A MERGERS & ACQUISITIONS ADVISOR EDUCATION SERIES

DOCUMENTS KILL: THE IMPORTANCE OF A COMPANY'S EVERYDAY BUSINESS DOCUMENTS IN THE ANTITRUST MERGER REVIEW PROCESS

INTERNAL DOCUMENTS DISCUSSING NEARLY ANY ASPECT OF A MERGER'S MARKETPLACE BENEFITS MAY BECOME CRITICAL EVIDENCE IN GOVERNMENT ANTITRUST INVESTIGATION

By Scott A. Sher

Documents created by parties to a merger oftentimes unwittingly steer the government's antitrust review of the transaction. Specifically, documents created before, during and immediately following the merger announcement provide the government with a quick and easy indication of how the parties and the industry view the merger in competitive terms. "Bad" documents (i.e., those documents indicating the merger will possibly lessen competition) will likely lead to a prolonged antitrust investigation and may form the basis of a challenge of the proposed merger or acquisition in court. "Good" documents (i.e., those documents demonstrating the merger will result in synergies or efficiencies to the benefit of consumers), on the other hand, can facilitate—and in fact, short-circuit—a merger investigation.

Newly appointed Federal Trade Commission Chairman Timothy Muris has emphasized that under his guidance, the commission will take a renewed interest in "the facts." In his inaugural speech on August 17, 2001, Chairman Muris provided us with a glimpse into this new emphasis of the Bush Administration: "We learned long ago that *facts are stubborn things* in merger enforcement. No economic theory or story-based advocacy about a merger will give you a reliable answer unless the facts firmly support it. This is absolutely as it should be. This is why no change in Administration or change in faces in the agencies will significantly change merger enforcement. Just as we have the burden of proving that a merger likely will be anticompetitive, you will need to demonstrate with sound, stubborn fact-based analyses the claims that you make."[1]

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According to Muris, no amount of legal persuasion or artifice can overcome actual facts. Thus, it is important to be cognizant of how the transacting company and industry—from competitors to customers to third party analysts—describe the competitive landscape of the industry. Equally important, parties to a merger must consider how they describe the reasons for the transaction in board presentations, internal e-mails, press releases and public filings submitted to other government agencies in connection with the merger process (e.g., SEC filings). In "close-calls" these documents may carry the day and tip the government's decision in favor of allowing a merger to proceed rather than expanding an investigation or ultimately, challenging the transaction in court.

A Multi-Step Process

The antitrust merger review process consists of various steps. Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR)[2], mergers or acquisitions of assets or voting securities of a certain size (generally $50 million)[3] are reportable to the government. The Department of Justice and FTC have concurrent jurisdiction to review the merger, and these two agencies decide amongst themselves which will take the lead in the investigation *(see related article on page 1)*. Upon such notification, the parties to the planned transaction are required to submit certain information to the reviewing agency. Most of the information relates to how the parties categorize their revenues by product; where the parties have revenue generated from overlapping products, the government has its first indication that the proposed combination will result in some consolidation in the industry.

More importantly, HSR requires the parties to submit to the government certain documents that discuss the transaction. Item 4(c) of the HSR Act Notification Form requires each party to submit: "All studies, surveys, analyses and reports which were prepared by or for any officer(s) or director(s) for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, competitors, markets, potential for sales growth or expansion into product or geographic markets and indicate (if not contained in the document itself) the date of preparation, and the name and title of each individual who prepared such document."[4]

> HSR requires the parties to submit to the government documents that discuss the transaction.

Any document addressing the competitive effects of a proposed transaction and prepared by or for an officer or director—whether a formal analysis or study prepared for management, a draft of a document prepared by or for an officer that was never finalized, a presentation annotated by a member of the Board of Directors, the handwritten notes of any officer or director, or an e-mail prepared by or for an officer or director—must be provided to the government with a party's pre-merger filing. In addition, documents prepared by non-employees, such as investment bankers or consultants, for officers or directors, also fall within the scope of Item 4(c).

Government May Review Many Types of Documents

In addition to Item 4(c) documents, the government will also have access to the parties' public filings, from ordinary course Securities and Exchange Commission documents, including 10-Ks, 10-Qs and proxy statements, to Rule 425[5] documents (e.g., press releases discussing the merger, analyst call transcripts and Q&As). This collection of documents will guide the government's initial review, and this article will discuss how the

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government uses information gleaned from such submissions.

After the parties submit their filings, the government has a certain period of time—generally 30 days—to conduct an initial review of the transaction. If the government, at the end of that period, still has questions regarding the transaction, it will issue a broad, open-ended subpoena, a "Request for Additional Information,"[6] calling for a substantial portion of the parties' documents generated over the past several (generally three) years. It is through this process that the government gains a more full and unadulterated view of how the parties view their relative positions in the market, as well as their business, marketing and strategic future plans. In addition to the time and expense associated with compliance with the government's request, parties also become highly "exposed" during this secondary process, as document requests are no longer targeted. It is during this latter review that the government collects its weapons—the parties' "bad" documents—to use if it ultimately challenges the merger in court.

Through the (document review) process, the government gains an unadulterated view of how parties view their relative positions in the market.

This article will discuss three categories of documents targeted during the different phases of antitrust review of a merger and provide recent examples of how such documents were used during enforcement actions initiated by the early-Bush and late-Clinton administrations. Specifically, the article will look at: (1) merger related documents (i.e., all documents created by the parties used to analyze the merger); (2) merger "collateral" (e.g., press releases, analyst call transcripts and SEC filings); and (3) contemporaneous business documents created during the ordinary course of a company's business (e.g., business, strategic and marketing plans as well as product roadmaps, discount schedules, and pricing plans).

The goal of this article is to provide an understanding of what the government considers important in its review of business documents, and how the company can more carefully draft such documents with an eye towards antitrust review.

1. Documents that Analyze the Merger in Competitive Terms

"After the merger, customers will have the choice, but of course the only choice is ours. We will obviously increase prices. . . ."

"This merger will give us leverage over customers, allowing us to raise our gross margins." [7]

Documents kill. Parties, of course, create documents during the merger consideration and negotiation process: Bankers are retained; they create books and analyses to present to the board; board members and officers deliberate the merits of the proposed transaction, oftentimes generating presentations or memoranda summarizing key points related to the merger; high-level officers and directors send e-mails back and forth discussing the positives and negatives of the deal. These documents are reportable to the government during the antitrust review process as Item 4(c) documents, and may seriously impact the length and ultimately the outcome of a merger investigation.

The antitrust agencies attribute great significance to Item 4(c) documents; in fact, these documents provide the agencies with the only true "inside" look at a merger during the initial review process—all other information available to the government is found within the public domain. Very recently, the government brought an action for divestiture and disgorgement of profits against the Hearst Trust, relying on the failure to submit crucial 4(c) documents as the basis to challenge a merger that had been consummated three years prior.[8]

Internal documents may seriously impact the length and ultimately the outcome of a merger investigation.

<u>*Federal Trade Commission v. The Hearst Trust*</u>

In April, the FTC brought suit against the **Hearst Trust** in connection with the company's 1998 acquisition of **Medi-Span, Inc**.[9] The government complained that "the acquisition took place after Defendant Hearst failed to produce documents required by HSR for the commission's pre-merger review of the proposed acquisition."[10] Thus, the failure to produce these documents resulted in a significant civil suit against the Hearst Corp.

Initially, the FTC filed a civil suit against Hearst, and sought to unwind its three-year-old merger. Additionally, the FTC sought disgorgement of profits and an order imposing fines of $11,000 per day from the closing date for Hearst's alleged failure to fully comply with the pre-merger filing requirements imposed by HSR. In November 2001, Hearst agreed to divest Medi-Span, pay a $4 million fine for failing to comply with HSR, and disgorge $19 million in profits that it accumulated as a result of the Medi-Span acquisition. *Hearst* arose, in large part, because the parties failed to submit all documents required by HSR. That failure enabled the FTC to seek and ultimately prevail in obtaining extraordinary and unprecedented relief.[11]

Draft Documents with Care

Hearst is but one recent example of the importance of 4(c) documents. Although it is impossible to hide a "bad" merger from the government, it is possible to educate the parties and their representatives (including bankers) as to the importance of careful drafting. Authors of board books, e-mails, and memos must be cognizant of the danger that what they write—ostensibly for their own personal purposes—may indeed end up in the

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hands of the government during the antitrust review process. Informal or off-hand hyperbole discussing how the combined entity will be a "dominant gorilla" or would be able to "muscle their distributors" could end up costing merging parties crucial time and money defending an otherwise benign merger from a competitive standpoint.

Ill-chosen informal or off-hand written remarks could end up costing crucial time and money.

It is important that parties work with counsel to discuss the pratfalls associated with poorly drafted merger-related documents. It is also important that parties remember, when drafting these documents, to enumerate—rather than hide—the pro-competitive reasons that spurred the parties to enter into the agreement in the first place. It could not hurt, if true, to highlight in a board presentation that the parties are merging to provide their customers with a broader portfolio of products or, in the high-technology world, to elaborate that the combination will provide the combined entity with sufficient engineering resources to innovate more quickly and make best-of-breed products. Such emphasis could significantly assist the parties during antitrust review.

2. Merger Collateral

Careful drafting of merger collateral is also important for several reasons. First, merger collateral is available in the public domain. The government can and does search through a party's SEC filings for Rule 425 documents—the press release announcing the merger, the transcript of the analyst call discussing the merger and the Q&As—during its review of a transaction. And the government can and does listen in on webcasts of company calls discussing the merger. Second, the material, even if not available publicly, may very well be reportable in connection with the HSR process, as the government has taken the view, time and time again, that *all* collateral is responsive to Item 4(c) of the HSR Form.

Recently, the government brought a civil suit against **Computer Associates**[12] [NYSE:CA] in connection with its acquisition of **Platinum Technology Corp.** ("Platinum"). The government based its complaint upon actions that it learned of through statements Platinum made in public SEC filings as well as statements the parties made in the merger agreement itself.

United States of America v. Computer Associates

In March of 1999, Computer Associates and Platinum Technology entered into an agreement to merge.[13] The two companies were direct competitors—and actually, in some instances, the only two competitors—in the software management industry. The DOJ challenged the merger, and the parties ultimately agreed to divestiture of several divisions of Computer Associates in order to maintain competition in the problematic areas. That did not mark the end of the story for Computer Associates, and in fact, represented only the beginning of an action that culminated in a $1.2 million civil penalty imposed upon Computer Associates by the DOJ.[14]

In *Computer Associates*, the merger agreement contained extraordinary "conduct of business" provisions that prevented Platinum from engaging in certain activities during the HSR waiting period (i.e., before the merger was consummated) without first obtaining Computer Associates' approval.[15] Specifically, the merger agreement stated that Platinum could not unilaterally determine the prices and terms it would offer to its customers. Under the merger agreement, Platinum could not:

Terms of a merger agreement resulted in a huge fine for Computer Associates.

- offer discounts greater than 20 percent off list prices,
- vary the terms of customer contracts from a mutually agreed-upon "standard" contract,
- offer computer consulting services over 30 days at a fixed price, or
- enter into contracts to provide Y2K remediation services.

Computer Associates was "the sole arbiter" of whether to grant exceptions to these business restrictions during the HSR waiting period.[16] In fact, Computer Associates installed a division vice president at Platinum headquarters to approve Platinum customer contracts. Platinum even announced in its May 14, 1999, SEC 10-Q filing that these "extremely tight restrictions" on the ability to conduct business "could have a severe detrimental effect" on business.

To add insult to injury, on March 30, 1999, the day after the merger was announced, Platinum's President sent an e-mail notifying senior management that he would *terminate* any employee who violated these rules![17]

Ostensibly, these documents were crystal-clear evidence of collusion among competitors. Platinum, through its SEC filings and internal e-mail, connected the dots for the government. Platinum noted that the merger agreement with Computer Associates restrained its discounting program (i.e., ***price fixing***) and precluded Platinum from entering into contracts with certain customers without first obtaining approval from Computer Associates, its primary competitor (i.e., ***market allocation***). Obviously, prior to merging, these activities were illegal under our antitrust laws, and potentially even *criminal*, punishable with substantial prison time.

Government Scrutinizes Public Filings

More subtly though, is that parties must be aware that the government can and does carefully review publicly filed documents, and will use information obtained in 10-Ks and 10-Qs to help frame its merger review. Of course, most cases are not like *Computer Associates*. Most companies do not reduce to writing for their public SEC filings agreements not to compete or to fix prices. However, all companies do report in their 10-Ks and 10-Qs the competitive state of their industries. They list their primary competitors. They discuss competitive threats in their indus-

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tries—for example, blocking patent rights that preclude competition or costs that make it difficult for greenfield entrants to penetrate the industry—and these statements help shape the government's understanding of the industry involved. Thus, it is imperative that these filings be complete and accurate. It is important not to gloss over the competitive state of the industry and fail to state all businesses that the company competes against. It is important to set forth emerging competitive threats. With that in mind, it is becoming essential to involve antitrust counsel in the process of creating these documents, so that they are complete and do not paint the company into the corner when review of a merger occurs.[18]

3. Contemporaneous Business Documents

There is no substitute in the fact inquiry for contemporaneous business documents that discuss a company's view of itself in relation to the rest of the industry in which it participates. To the agencies, these documents represent unadulterated thoughts, not tainted by authors anticipating a government investigation. For example, "lost sales" reports, also commonly referred to as "won/loss" data, can be crucial in the merger review process. Lost sales reports—a company's business reports that list all of the companies that bid for each customer account—provide snapshot images of the competitive makeup of an industry. On the one hand, if won/loss data shows that multiple companies bid for customer accounts, that is strong evidence that an industry is competitive. Conversely, a company that argues that it faces vigorous competition from multiple sources will likely face an uphill battle if won/loss data reveals that only one or two other bidders regularly compete for the same accounts.[19]

In United States v. **SunGard Data Systems Inc**.,[20] [NYSE:SDS] a recent decision from the District Court for the District of Columbia, the DOJ sought to enjoin the merger of SunGard and **Comdisco** [NYSE:CDO], two "shared hotsite disaster recovery services" companies. The government argued that the merger represented a merger to duopoly, and post-merger there would be only two competing "shared hotsite disaster recovery services" companies left in the market. SunGard argued that the government incorrectly constricted the relevant product market to include only externally developed "shared hotsite" solutions; instead, SunGard contended that the proper market definition must include internally developed disaster recovery services. SunGard's proposed definition greatly expanded the number of competitors in the market, thereby lessening the concern that the merger would result in too much concentration. Judge Huvelle concluded that SunGard did compete with internally developed disaster recovery services, in large part because both SunGard and Comdisco's internal documents demonstrated that the companies lost a significant number of bids to companies that instead chose to develop their own solutions (i.e., won/loss data). Again, documents carried the day.

Fortunately, in the ordinary, vanilla-flavored merger investigation, these documents need never be turned over to the government. During the government's initial review of a proposed merger, these documents are shielded from government review, as merging parties are required to turn over to the government only documents that concern the transaction at hand. However, in the second request phase, the government has nearly unfettered access to all of a company's documents. What a company's business, strategic and market plans say about the industry gives the government the clearest indication of the state of competition. These "stubborn facts" often form the basis for a government challenge to a merger. In the end, merger "assessment is a matter of probability, not speculation, and the inquiry is necessarily factual."[21]

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After the second request phase of its investigation, the government has two choices: to allow the merger to proceed or to challenge it in court. What the government learns during the second request, from documents, interviews, depositions, and narrative responses, forms the basis for the decision to proceed. The decision in FTC v. **Staples Inc**. [Nasdaq:SPLS] perhaps provides one of the most glaring examples of how documents undermined arguments in support of a proposed transaction and spelled the end of a major business combination.[22]

Federal Trade Commission v. Staples Inc.

In Staples, the government challenged the proposed merger of two of the remaining three office superstores, Staples and **Office Depot Inc.** [NYSE:ODP] (the third was, and still is, **Office Max** [NYSE:OMX]). In that case, the government contended that the relevant market was the office supply superstore market, and the merger would result in a significant concentration of that market. In turn, the government contended that the merger would result in an increase in the prices of office supplies found in these superstores if the court allowed the merger to proceed. On the other hand, the merging parties contended that the government's definition of the market was too narrow: the parties argued that other stores, including giants such as **Wal-Mart** [NYSE:WMT] and **BJ's Wholesale Club** [NYSE:BJ], as well as the thousands of smaller office supply stores competed with the superstores, and surely would be able to constrain the parties' ability to raise office supply prices. The documents belied Staples' story. For example, Staples and Office Depot maintained documents showing that the companies promulgated different pricing policies, depending on whether another office superstore (i.e., Office Max or Office Depot) competed in the area, or whether only other retail stores like WalMart or BJ's were located in the area. These documents ultimately hamstrung the merging parties, as these business plans demonstrated that only other office superstores restrained the

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companies' pricing policies; retail giants like WalMart did not. It followed that Staples and Office Depot did not consider these companies to be true competitive threats.[23]

Staples also advanced an argument that the merger would generate significant efficiencies and would save the combined entity between $4.9 billion and $6.5 billion dollars.[24] Unfortunately for Staples, during the merger process, the company's board of directors had created documents detailing the merger efficiencies. These documents projected merger efficiencies totaling nearly 500 percent less than those numbers advanced by Staples in court. The court rightly discounted Staples' efficiency defense in light of these "stubborn facts," dismissing the efficiency argument as unbelievable and "unrealistic." [25]

Challenges such as the one in Staples do not happen often, but when they do, they almost invariably lead to the abandonment of a proposed merger. In April of this year, in FTC v. **H.J. Heinz Co**.[26] [NYSE:HNZ] the government successfully challenged and blocked the merger of two baby food companies. The "facts"—documents created by the parties in the ordinary course of business—ultimately undermined all of the parties' arguments in defense of the merger.

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<u>Federal Trade Commission v. H.J. Heinz Co.</u>

In April of this year, the U.S. Court of Appeals for the District of Columbia blocked the merger of the second- and third-largest baby food makers, H.J. Heinz Co. and **Milnot Holding Co.**, better known as **Beech-Nut**. The court, in FTC v. H.J. Heinz Co., concluded that the FTC had raised serious questions as to whether the merger would be anticompetitive; in face of the court-approved agency opposition, the parties cancelled all plans to consummate the merger.[27]

In February 2000, Heinz and Beech-Nut agreed to merge and notified the antitrust agencies of the merger under HSR. During the course of the investigation that ensued, the FTC raised concerns about the effect the merger would have on competition in the baby food industry, and ultimately challenged the merger, seeking a preliminary injunction. The district court denied the injunction and the FTC appealed. The Court of Appeals reversed the trial court's decision, concluding that the proposed merger raised questions "so serious, substantial, difficult and doubtful" that an injunction was warranted.[28] In other words, the Court of Appeals agreed that the proposed merger appeared anticompetitive. In the face of this opposition, the parties abandoned their plans to merge.

The parties argued that the facts compelled the FTC to allow the merger. Although the market was dominated by three firms—**Gerber Products Co**., Heinz and Beech-Nut—Gerber was far and away the industry leader, enjoying a 65 percent market share while Heinz and Beech-Nut had only 17.4 percent and 15.4 percent shares of the market, respectively. While Gerber's products are found in over 90 percent of all American supermarkets, Heinz is sold in approximately 40 percent and Beech-Nut is carried in approximately 45 percent of all supermarkets. The parties argued that the merger was necessary to compete with Gerber. The FTC disagreed. [29]

The Heinz court looked first to the FTC's case and concluded that there would be a significant concentration in the market—after all, the merger would result in only two companies competing in the baby food market. As the court noted, "[a]s far as we can determine, no court has ever approved a merger to duopoly under similar circumstances."[30] This left to the parties the burden of rebutting this prima facie showing. Their own business documents undercut their arguments.

When analyzing whether products compete, one must consider whether the products are interchangeable as far as customers are concerned.

Consider Competition at All Levels

The parties to the merger argued that Heinz and Beech-Nut did not in fact compete: they presented evidence that at the supermarket level only two brands of baby food are carried on shelves—Gerber and one of Heinz or Beech-Nut. Thus, as far as consumers are concerned, they never have the choice between Heinz and Beech-Nut. The Court of Appeals rejected this argument out of hand, concluding that the parties ignored the intense competition at the wholesale level: every day, Heinz and Beech-Nut compete for the right to have that shelf space in the supermarket (i.e., the "second shelf position"). Moreover, the court pointed out that when analyzing whether products compete, one must consider whether the products are interchangeable as far as customers are concerned. There was no escaping the conclusion that strained carrots in different jars are still strained carrots.[31]

The parties' own documents undermined their story. As the court pointed out: "Heinz's own documents recognize the wholesale competition and anticipate that the merger will end it. Indeed, those documents disclose that Heinz considered three options to end the vigorous wholesale competition with Beech-Nut: two involved innovative measures while the third entailed the acquisition of Beech-Nut." [32] The parties' business plans also showed that the two companies priced against each other, and where they were both present in the same geographic areas, served to depress each other's and Gerber's prices.[33] No amount of legal persuasion could overcome those hard facts.

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Heinz is important for a number of reasons; however, one salient point stands out: during the extended merger review process, the government will have significant access to a company's documents. These documents—almost all of the information generated and maintained by a company for several years—often provide the lynchpin for a successful government

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investigation. That is why it is crucial to resolve antitrust investigations before that phase begins. Where reaching that phase is inevitable, it is important to understand that the government will have the opportunity to review substantially all of a company's files. So it is important for a company's employees—particularly officers and directors, but also sales and marketing employees who create much of this relevant information—to understand that their daily writings can form the basis of an antitrust investigation.

Conclusion

Parties contemplating a strategic transaction must consider that the government's antitrust review will focus on the documents that the parties created to analyze the transaction. The Bush Administration, specifically FTC Chairman Timothy Muris, has gone to great lengths to emphasize that "the facts" will take on even greater importance over the coming years, perhaps even eclipsing (or at least diminishing) the value of economic analysis and straight legal theory. With that in mind, it is becoming increasingly important to involve antitrust counsel not only in the early stages of consideration of a strategic transaction to help shape the creation of important documents with an eye towards antitrust scrutiny, but also in the process of creating and modifying ordinary course of business filings such as 10-Ks, 10-Qs and even strategic business plans. Careful planning and drafting can help circumvent costly and lengthy government investigations and help shape the direction of antitrust review. ⌘

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