If at First You Succeed . . . Counseling for the Close of a Merger Between Competitors

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Clearance under the Hart-Scott-Rodino ("HSR") Act, or closing a merger too small to trigger the thresholds for HSR notification and review altogether, is no guarantee that the government will not one day decide to open an investigation into the competitive effects of a consummated transaction. In the wake of FTC Chairman Muris' August 7, 2001, introductory speech foreshadowing increased agency focus on closed mergers[1] the government has challenged several consummated transactions, including those against both Chicago Bridge and Aspen Technology; has negotiated divestitures following the closing of acquisitions by MSC.Software and Airgas; and has challenged a license agreement between Wind River and MathWorks. Success, if defined by closing, may only be temporary.

While merging parties can look to no statute of limitations or other safe harbor for their transaction, they can minimize the likelihood of a post-closing investigation, lessen the likelihood of challenge, mitigate the business impact if the government seeks relief after the closing, and position themselves for a strong defense in the event of a post-consummation antitrust challenge. Below, with a particular eye to transactions in high-technology industries, we discuss practical tips to minimize the risk of a post-closing investigation and some of the unique substantive legal issues that frequently arise in such investigations. Finally, we leave with a cautionary word regarding unintended potential hazards of aggressive post-closing enforcement tactics.

Minimizing the Risk of an Investigation

One easily overlooked consideration to minimize the risk of a painful, post-closing investigation is to pay attention to third parties—customers, as well as suppliers, distributors and employees—who could feel aggrieved by the transaction and potentially feed a government investigation. In large acquisitions, where pre-acquisition HSR scrutiny is expected, the merging parties typically expend significant energy assessing and courting positive customer and other third party reaction to their deal. In non-reportable transactions or transactions that pass HSR scrutiny intact, however, the contrast may be stark: concern for these constituencies is likely to be relegated far below more immediate details of post-consummation integration.

[1] Timothy J. Muris, Antitrust Enforcement at the Federal Trade Commission: In a Word – Continuity, Prepared Remarks Before the ABA Antitrust Section Annual Meeting, Chicago, IL (August 7, 2001) ("[w]e are quite prepared to go after consummated mergers or mergers that are too small to require an HSR filing"), http://www.ftc.gov/speeches/muris/murisaba.htm.

But beware—merging parties insensitive to third party interests act at their own peril. The government often makes evidence supplied by customers, distributors, and suppliers the crux of its post-closing case. Even if, as discussed below, this evidence may not be particularly probative in a challenge, it can and often does serve as the basis to bring an action.

The Hearst Trust[2] and Monier Lifetile[3] cases provide two examples. In The Hearst Trust, the government brought suit to unwind the merger of The Hearst Corporation's subsidiary First DataBank, Inc. with Medi-Span, Inc. The companies were the only two suppliers of integratable drug information databases that contained comprehensive clinical, pricing and other information on prescription and non-prescription medicines used by pharmacists and physicians to obtain critical information about drugs for patients. Following the acquisition, the FTC alleged that First DataBank "drastically increased prices . . . . in some instances more than doubled or tripled the total fees previously paid" and reduced the level of "customer service quality" and the level of "development of new and innovative products." In Monier Lifetile, two of the largest concrete roofing companies—Lafarge (through its subsidiary Monier, Inc.) and Boaral Ltd.—formed an LLC, combining their concrete roofing operations. Following the formation of the Monier joint venture, the FTC alleged that "Monier Lifetile ... closed plants and reduced the amount of production capacity. . . . [C]ustomers ... report[ed] significant tile shortages in the relevant markets." Monier also increased prices significantly and the remaining, smaller competitors quickly followed suit. The FTC learned of these competitive problems from complaining customers.

These cases teach a clear lesson: take special care to ensure that post-closing actions do not unnecessarily prompt those who have a relationship with the company to complain about what they may perceive as a transaction's anti-competitive effect. Listed below are some considerations that—depending on the level of perceived risk—it may be appropriate to follow:

1. Defer or exercise great caution in raising prices, particularly in the first few quarters after closing. This rule encompasses more than just naked price increases. Even obvious slowing in the rate of price decreases may elicit antitrust interest. Further, parties should carefully consider keeping existing distributor discount schedules and honoring (even where not binding) upgrade schedules and service plans of the acquired party.

2. Do not terminate distributors or suppliers wholesale. If an entire class of distributors is eliminated as a result of a merger, the parties have created (from the government's perspective), the ideal group of complainants to provide important evidence concerning the ill effects of the merger. At the same time, the parties should maintain volume commitments previously agreed upon with the acquired party.

3. Avoid forced migrations from one product to another and minimize the adverse impact on customers when migration is required. In high-tech industries, in particular, parties offering competitive products often want to ra-

[2] See Complaint for Permanent Injunction and Other Equitable Relief, FTC v. The Hearst Trust, et al., Civil Action No. 1:01CV00734 (D.D.C. filed April 5, 2001), http://www.ftc.gov/os/2001/04/hearstcmp.htm.

[3] See Administrative Complaint, In the Matter of Monier Lifetile, Docket No. 9290 (Sept. 22, 1998) http://www.ftc.gov/os/1998/09/moniercmp.htm. At the time, the formation of an LLC was not a reportable transaction under the HSR Act.

tionalize (i.e., eliminate) one of the two product offerings or technologies. Customers are often loyal to the product they purchase, especially if they have also been required to invest heavily in training and maintenance. Forced migrations might also require customers to purchase new hardware or additional software (e.g., middleware) to accommodate the migration.

4. For a reasonable period of time, it may be important to continue to develop (not merely service), the acquired party's product line. Software, in particular, is a durable good, and customers in the industry may expect continued enhancements of their products for at least a lifecycle or two. As always, being clear and straightforward with customers before the merger about these plans is critical—as is then meeting those expectations afterwards.

5. Do not eliminate the target's entire support organization, at least precipitously or without warning. Laying off this entire group on Day One, while perhaps tempting, should be assessed in light of the impact on customers. Here as elsewhere, good business sense goes a long way toward mitigating the antitrust risk.

Preparing for an Investigation

It may be difficult to convince clients that legal or economic consulting fees should be spent in the rush of a merger that escapes HSR review. But clear-headed antitrust risk assessment before closing, coupled with at least the skeleton of a winning strategy and some gathering of information, may determine success or failure in an antitrust investigation months or years later.

In post-closing investigations of high-tech mergers, we have found that there are several areas where the investigations bog down, and that there are several important legal points that the merging parties must be able to rebut in order to resolve the government's concerns quickly. Specifically, the parties should be prepared to (1) define the contours of the relevant market and demonstrate that the market has evolved since closing, (2) discount post-acquisition evidence that purportedly demonstrates that the merger resulted in competitive problems, and (3) in the event that the government's concerns cannot be resolved quickly, present a viable remedy that preserves the benefits of the transaction.

Defining the Market

In today's rapidly developing industries, markets and market definitions change frequently. What may have been considered a market yesterday is an afterthought today. For example, no one is concerned about the electronic word processor market or the company that once dominated it, Wang.

Historically, regulatory review focused on a static view of relevant markets. Because high-tech markets change dynamically, it is imperative to argue to the agencies that they carefully consider whether mergers that lead to apparent concentration truly are anticompetitive or instead represent a temporary concentration. As the Court of Appeals for the D.C. Circuit observed in Microsoft, "[r]apid technological change leads to markets in which firms compete through innovation for temporary market dominance, from which they may be displaced by the next wave of product advancements."[4] Concentration does not result in anticompetitive market power if the market itself is only short lived. The problem is that post-close review may occur after considerable change in

[4] United States v. Microsoft Corp., 253 F.3d 35, 49 (D.C. Cir. 2002).

the market and competitive environment. Once the post-closing investigation has begun, it is all the more important for the merged company to debunk a static view of the market, whether measured now or when the merger closed months or years before.

Additionally, the parties should not overlook an argument that their products do not truly overlap. In Aspen Technology, the government contends that the parties' products overlap in several process software product lines.[5] The products, however, apparently serve distinct sets of customers in different industries.[6] Although how to draw the boundaries of a market appropriately is not unique to post-closing challenges, if the government seeks to unwind a merger already closed and after which the parties already have undertaken efforts to blur the lines of their products, it is especially important to determine, at the time of the merger, what the market looked like, and whether the parties served distinct sets of customers.

In short, the parties should be prepared to present their position to the agencies that, particularly in high-tech industries, the agencies must be cautious before rushing to judgment in defining relevant markets, especially following the closing of a transaction.

Use of Post-Acquisition Evidence

In their review of consummated mergers, the antitrust agencies often take a retrospective approach to examining the effects of a merger. The agencies can and do look at what has actually occurred in the market to determine the actual and potential competitive effects of the transactions that they are reviewing. Yet this should not be the end of the analysis. The parties should press the argument that, absent the government's ability to establish a causal link between the merger and the cited post-closing conduct or condition, the conduct or condition should not be considered probative.[7] That is, the government must establish that the merger is the reason for the arguably anticompetitive result.

Especially in today's quickly changing markets, this may be a difficult burden for the government to meet. For example, in a networked industry, one must seriously question whether the tipping of a market to a technology adopted by a firm that recently engaged in a series of acquisitions is a result of those acquisitions, or alternatively (and equally likely in many industries), because of an inherent advantage in the technology that caused customers to choose that platform over its rivals.[8]

Thus, if the government claims that the merger resulted in market shares that are too high and have increased disproportionately following closing, the parties should look for post-merger evidence to rebut these claims, showing that the merger did not result in market power. The combined company should carefully consider, for example, whether the merger occurred in an industry that developed rapidly in the past and where market leaders have been supplanted by challengers who developed disruptive technology that changed the fundamental features of the market. If so,

[5] See Complaint, In the Matter of Aspen Technology, Inc., Docket No. 9310, (August 6, 2003), http://www.ftc.gov/os/2003/08/aspencmp.pdf.

[6] See Jaret Seilberg, "Defining Terms," The Deal.com (Sept. 19, 2003), at http://www.thedeal.com.

[7] See United States v. Archer-Daniels-Midland Co., 781 F. Supp. 1440 (S.D. Iowa 1991).

[8] See FTC v. Procter & Gamble Co., 386 U.S. 568, 591 (1967) (Harlan, J. dissenting) ("[P]ost-merger evidence [is] generally irrelevant and 'proper only in the unusual case in which the structure of the market has changed radically since the merger. . . . Market structure changes, rather than evidence of market behavior, [are] the key to a section 7 analysis.").

then it is possible that the post-closing firm's product is either part of a much larger market, or, instead, is in a market that fundamentally has or is about to change, making a challenge unnecessary. To demonstrate, for example, that a new challenger can develop technology making current market definitions, shares and inferences invalid would require an in-depth analysis into whether such changes have occurred in the past or are occurring in adjacent markets, and whether customers are demanding significant changes to existing products.

The parties also should gather evidence to rebut claims that market shares are high. For example, the parties might contend that the agencies not only should look at changes in market share following closing, but also should consider current pipeline opportunities for competitors and potential competitors, to determine whether such competitors will, in the future, become significant in an industry. Even if not significant by present-day market share standards, a company could be competitively substantial if, for example, that company has an increasing number of design wins for next generation technology.[9]

Relief, After the Eggs Have Been Scrambled

There are times, no doubt, when relief requires the divestiture of acquired assets, along with improvements to restore an industry's pre-transaction competitive balance.[10] However, particularly if a transaction has closed and integration has occurred, a compelling argument may exist that non-structural relief provides the best means not only to restore competitive balance, but, to the extent possible, to preserve the benefits created by the merger.

The FTC's 2002 negotiated consent with MSC.Software highlights some of the more significant concerns associated with post-closing relief in today's high-tech markets. In its administrative complaint against the company, the FTC sought to unwind two previously closed acquisitions by MSC.Software of its rivals. The value of each deal had been well below the HSR reporting threshold ($8 million and $10 million). As part of a post-closing consent order the FTC and MSC.Software agreed that MSC.Software would divest at least one clone copy of its current advanced Nastran software, including the source code, to one or two acquirers who must be approved by the FTC.[11]

The proceedings in MSC.Software cost the company millions of dollars, took more than a year to resolve, and resulted in a substantial diminution in the competitive significance of MSC.Software's Nastran business unit. Pre-acquisition, MSC.Software was the dominant player in the market and presumably did not need to expend tremendous resources competing against its two inferior competitors. One must wonder whether the ordered relief and the lengthy and costly proceedings that led to that decision will impair MSC.Software's ability to compete effectively, causing a reduction, rather than the promotion, of competition.

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[9] See Gregory J. Werden, Assigning Market Share, 70 Antitrust L.J. 67, 89-90 (2002) ("Recent orders, like recent contract awards, reflect the current competition in the market, while deliveries reflect conditions at some point in the past, possibly even the distant past. A good case can be made for assigning shares on the basis of orders . . . .").

[10] See, e.g., In the Matter of Crown Zellerbach Corp., 54 F.T.C. 769 (1957). The Commission is currently litigating the appropriate scope of relief in In the Matter of Chicago Bridge and Iron Co. N.V., et al., Docket No. 9300, http://www.ftc.gov/os/caselist/d9300.htm.

[11] See FTC Press Release, MSC.Software Settles FTC Charges by Divesting Nastran Software (Aug. 14, 2002), http://www.ftc.gov/opa/2002/08/mscsoftware.htm.

Especially in high-tech markets, the parties should emphasize that post-closing divestiture of assets may very well reduce consumer welfare. Consider, for example, the difficulties of unwinding a high-tech hardware merger. Assuming that the assets of the acquired party still exist, it is possible—if not probable—that the assets of one of the two parties have become outdated. To improve them to a state such that they would represent a viable competitive business would cost a tremendous amount of money and time, and would create a tremendous inefficiency in the market. In the end, there is no guarantee that divestiture would restore the competitive balance. Nonstructural relief, such as granting third parties access to the hardware, could achieve the same result, while maintaining the efficiencies that the parties realized as a result of merging.

Conclusion

We conclude with an observation. Last year, the FTC closed its antitrust investigation and approved the merger of Synopsys, Inc. and Avant! Corporation.[12] Although the investigation neither resulted in a challenge to the merger nor required the parties to restructure the deal in any way, the FTC's inquiry was searching, lasting almost eight months beyond the closing of the transaction. In an admonition to the post-merger company, three Commissioners—Anthony, Leary and Thompson—separately drafted public statements, announcing to the industry that although the agency cleared the merger, it did so only hesitantly; Commissioner Anthony urged "customers and competitors to keep the Commission fully apprised of post-acquisition market developments, in case a future enforcement action becomes necessary."[13] In doing so, the Commissioners gave notice that they would be watching the activities of the combined firm closely and would not hesitate to intervene if they learn that the company engaged in anticompetitive conduct.

The danger of the Commissioners' approach in Synopsys / Avant! is that it may carry unintended consequences. Under the gaze of perpetual merger review, firms may feel prevented from competing aggressively. High-tech firms engaging in competitive transactions likely may feel some pressure from the Commission's statement to act conservatively, fearing that the antitrust agencies—spurred by complaints from, for example, suppliers and distributors who were eventually rationalized by the combined company—may at some point in the future challenge their deal as anticompetitive. As a result, otherwise procompetitve conduct may be inhibited out of concern for engendering third party complaints.

While post-acquisition review and challenge may be necessary in some cases to correct problems not captured during HSR review (if any), these legitimate business concerns—and the attendant risk of chilling procompetitive conduct—militate against aggressive use of such review. As Congress noted during debate over the enactment of the HSR Act, post-closing review can impose substantial costs "to the [merging] firms, the courts and the marketplace."[14] The specter of aggressive post-closing review could have the same effect.

[12] See In the Matter of Synopsys, Inc./Avant! Corp. (closing letter) (July 26, 2002), http://www.ftc.gov/os/caselist/0210049.htm.

[13] Statement of Commissioner Sheila F. Anthony, In the Matter of Synopsys, Inc/Avant!Corp., http://www.ftc.gov/os/2002/07/advantanthonystmnt.htm.

[14] See H.R. No. 94-1373 (1976), reprinted in 1976 U.S.C.C.A.N. at 2637.