ABA SECTION OF ANTITRUST LAW

The Threshold

The Newsletter of the Mergers & Acquisitions Committee

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From the Chair

To all Committee Members:

To the M&A lawyer's lexicon of acronyms—EBITDA, TEV, LTM, DCF, P/E, IRR, etc.—must now be added SWF (Sovereign Wealth Fund). At the recent "Super Return" conference in Munich, there was talk of the SWFs "replacing Wall Street" as the financial engine of M&A, and in particular PE (private equity)-driven M&A.

Although here at the M&A Committee our remit does not extend to chronicling let alone predicting the vagaries of the financial markets, we are attuned to trends and seek to keep you our loyal readers current. We thus take some measure of satisfaction in noting that The Threshold last year ran a series of articles on national security review of transactions, an increasingly hot topic given the rise of SWFs, and we also held a CFIUS brown bag. Following the enactment last summer of amendments to the Exon-Florio Act (the so-called FINSA law), CFIUS is scheduled to amend its regulations, and we will keep you posted on that development.

Although as we go to press Spring is in the air, the Grapefruit and Cactus Leagues are in full swing, and the Washington Nationals new park is getting a final coat of paint, I will disappoint a few and cheer many more by not engaging in my usual exegesis on the wonders of baseball and how we can draw useful analogies and lessons from it. More disappointingly, we have broken our streak of publishing an "inside baseball" look at a recent merger for reasons not worth explication but which include foul balls and futilely swinging for the fences.

There is no reason to despair, though, because this issue of The Threshold is chock-full with a wide assortment of informative articles:

- We continue The Threshold tradition of interviewing government enforcement officials by publishing here an interview with Dr. Michael Baye, the Director of the FTC's Bureau of Economics. We are grateful to Rhett Krulla and Carl Shapiro—two obviously very well qualified interviewers—for the exchange with Dr. Baye, and I would direct our readers especially to the discussion of critical loss analysis. [In the interest of full disclosure, I note the Antitrust Source also published in its February 2008 edition a separate interview with Dr. Baye, confirming that there is no market allocation agreement between competing Section publications.]

- We are pleased to get back to basics and indebted to Kate Walsh of the FTC's Premerger Notification Office for building on her highly successful brown bag presentation in outlining for us important rules of the road and do's and don'ts that should be observed in preparing our HSR forms.

- The potential competition doctrine is alive and well in various guises and here Charles Biggio and Scott Sher take a fresh look at how the FTC applies it.

- Dave Saylor takes a critical look at the DOJ's lengthy investigation of the Abitibi/Bowater newsprint merger and resulting consent decree.

- Shawn Johnson brings us some highlights from the recent FTC Unilateral Effects Workshop.

- The FTC's challenge to a merger between two public gas utilities in western Pennsylvania (<u>Equitable Resources</u>) generated a fascinating intersection of the State Action doctrine and merger enforcement; to explore that world, we brought together a very knowledgeable panel including protagonists in that litigation, all of which is summarized here by Paul Spelman.

Finally, although not featured in this issue, the M&A Committee is currently quite busy on the international front, contributing to the efforts of the ICN Mergers Working Group in advance of the annual ICN meeting next month as well as to comments from the Section on merger developments in Australia, India and Ireland. More on all of the above in the next issue.

See you at the Spring Meeting,

Bob Schlossberg
Chair, Mergers & Acquisitions Committee

Unilateral Effects: Looking for a New Perspective

[top]

A Report from the Federal Trade Commission's Unilateral Effects and Litigation Workshop

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On February 12, 2008, the Federal Trade Commission ("FTC") sponsored a public workshop to examine the application of the unilateral effects theory to mergers and acquisitions among competitors offering differentiated products. The workshop consisted of a series of panel discussions among government officials, antitrust practitioners, economists, and others. The topics included the foundations of the unilateral effects theory, the challenges of defining a relevant product market in differentiated products cases, judicial perspectives on the unilateral effects theory, and evidentiary issues related to the application of the theory itself. This report provides a brief introduction to the unilateral effects theory as well as highlights from those panel discussions. A transcript of the proceedings and a webcast of the entire workshop is available on the FTC's website.[1]

The Unilateral Effects Theory–A Short Primer

The unilateral effects theory of potential competitive harm posits that a merger or acquisition may diminish competition because the resulting merged firm may find it profitable to unilaterally increase its price or reduce its output. Unilateral effects can arise in a number of factual settings, the most common being a differentiated product market in which competitors sell various products that are close, but not perfect, substitutes for one another. Where the merging firms' products are considered particularly close substitutes by a number of consumers, an increase in price may result in many sales lost by one product being diverted to the merged firm's other product. In this way, the price increase may be profitable, even though it would not have been prior to the transaction. The ultimate profitability of such a strategy is a function of many factors, including the diversion ratio between the merging firms' products, their relative profit margins, and the ability of other competitors to reposition their own products in order to replace that degree of competition that would have otherwise been eliminated by the merger.

The unilateral effects theory is neither new nor novel. While many trace its roots to the 1890s, the modern era of unilateral effects analysis and its application to merger policy began in the 1980s with its inclusion in the 1982 Merger Guidelines issued by the Department of Justice ("DOJ") and its explicit treatment in the 1992 DOJ and FTC

[1] See http://www.ftc.gov/bc/unilateral/index.shtm.

Horizontal Merger Guidelines ("Horizontal Merger Guidelines"). These developments coincided with the emergence of scanner data and other sources of information that facilitated the application of empirical econometric analyses to simulate the likely unilateral effect of proposed transactions. As the FTC/DOJ Commentary on the Horizontal Merger Guidelines (2006) demonstrates, the unilateral effects theory has since played a significant role in the agencies' merger review process and has been the basis for many merger enforcement actions.

Two recent merger cases involving the application of the unilateral effects theory have been the focus of both antitrust regulators and practitioners. In 2004, DOJ challenged the proposed merger of Oracle and PeopleSoft, two of the largest providers of enterprise application software.[2] In order to support its claims under the unilateral effects theory, DOJ sought to define a narrow market for "high function human resource management software" and "high function financial management services" sold in the United States.[3] This market definition excluded so-called "mid-market" vendors as well as providers of "best-of-breed" software solutions.[4] DOJ alleged that the proposed transaction would reduce the number of competitors from three to two and would allow the merged entity to raise prices unilaterally. In support of its claims, DOJ relied principally on qualitative evidence, including customer testimony and market research reports. It did not provide any quantitative evidence to define the market or any econometric analysis that demonstrated the diversion ratios between the merging parties' products.

The district court found that DOJ had failed to prove the relevant product market. Specifically, the court found that DOJ's reliance on customer testimony was inadequate and represented an expression of customer "preferences" rather than "hard evidence" of the relevant product market.[5] The court also noted that DOJ's economic testimony was fundamentally flawed due to the lack of any thorough econometric analysis.[6] The court held that DOJ had failed to "prove that there are a significant number of customers … who regard Oracle and PeopleSoft as their first and second choices" and had failed to demonstrate that the merging parties "would enjoy a post-merger monopoly or dominant position, at least in a 'localized competition' space."[7] Based upon these findings, the court refused to enjoin the transaction.

The government went to court again in 2007, when FTC sought to enjoin the proposed merger of Whole Foods and Wild Oats.[8] FTC alleged that the merger would substantially lessen competition in the market for "premium natural and organic supermarkets" and allow Whole Foods to unilaterally increase its prices.[9] FTC argued that competitors in this narrow product

[2] See United States v. Oracle Inc., 331 F. Supp. 2d. 1098, 1119 (N.D. Cal. 2004).

[3] Id. at 1123.

[4] Id. at 1125.

[5] Id. at 1131.

[6] Id. at 1172.

[7] Id.

[8] See FTC v. Whole Foods, Inc., 502 F. Supp. 2d 1 (D.D.C. Aug. 16, 2007).

[9] Id. at 16.

market are distinct from more conventional supermarkets like Safeway and Kroger, and that those conventional supermarkets are unable to constrain the prices of premium natural and organic supermarkets in the same manner as Whole Foods and Wild Oats constrain one another. In support of these claims, FTC cited a number of features that distinguish premium natural and organic supermarkets and made extensive use of internal Whole Foods documents and deposition testimony.[10] The two merging firms were by far the largest competitors in this narrow proposed product market, and FTC alleged that the market shares alone were sufficient to make a prima facie showing that the proposed transaction violated the antitrust laws.[11]

The district court rejected FTC's proposed product market definition.[12] The court found that premium natural and organic supermarkets compete not only among themselves but also with so-called conventional supermarkets.[13] The court cited testimony and evidence that grocery shoppers are price sensitive and can (and do) easily shift their purchases among supermarkets.[14] The evidence also showed that Whole Foods conducts price checks of conventional supermarkets, and that many large supermarket chains have re-positioned themselves to offer more natural and organic products.[15] Rather than supporting a separate product market, the court found that the attributes of premium natural and organic supermarkets are simply a way to differentiate those stores from other competitors in the supermarket business.[16] Applying the Horizontal Merger Guidelines, the district court found that conventional supermarkets would continue to constrain Whole Foods' prices post-merger such that Whole Foods would be unable to profitably increase its prices.[17] Based on these findings, the court denied the FTC's challenge.[18]

These two recent high-profile cases have raised questions in some minds regarding the government's ability to successfully prosecute cases under the unilateral effects doctrine, focused attention on the grounds upon which the doctrine has been attacked, and led some to wonder aloud whether and how the agencies should take action to strengthen its application.

The Potential Grounds for Attack

The focus of the first panel, and the subject of many subsequent comments, was on the foundations and core features of the unilateral effects theory and how the underlying predicates of that theory can come under attack. Professor Andrew Gavil began the day's discussions by reviewing the historical development of the theory

[10] Id. at 28.

[11] Id. at 8.

[12] Id. at 35-36.

[13] Id. at 20.

[14] Id. at 19-20.

[15] Id. at 29, 33.

[16] Id. at 36.

[17] Id. at 35, 43.

[18] Following this decision, the FTC sought a stay of the district court's ruling from the D.C. Circuit Court of Appeals. While that stay was denied, as of the date of this publication the FTC had not yet announced whether it will continue to pursue this case through an administrative proceeding.

itself and its integration into the Horizontal Merger Guidelines. While not law, the Horizontal Merger Guidelines have become extremely important in light of their widespread use by both the regulatory agencies and the parties. Professor Robert Willig noted, however, that the Horizontal Merger Guidelines have also become a double-edged sword: while they provide useful and important guidance for businesses that are considering a potential transaction, the Horizontal Merger Guidelines also impose significant burdens on the government. The primary burden? Defining and proving the relevant product market.

As demonstrated in both Oracle and Whole Foods, proving a relevant product market can be difficult, especially for differentiated products. Narrowly-defined markets are often assailed as sub-markets and prove difficult to defend, while more broadly-defined markets result in lower market shares and diminished competitive impact. As many panelists recognized, this situation creates an inherent tension for the government. On the one hand, the agencies have an incentive to define narrow product markets in which the parties' market shares are prima facie evidence that the merger would be anticompetitive, but those markets can appear gerrymandered and artificial. On the other hand, while broad product market definitions may be easier for the government to defend, they also raise questions regarding whether the merger would substantially reduce overall competition in that broader market within the meaning of Section 7. Janet McDavid pointed out that differences in the quality of the available data can also lead to significant differences in the quality of the analysis that can be performed and the evidence that can ultimately be presented in support of market definition. Where there is no ready source of data to support a rigorous market definition analysis, or where all of the evidence is not aligned, the agencies often find the Horizontal Merger Guidelines being wielded against them.

An economic analysis under the unilateral effects theory can also be hard to sell in court. As Professor Gavil noted, qualitative evidence is often more straightforward, and empirical evidence is generally more appealing. Unilateral effects analyses, on the other hand, are highly complex and necessarily dependent upon assumptions. Due to that fact, these analyses can lead to a false sense of precision and are subject to attack on that basis. While antitrust practitioners may be familiar with and persuaded by these analyses, the panelists noted that the agencies need to remain conscious of the limitations of this type of analysis as well as the limitations of their audience. Even the most sophisticated jurists are rarely presented with this type of complex economic evidence and may be unconvinced of its value. Both judges at the workshop, the Honorable Judge Douglas Ginsburg and the Honorable Judge Diane Wood, agreed that these high-powered quantitative techniques can create a challenge for generalized judges. To be effective at trial, unilateral effects analyses must be made accessible. While this imposes a significant burden on the agencies, it is imperative in order to challenge cases successfully under the unilateral effects theory.

Defining a Relevant Market– Who Needs it?

Throughout the day, panelists focused on the probative value of market definition in unilateral effects analysis and whether, as a matter of law or policy, there should be a requirement to prove a relevant market at all. These discussions raised two main issues with respect to relevant market definition: (1) whether a formal definition is legally required and (2) pros and cons of such a requirement.

The panelists generally agreed that defining a relevant market remains a legal requirement. As Professor Jonathan Baker pointed out, the statutory language of Section 7 (prohibiting transactions that would substantially lessen competition "in any line of commerce") makes proof of that market an element of the offense. Kathy Fenton further noted that, while there has been very little guidance from the Supreme Court regarding the issue, the language of the Court's Marine Bancorp[19] decision mandates the definition of a relevant market. The particular unresolved question is whether evidence of a direct competitive effect may be sufficient to alleviate the need for a formal market definition.

Defining a relevant market does have some benefits for economic analyses conducted under the unilateral effects theory. Professor Baker explained that high market shares indicate that there are likely significant diversion ratios between the merging firms' products and even an informal market definition can assist in identifying those third-party competitors that have to be included in an analysis in order to avoid bias. As Dan Wall pointed out, however, the economic analysis of potential unilateral effects is the same regardless of whether the case is framed as a merger which will result in a high level of concentration in a narrow market or the loss of direct competition among the merging firms in a broader market. Based upon these facts, while there is no requirement to define a relevant market from the economic perspective, it appears that this exercise can and does inform that analysis.

Mr. Wall suggested that, as a matter of trial tactics, the legal requirement of market definition and the Horizontal Merger Guidelines are the agencies' worst enemy. The relevant market requirement is not only well entrenched in the case law, it is also embraced in the Horizontal Merger Guidelines. This creates a significant litigation burden for the agencies, and exposes the agencies to impeachment where they choose to pursue a case in which market definition is not part of the equation. For these reasons, Mr. Wall suggested that the agencies must amend the Horizontal Merger Guidelines if they intend to pursue those cases. In one, among many strong perspectives at this workshop, Mr. Wall concluded that bringing such a case in the absence of those reforms would be "a recipe for disaster."

Making Your Case–Evidentiary Issues

The FTC's workshop also focused on the value of various types of qualitative and quantitative evidence in unilateral effects cases. Participants in the workshop agreed that these cases are strongest when backed by both economic and non-economic evidence that consistently points in the same direction. Where other types of evidence diverge from the results of a merger simulation, however, the agencies and parties alike should be prepared for significant skepticism.

The panelists identified a number of important sources of qualitative evidence. Notwithstanding the court's decision in Oracle, Susan Creighton indicated that the

[19] See United States v. Marine Bancorp., 418 U.S. 602 (1974).

testimony of knowledgeable customers likely remains key. Few other sources can offer such an informed view of existing competitive options and the proposed transaction's likely impact. In addition, while the court's decision in Whole Foods seems to indicate otherwise, Connie Robinson noted that internal company documents also can provide strong evidence in these cases. Other types of evidence, including natural experiments and competitor statements, also were acknowledged. As Richard Rapp noted, however, each of these has inherent limitations. For example, natural experiments without controls can be dangerous and misleading precisely because they appeal to intuition. As such, it is important to draw upon a wide variety of evidentiary sources in order to repeatedly reinforce the points being made.

Similarly, in merger challenges, both econometric and non-econometric economic evidence is important. As noted earlier, because they rely on assumptions, merger simulations can be hard to present in court and may face some additional judicial scrutiny. While empirical methods such as critical loss are helpful, these methods are only compliments (not substitutes) for other types of economic evidence. For this reason, it is important to utilize the full range of economic tools available when presenting a unilateral effects case.

Across the board, panelists recognized the extraordinary complexity of unilateral effects cases. Despite this, there was widespread support for the prosecution of mergers that would otherwise result in an anticompetitive effect and the agencies' continued use of unilateral effects analyses in support of those challenges.

About the Mergers and Acquisitions Committee [top]

The Mergers and Acquisitions Committee focuses on issues relating to mergers, acquisitions and joint ventures. Committee activities and projects cover private litigation, both state and federal enforcement, and international merger enforcement activities.

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About The Threshold [top]

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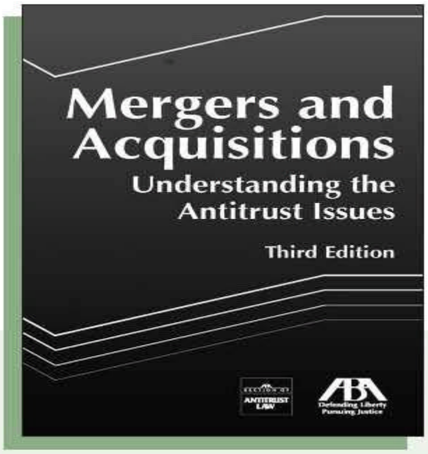

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