelists generally agreed that the "safe harbor" provided by the DoJ/FTC's "Antitrust Guidelines for the Licensing of Intellectual Property" should apply to innovation analysis in merger investigations. If following the merger, there remain four or more independent firms with relevant and viable innovation/R&D capabilities, the transaction is unlikely to reduce innovation competition.

On remedies, the government enforcers expressed a strong preference for divestiture of complete R&D units, rather than piecemeal assets. They conceded this may be difficult when a firm performs R&D for all of its product lines in a single unit. In such cases, the mandatory non-exclusive licensing of the firm's patents to a third party may be the only feasible remedy.

Views From the Bench on Mergers

The United States district court judges who presided over the Anthem/Cigna, Aetna/Humana and St. Luke's/Saltzer Medical merger trials described case management problems unique to merger litigation.

The judges agreed that merger cases are unique in that they require the court to predict future facts—such as considering if this transaction will substantially lessen competition—rather than analyze and determine the legal consequences of past conduct. When, as is typical, the parties are pursuing preliminary injunctive relief, the need for speed will affect all aspects of litigation. The judges strongly urged the parties to narrow legal claims early in the case, and identify legitimately disputed factual issues.

In addition to the substantial pre-trial discovery typical of large civil litigation, merger cases typically involve a large number of third-party customer and competitor witnesses, with concerns of their own regarding the use of their data. These concerns can multiply the number of discovery disputes. At a minimum, the parties should develop a protective order governing the use of third-party data. Two of the three judges appointed special masters to preside over discovery and other pre-trial matters.

The judges warned that, although a bench (non-jury) trial is more relaxed for judges and lawyers, counsel should not assume that otherwise inadmissible "summary" evidence is going to be admitted, or that live witness testimony is unnecessary. Although judges are accustomed to reviewing designated deposition testimony from nonparty witnesses outside the court's jurisdiction, they are unlikely to credit (or even permit) written direct testimony from witnesses who are available to appear in court.

The judges agreed that one of the strengths of a bench trial format is the judge's ability to question expert witnesses to ensure he or she fully understands the expert's analysis. Experts should be prepared for this. The judges also observed that an economic expert's qualifications are almost never an issue. They cautioned, however, that, no matter how good, the technical analyses of competing experts are likely to cancel each other out. The key question for the judge is whose expert's conclusions are more consistent with the parties' internal documents and credible witness trial testimony?

The judges also cautioned that, although the plaintiff bears the burden of proof on all elements of a Clayton Act claim, including definition of the relevant market, they expect the defendant to posit a competing relevant market rather than simply poke holes in plaintiff's theory.

Do Efficiencies Ever Offset Potentially Anticompetitive Effects?

A threshold question was whether an efficiencies argument is worth the time and trouble. The panel observed that some courts have questioned whether the efficiencies defense exists at all, and no court has found that an efficiencies defense was sufficient to save an otherwise anticompetitive merger. Moreover, microeconomists are taught on the first day of graduate school that competition is the best way to generate efficiencies. For these reasons, agency staff are inherently skeptical that efficiencies can be enhanced by eliminating competition.

For these reasons, the odds of prevailing before the agency on an efficiencies argument are stacked against the merging parties from the beginning.

The panelists noted what constitutes a merger-specific efficiency is often far different than what business people think about. "Efficiencies" are different than "cost savings." A merger may result in cost savings because, for example, two companies qualify for a bigger volume discount from upstream suppliers. But from an enforcement perspective, paying suppliers less is not of itself an efficiency; it's just a wealth transfer unless the savings are likely to be passed on to customers.

The panelists agreed that although efficiencies arguments should be made, they should be conservative and verifiable. Verifiability is critical. Will the efficiencies actually be realized? On this point, one of the agency representatives observed that when considering efficiencies, he doesn't just look at numbers, he weighs **probabilities**. Where agency staff has presented strong prima facie evidence that a merger will have substantial anticompetitive effects, are the claimed efficiencies likely? If so, are they likely to outweigh the potential anticompetitive effects? Where the prima facie case is weak, the agencies are likely to close the investigation based on a combination of the competitive effects and efficiencies analysis

On a practical note, the panel observed that lawyers considering an efficiency defense read both the 2010 Horizontal Merger Guidelines and the commentary to the 2006 guidelines, which discuss the applications of principles to specific cases.

Read the entire ABA Antitrust Law Spring Meeting recap series:

- Part 1: Federal and State Antitrust Enforcement
- Part 3: Consumer Protection

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