Managing Antitrust Issues In Mergers And Acquisitions

Jack A. Rovner
Partner
Michael Best & Friedrich
Chicago
312 845-5812

Your deal looks great: the financial terms are set; management structure is resolved; your strategic planners project increased profits from the price increases they claim the combined firm's "market dominance" should allow. Time to close the deal; you call in the antitrust lawyers to get government pre-merger clearance. Too late! If the strategic planners are right, your deal may be infected by "market power" and may not survive antitrust scrutiny, a situation that should have been determined early on. And your planners' bravado characterization of "market dominance" may well cause extensive delay and substantial expense by suggesting significant competitive concerns. After all, if your advisors say the deal will create "market dominance," "drive out competition," "eliminate a price-cutter," "permit price increases" or such, why should government antitrust enforcers not take them at face value? The enforcers are likely to be quite skeptical as you try to prove why those statements conflict with marketplace realities.

Antitrust issues lurk within every merger and acquisition of any appreciable size. Failure to manage these issues from the outset of deal planning can impose substantial cost and complications on a deal and even scuttle it. Give these issues the attention and sensitivity they merit from the inception of a deal, and the antitrust issues can be effectively managed. You can determine early on whether your deal presents competitive concerns. If so, your antitrust experts can develop the market facts to defend your deal on the competitive merits. Also just maybe you'll be able to avoid deal-promotion bravado that may needlessly create antitrust problems that otherwise might not exist.

Antitrust Regulation of Mergers and Acquisitions

The antitrust laws are intended to protect consumers by preserving competitive markets, thereby ensuring broader choice, better quality and lower prices. The principal concern of antitrust enforcement is to prevent the acquisition or maintenance of "market power"—the ability to control industry price or reduce industry output—either unilaterally or through collusion.

To prevent deals that may result in market power, federal antitrust law empowers the Department of Justice, the Federal Trade Commission, state attorneys general, and even private plaintiffs (*e.g.*, competitors, customers, and anyone else "adversely affected" in their business or property) to challenge mergers and acquisitions. A prevailing plaintiff, including a private plaintiff, has available all remedies, including court-ordered divestiture, treble any actual damages and attorneys' fees and costs. Government case judgments and consent decrees can and often do impose onerous terms that may seriously impede future acquisition opportunities and other strategic business objectives. Antitrust liability is serious stuff.

The primary federal law for antitrust regulation of mergers and acquisitions is Clayton Act § 7. It prohibits mergers and acquisitions that *may* substantially lessen competition or *tend* to create a monopoly. This means Clayton Act § 7 is predictive; it is concerned with a deal's probable future competitive effects. An acquisition opponent need not prove that competition will be substantially lessened; only that, looking forward, the acquisition is likely to have that effect.

To aid federal antitrust enforcement, mergers and acquisitions of any appreciable size must be reported to the Department of Justice and FTC before they may legally be closed. Hence, only the rather small and a rare few other types of deals won't come to the attention of government antitrust enforcers before they close.[1] So if you don't manage antitrust from the outset of the deal, antitrust may well manage your deal at the end.

Analyzing the Antitrust Implications of a Deal

The Department of Justice and FTC have developed an analytical framework for predicting the likely competitive effect of mergers and acquisitions. These *Horizontal Merger Guidelines* give somewhat of a roadmap of the market facts to gather, and they provide statistical tests to help predict whether a deal may present significant competitive concerns likely to attract the attention of government enforcers. Here is how the *Merger Guidelines* analyze deals.

1. Define the "Relevant Market"

Merger analysis begins with defining the relevant product and geographic markets. These markets are then used to identify the competitors, determine their respective market shares and calculate the effect of the proposed merger on market concentration. Market concentration is generally used as a proxy for predicting whether the combined firms will be able to obtain or exercise market power.

The relevant product market consists of the products or services of the merging parties and all reasonable substitutes for them from the buyers' viewpoint. The relevant geographic market includes all areas to which buyers can practically turn to obtain the relevant products. Both include firms that can easily shift their production to those products or services or into those areas in response to a significant and sustained market price increase. The universe of products offered by these firms and the areas of their operations make up the relevant market. This is an "economic" market, usually quite different from and broader than "business" markets often referenced in business plans, marketing programs and other strategic business contexts.

[1]Federal and state antitrust law is extensive and complex. This article is not a substitute for consultation with experienced professional antitrust advisors.

2. Determine Market Shares

Market shares for each of the firms participating in the relevant market are calculated using the data that will best indicate the future competitive structure of the relevant market. Data commonly used are dollar sales, unit sales, or physical capacity, depending on the particular competitive characteristics of the relevant market under examination.

3. Measure Market Concentration

Market concentration is a function of the number of market competitors and their respective shares. The competitive significance of market concentration is now usually predicted by the Herfindahl-Hirschman Index ("HHI"). HHI is determined by summing the squares of the individual market shares of the competitors within the relevant market. Because the square of a small market share (*e.g.*, under 3.0%) will be relatively insignificant in the analysis, only the market shares of the larger competitors are needed to obtain a reasonably accurate picture of the market. The *Merger Guidelines* set three tests for the initial assessment of the likely competitive significance of a merger:

- **Post-Merger HHI Below 1000:** Market is "unconcentrated"; government challenge is unlikely.
- **Post-Merger HHI Between 1000 and 1800:** Market is "moderately concentrated." If the merger raises the HHI less than 100 points, government challenge is unlikely. If the merger raises the HHI more than 100 points, various market factors need to be examined to assess whether the merger may adversely affect competition.
- **Post-Merger HHI Above 1800:** Market is "concentrated." If the merger raises the HHI less than 50 points, government challenge is unlikely. If the merger raises the HHI between 50 and 100 points, various market factors need to be examined to assess whether the merger may adversely affect competition. If the merger raises the HHI more than 100 points, adverse competitive effects are presumed, though the presumption may be overcome by market factors that show it unlikely that the merger will create or enhance market power or facilitate its exercise.

These HHI tests are not rigorous rules. The *Merger Guidelines* caution that "market share and concentration data provide only the starting point for analyzing the competitive impact of a merger." (*Merger Guidelines* § 2.0) That is a particularly apt observation as market data are inherently historical and static, while merger analysis is concerned with likely future market conditions, hence predictive and dynamic. Accordingly, it is important to assess other market factors that pertain to competitive effects—such as entry conditions, reactions of market participants such as customers and competitors, and efficiencies resulting from the merger—particularly when HHIs are high. Otherwise a good deal may get sunk.

4. Assess Market Factors Beyond Concentration

Entry Conditions

When new firms can readily enter the market affected by a merger, their potential competition tempers the ability of existing market participants to exercise market power. Any attempt by the post-merger market participants to raise price above competitive levels would invite the entry and render the price increase unprofitable and, therefore, unsustainable. The factors affecting entry include, the degree of planning and preparation required; the size of investment and the degree to which the investment becomes "sunk cost"; the time needed to build facilities, bring them to efficient operation and begin competitive production and sale; licensure and other forms of approvals; etc.

The *Merger Guidelines* consider firms that would enter the market within one year without significant sunk cost investment as already affecting market competition. These firms should be included in the HHI calculation even though they do not currently sell in the relevant market. Where significant sunk cost investment would be required for entry, the *Merger Guidelines* use two years "from initial planning to significant market impact" as the measure of timely entry, and consider entry likely and sufficient if the entrants would within that time reach profitable sales at premerger price levels with sufficient competitive impact to counter an exercise of market power.

Empirical evidence of ease of entry can be particularly powerful in counteracting high market concentration statistics. Such empirical evidence may be found in: (a) prior entry; (b) excess or uncommitted capacity among existing competitors; (c) small, fringe, or start-up firms that can readily expand production at reasonable and available investment; (d) foreign competitors with the resources and know-how to penetrate U.S. markets; and (e) the absence or presence of significant entry barriers, such as licensure, regulatory restrictions, substantial sunk cost investment and lead times, patents, trade secrets and other proprietary know-how.

Customers and Competitors

A critical factor in assessing antitrust risk is how consumers will view the deal. If consumers oppose it, government challenge is more likely and carries higher probability of success. After all, the antitrust laws are intended to serve consumers. Government agencies routinely contact customers as part of their investigation of deals that appear to raise competitive concerns. It may accordingly be prudent in appropriate circumstances to alert key customers about a potential acquisition and ascertain their reaction to and support for it.

Deal opposition by competitors is a different story. Competitor opposition may well suggest that the deal should *enhance* competition; no rational competitor would oppose a deal that may result in higher market prices generating higher profits because the combined firms gain sufficient market power to support an inflated price umbrella for the industry participants. Nonetheless, opposition by small, struggling competitors afraid of being driven from the market by predatory pricing or market foreclosure tactics can prompt government investigation and opposition.

Efficiencies

Efficiencies that are the product of the transaction can outweigh the market power concerns predicted by post-merger concentration data. The efficiencies must flow from the combination and not be reasonably achievable by other means. The efficiencies should impact the ability of the merged firms to provide improved products or services at lower prices.

The *Merger Guidelines* identify economies of scale, better integration of productive capacity, reduced distribution and transportation costs, and reductions in general, administrative and other overhead expense as examples of efficiencies that the federal enforcement agencies may take into account in assessing a merger. The quantum of demonstrable net efficiencies increases the more significant are the competitive risks raised by the transaction, and the merging firms bear the burden of establishing the efficiencies likely to be gained by their transaction.

Pre-Merger Reporting

You did the antitrust homework. Antitrust counsel was part of the deal team from day one. You even hired economists to measure the markets and potential competitive effects. Sure it seemed costly, but you're comfortable the deal can be effectively defended on the competitive merits. Good thing, because now you likely have to tell the federal antitrust enforcers about it before the deal can close.

Here's a rule of thumb to determine if pre-merger reporting may be required:

- First, look at the size of the parties to the deal—if all members of the control group on one side of the transaction collectively have total sales or assets of at least $100,000,000, and all members of the control group on the other collectively have total sales or assets of at least $10,000,000, the first test for reporting—"size of person"—is probably met.
- Next, look at the size of the deal—if it's worth more than $15,000,000, then the second test for reporting—"size of transaction"—is probably met, too, and the deal may have to be reported.

The reporting rules are much more complicated than this. There are a variety of technical regulations explaining how to define the control group, how to measure sales, assets and deal value, when to report stepped transactions or the formation of new ventures, when reporting exceptions apply, etc. This rule of thumb is simply a tool to tell you the deals that need careful examination for pre-merger compliance by pre-merger experts.

Reportable deals cannot legally be closed until the "waiting period" expires. Violate this and face fines of $10,000 per day. The waiting period ends 30 days after *both* sides to the deal have submitted completed pre-merger notification forms. (For cash tender offers, the waiting period is 15 days and starts with the offeror's completed filing.) The acquiring party pays a $45,000 filing fee.

Once the filing is done, the waiting period will expire automatically unless the Department of Justice or FTC issues the dreaded "second request." A second request—usually a massive request for information and documents—tolls the waiting period. It doesn't restart until the parties have complied with the second request. The waiting period then extends for an additional 20 days (10 in cash tender offers). As a practical matter, the second request means negotiations with the government enforcers to convince them to let the deal close, rather than bring an injunctive action to block it. These are the times with that investment for antitrust counsel and economists early in deal planning pays dividends.

There can be pay-back on that investment even for deals that have little competitive significance. You can request early termination of the waiting period, and because you invested in the antitrust homework, your antitrust counsel should be able to demonstrate why early termination is appropriate as part of the pre-merger notification filing. The only down-side to early termination is those granted are publicized in the *Federal Register*. The up-side is early termination can cut two to three weeks from the waiting period.

Avoid Antitrust Traps

1. Know the Competitive Benefits of the Deal

Be prepared to "tell your story" of the benefits of the deal for consumers and competition. There is nothing wrong or illegal about seeking to increase profits or investment returns as a result of an acquisition, but the means to achieving those ends cannot be based on gaining "market dominance" through the acquisition. Any deal worth its salt ought to present tangible benefits for the consumers in the markets served by the merging firms. Identify them early, and repeat them often, particularly in transaction analyses and other deal documents. Be sure those strategic planners understand and focus on these benefits in their promotion of the deal.

2. Avoid "Bad" Documents

As most deals of any significance will be subject to premerger reporting, most deal parties will have to submit to the Department of Justice and FTC all documentation prepared "for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, product or geographic markets." (*Premerger Notification and Report Form*, Instructions for Item 4(c)) Documenting bravado characterizations like "market dominance," "ease the way for price increases," "eliminate a price-cutter or renegade or aggressive or disruptive competitor," etc., is a sure way to generate antitrust scrutiny. Such characterizations are seldom factually accurate, yet they suggest at least an anticompetitive purpose for the deal. Remember—you may have to explain what appears in your documents to a hostile government enforcer, a court, or a jury.

3. Be Careful about Exchanging Competitively Sensitive Information

There is no exemption for deal due diligence from the Sherman Act § 1 *per se*, prohibitions against competitors exchanging price, cost, customer and similar competitively sensitive information. It is therefore prudent to enter into a confidentiality agreement that limits access to such information to those who need to know for purposes of deciding whether to proceed with the transaction. In addition, only that information legitimately required for such decision-making should be exchanged. Once agreement on the essential terms of a deal has been reached, there may be little further justification for continued exchange of competitively sensitive data before the deal closes.

Conclusion

The impact of the antitrust laws on mergers and acquisitions can and should be aggressively managed from the outset of deal planning. All it takes is sensitivity for the competitive issues deals may present, willingness to invest the resources to determine early on whether a transaction may raise competitive concerns, and commitment to develop the market facts needed to defend it on the competitive merits. The alternative could be a good deal lost because you failed to consider and prepare for antitrust issues.