Claiming merger efficiencies at agencies, courts

Merging parties must meet high standards in detailing possible consumer benefits.

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EFFICIENCY CONSIDERATIONS often drive companies to merge. The prospect of reducing overlapping research and development, realizing production efficiencies and creating synergies in distribution, sales and marketing offers companies the opportunity to drive innovation, reduce overhead and pass significant savings along to customers. Yet the courts and antitrust agencies have not always been receptive to such justifications for mergers—in fact, until recent times, claims of efficiencies were considered irrelevant in merger analysis.

During the Clinton administration, the Federal Trade Commission (FTC) and the Antitrust Division of the U.S. Department of Justice sought to reverse this skepticism in their 1997 revisions to the 1992 Horizontal Merger Guidelines, available at www.ftc.gov/bc/docs/horizmer.htm. The revisions reflected the agencies' intent to become more receptive to claims of efficiency in evaluating mergers and their effect on the competitive balance in an industry.

Seven years after the 1997 revisions, antitrust practitioners are still left wondering whether, and to what extent, efficiencies analysis affects the antitrust analysis of mergers. Shortly before being named chairman of the FTC, Timothy J. Muris, at the time a professor at George Mason University School of Law, published an article examining the shortcomings of the antitrust agencies in analyzing claims of efficiencies. Timothy J. Muris, "The Government and Merger Efficiencies: Still Hostile After All These Years," 7 Geo. Mason L. Rev. 729, 732 (1999). Yet after almost four years of the Bush administration, Muris' observation still holds true.

This article provides an overview of the framework of efficiencies analysis, focusing on suggestions as to how parties can best present efficiency arguments to the antitrust authorities.

The 1997 revisions tied efficiencies directly to a competitive-effects analysis. The revisions recognized that efficiencies could "increas[e] the...incentive and ability to compete." The revisions included as potential efficiencies improved quality, enhanced service or new products as well as the availability of lower prices. So long as the efficiencies were cognizable—according to the guidelines, cognizable means merger specific, verifiable and not arising from anti-competitive reductions in output or service—such efficiencies must be considered in merger analysis. The ultimate determination is that a merger will not be challenged "if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market."

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Because the antitrust agencies and courts remain extremely skeptical when analyzing efficiency claims, it is of critical importance to present such claims properly during the merger investigation. Below are suggestions on how best to approach the agencies when making efficiency claims.

Efficiencies in practice

The standards that the agencies and courts have set for parties to successfully defend a merger with claims of efficiencies are extremely high, and require the parties to detail possible benefits to consumer welfare with a level of particularity that generally is not part of the premerger process. Of course, companies have general conceptions that mergers will result in cost savings, make production more efficient or enable the creation of best-of-breed innovative products. Without the benefit of actual integration, however, it is difficult to quantify such benefits in the particular detail that the agencies require.

Given that the agencies still are relatively hostile to claims of efficiencies in merger analysis, it is extremely important that parties carefully consider how to position their efficiency claims before the government. Parties should probably consider the following before making an efficiency claim to the antitrust agencies:

■ Are the company's claims well documented in ordinary-course-of-business documents? The agencies and courts have taken the position that post hoc efficiency studies are not persuasive, and tend to discount them for antitrust analysis. It is important from the outset to engage antitrust counsel as to how best to document efficiency analyses from the earliest stages of transaction planning.

■ What types of efficiencies is the company highlighting? Practitioners know from agency actions, speeches, case law and reports which types of efficiency claims are most persuasive to the agencies, and which will not carry much weight in a merger analysis. On the one hand, the agencies tend to place great emphasis on production efficiencies, but

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ers, as well as consumers, by reducing the costs of other software products that would be added on to the platform.

The court, therefore, adopted a rule-of-reason approach, under which the government would bear the burden of showing that the harm to competition from integration of features into software outweighs its efficiency benefits. This test, which the *Microsoft III* court expressly limited to software tying cases, is a far cry from the presumption that tying is per se illegal. Far more than under European competition doctrine, the rule-of-reason approach seems in keeping with an understanding of why all software firms bundle features together rather than sell each one discretely and why software programs grow over time to house more and more features that once were sold separately.

Microsoft III's test stops well shy of acknowledging that the practice the court was addressing—and the problem with treating the practice as presumptively illicit—was not peculiar to the software business. The court also set forth a test that does not readily distinguish the problematic tie from the ordinary, market-driven integration of features and that leaves a great deal of discretion to the decision-maker in the particular case.

Microsoft III's rejection of the per se illegality approach clearly goes a step beyond *Jefferson Parish* in its recognition of the efficiencies of tying. Before software businesses crack open the champagne to celebrate, however, they should think about two things. First, the new rule-of-reason test for software integration, although more lenient than the hybrid per se test generally applied to tying, is actually a more restrictive test than the one courts traditionally have applied to the physical integration of existing products. In this sense, *Microsoft III* will appear to some as a step backward along tying law's path.

Second, software businesses should consider the difficulties that arise under the rule-of-reason test. How will the burden of proof ultimately be allocated by courts? How will anti-competitive harms be determined—by the complaints of rival software firms or by proof of harm to the typical consumer? Will the test accommodate instances in which efficiencies are likely to be realized only after several years have passed? Will allowance be made for "honest mistakes" in business judgment, as when a firm takes a competitive action that harms a rival and the resulting efficiencies are weaker, or further delayed, than anticipated? How much weight should be put on market share in software markets, where consumer herding imparts volatility to market share statistics?

Given the continuing pressures on the per se illegality rule, the future of tying law depends on how courts answer these questions. A rule-of-reason test that makes sense in light of tying's efficiencies, in software and in other markets, would set a high standard of proof—perhaps requiring "clear and convincing" evidence—and put the burden on the plaintiff.

A test that aims for a formal neutrality by imposing significant proof burdens on the defendant would leave many businesses in the position they are in today, uncertain about the liability risks of tying. When the vast majority of ties are efficient, as observation suggests, the proper resting point for tying doctrine would seem to be on the other end of the spectrum from its per se illegality starting point: something close in operation to a presumption of legality. But after *Wal-Mart* and the European Union's *Microsoft* decision, the path toward such a tying doctrine will be a long one. NLJ

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generally discount distribution efficiencies. The agencies also require that parties demonstrate that such efficiencies are merger specific and could not be achieved in the absence of the transaction they are considering.

With that in mind, here are the types of efficiencies arguments that have been, and most likely will continue to be, the most persuasive in analyses of whether to challenge a merger as anti-competitive. Also described is how best to present such claims to the antitrust agencies.

Production efficiencies

The guidelines highlight that production efficiencies—those "efficiencies resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the marginal cost of production"—are "among the most worthy of recognition." Thus, a merger that would enable a combined company to make better use of its facilities, or improve the quality and pace of production, likely would have an impact on merger analysis.

When two parties can provide the agencies with evidence that shifting production among facilities will enable the merged company to reduce the marginal cost of production, such evidence should go a long way to justify a merger.

The agencies should start with the presumption that production efficiencies benefit consumers: With the combined company able to reduce overall costs, unless demonstrated otherwise, the agencies should assume that such cost savings will benefit consumers in the form of lower prices or better goods in the long term. Thus, when the parties can demonstrate that a merger would provide economies of scale, economies of scope or other synergistic effects of a merger, such factors should go a long way toward demonstrating the pro-competitive rationale of a merger.

Two hospital mergers illustrate the importance of production efficiencies: *FTC v. Butterworth Health Corp.* and *U.S. v. Long Island Jewish Medical Center*. In these cases, the courts concluded, over government objection, that the mergers would produce significant efficiencies sufficient to allow the mergers to proceed.

In *FTC v. Butterworth Health Corp.*, 946 F. Supp. 1285 (W.D. Mich. 1996), aff'd, 121 F.3d 708 (6th Cir. 1997), the FTC sought to enjoin the merger of the two largest hospitals in the Grand Rapids, Mich., area. The district court found that the FTC had established that the merger would result in a significant increase in concentration in the markets for primary and general acute inpatient hospital services. Nevertheless, the court concluded that the public would be best served by permitting the hospitals to achieve the efficiencies that the merger would allow, creating a world-class health facility in western Michigan.

By allowing the merger to proceed, the court accepted the hospitals' efficiencies defense as a counterweight to the increased concentration caused by the merger. The court accepted the hospitals' claim that the merger would enable the parties to avoid approximately $100 million of capital expenditures in their ongoing "medical arms race" and lead to more than $68 million in operating efficiencies over a period of five years following the merger.

Likewise, in *U.S. v. Long Island Jewish Medical Center*, 983 F. Supp. 121, 147 (E.D.N.Y. 1997), the district court accepted the parties' proffered efficiency justification. The court held that the parties must prove that the merger is likely to "enhance rather than hinder competition because of increased efficiency." The court found that the efficiencies that were claimed, which were on the order of $25 million to $30 million per year, met both standards, in part because the hospitals were nonprofit and would therefore be likely to pass any cost savings on to the community, which they had committed to doing in an agreement with the New York state attorney general.

The court balanced the potential for reduced competition following the merger against the projected efficiencies that the merger was expected to generate. The court carefully considered the claimed efficiencies, including the elimination of duplicative managerial, administrative and clinical employees, reduced capital expenditures and economies in purchasing medical supplies.

Guidelines focus on merits of production efficiencies above all.

Distribution and promotion

The revisions to the guidelines do not discuss distribution and promotion efficiencies, but the FTC staff report does, stating that such efficiencies "are less likely to be substantial and are often likely to be difficult to assess." See FTC staff report, Anticipating the 21st Century: Competition Policy in the New High-Tech Global Marketplace, ch. 2, pt. III, at 20-43 (May 1996), available at www.ftc.gov/opp/global/report/gc_v1.pdf. Muris nevertheless has noted that in "some industries, economies in product promotion are as important as economies of large scale production and distribution in providing cost advantages for market leaders. In consumer goods, for example, promotion economies are substantial and may require larger market shares to achieve minimum efficient scale than would be suggested by only production and distributional efficiencies." See Muris, supra.

These promotion and distribution efficiencies have yet to carry much weight in recent FTC decisions, even though they may be substantial. The key to success in claims of distribution and promotional savings is carefully documenting up front, before the agencies begin their investigation, precisely where the savings will be generated, and that such savings will either be passed along to consumers, or alternatively, will enable further investment, e.g., into product innovations.

The guidelines do not spend much time on research and development (R&D) efficiencies, simply noting that claims "relating to research and development are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions." The FTC staff report accompanying the release of the revisions notes: "Claims of innovation efficiencies may be more difficult to evaluate depending on whether they rely on combinations of clearly complementary patent-protected technology or on vague assertions of synergies from combined personnel with certain scientific expertise, for example. Nonetheless, innovation efficiencies may make a particularly powerful contribution to competitive dynamics, the national R&D effort, and consumer (and overall) welfare." See FTC staff report, supra.

In high-technology deals, in particular, innovation efficiencies drive the decision to merge. Combining the R&D departments of two companies often provides synergies beyond just the elimination of duplicative efforts, and often will enable the combined company to pursue more diverse and complementary research efforts. When approaching the agencies with innovation efficiencies, it would be most helpful to demonstrate that future product development would be enhanced by the combination of the parties' research efforts.

The FTC recently considered innovation efficiencies in its decision not to challenge the merger between Genzyme and Novazyme—two companies engaged in the preclinical research of treatment for Pompe disease, a rare childhood illness. See Statement of Chairman Timothy J. Muris, *In the Matter of Genzyme Corp./Novazyme Pharmaceuticals Inc.*, available at www.ftc.gov/os/2004/01/murisgenzymestmt.pdf. In *Genzyme*, the FTC heavily relied on the existence of R&D efficiencies in its decision to pass on a challenge of the merger. The fact that this was an investigation into a merger that had already closed made the efficiencies analysis more important than in other cases; the efficiencies were readily observable, and in the consummated-merger context, any relief would have to undo any efficiencies already presented to the market. In *Genzyme*, Muris drafted a separate statement and observed that the merger resulted in several concrete benefits: It made possible comparative experiments between the Novazyme and Genzyme programs, and provided Genzyme with information that enabled the Novazyme researchers to avoid drilling dry holes; it accelerated the Novazyme program; and it resulted in synergies between the two programs.

Other efficiency defenses

The antitrust agencies have not traditionally looked to other categories of efficiencies. However, in addition to traditional distribution and promotion efficiencies considered by the guidelines, parties should consider bringing to the agencies other transactional efficiencies, including procurement savings, managerial savings and other reductions in duplicative resources.

When a merger enables, for example, the streamlining of the number of suppliers for a combined company, or provides additional purchasing power for the combined company, such efficiencies ultimately can benefit consumers. With fixed costs reduced, the combined company may be able to offer consumers lower prices or better products. Likewise, the elimination of redundant capital costs—e.g., leaseholds or other real-property expenses—also can result in cost savings and benefits to consumer welfare. Although not traditionally considered, a well-presented claim of "other" efficiencies could help the merger review process.

Convincing the antitrust agencies and courts to permit mergers based on efficiencies poses many challenges. Yet if properly prepared and documented, these claims may be vital to successfully demonstrating the pro-competitive nature of an acquisition. It is a vital endeavor in antitrust merger advocacy. NLJ