Technology mergers

US antitrust review of small technology mergers
By Charles T Compton and Scott A Sher of Wilson Sonsini Goodrich & Rosati, Palo Alto

Hewlett-Packard Company's $18.7 billion acquisition of Compaq Corporation is the largest technology merger in history.* The integrated company started life with the number-one global market share in enterprise storage, Windows servers, Unix servers and PCs. Yet the US Federal Trade Commission (FTC) and European Commission approved the merger without condition following a six-month investigation. Antitrust authorities did not require divestiture, impose licensing restrictions on the use of intellectual property (IP) rights, or place any operating limitations (such as requiring the parties to open their platforms to competitors) upon the combined company. Once the merger closed on May3 2002, the new Hewlett-Packard was free to function without regulatory restriction.

In recent times, by contrast, the FTC and US Department of Justice (DoJ) have seriously investigated - and challenged - many smaller high-technology transactions of far less obvious significance than the Hewlett-Packard/Compaq mega-merger. Clearly neither size nor celebrity is a predictor of antitrust scrutiny and challenge in the US. Indeed, recent enforcement actions have challenged mergers that were closed years earlier, or were so small as not even to require notification to the competition authorities. Aesop's observation that obscurity often brings safety is, in this world, no more than a fable.

Why have the US antitrust agencies paid so much recent attention to these smaller transactions? There are two reasons: First, Congress recently raised the transaction valuation thresholds that govern the reportability of mergers; ironically, this has heightened the agencies' focus on smaller mergers that do not require notification to the antitrust authorities. Second and more substantively, the special characteristics of emerging technology markets have provoked antitrust scrutiny regardless of a transaction's size or scope.

HEIGHTENED REVIEW OF TRANSACTIONS THAT ARE NO LONGER NOTIFIABLE UNDER NEW THRESHOLDS

The primary vehicle for merger enforcement in the US is the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act). Under the HSR Act, parties to a merger or acquisition of stock and/or voting securities of a certain size are required to report the transaction to both the FTC and DoJ. The parties must then await approval from the agencies or expiration of a 30-day waiting period before closing the transaction. Until recently, the HSR Act required notification of transactions valued at $15 million or more (the size-of-transaction test), where the acquiring and acquired parties had at least $100 million and $10 million in sales or assets, respectively (the size-of-parties test).

In December 2000, Congress changed the reporting thresholds for the first time since the HSR Act was implemented in 1976. Under the new reporting thresholds, only those transactions valued at $50 million or more (the size-of-transaction test), where the acquiring and acquired parties had at least $100 million and $10 million in sales or assets, respectively (the size-of-parties test).

In December 2000, Congress changed the reporting thresholds for the first time since the HSR Act was implemented in 1976. Under the new reporting thresholds, only those transactions valued at $50 million or more must be notified to the antitrust agencies. In addition, if the deal is valued at $200 million or more, the size-of-parties test is eliminated entirely.

The pre-merger notification rules of the HSR Act facilitate government merger review, but in no way proscribe agency investigation and challenge of problematic mergers at any time - even years after the companies combine. With the enactment of the higher HSR thresholds, key US antitrust officials have voiced their concern about overlooking transactions that raise competitive issues but slip below the bar for required notification. As Joseph J Simons, director of the FTC's Bureau of Competition, recently stated in connection with the agency's decision to sue to unwind two mergers that had been too small for HSR Act notification: "In this matter, the Commission reaffirms its practice of pursuing acquisitions that
harm consumers, even where the acquisition may not be reportable to the Antitrust Agencies under the Hart-Scott-Rodino Act. This practice is particularly important now because the thresholds for reporting acquisitions recently were raised."

The year-2000 changes to HSR notification thresholds, coupled with a dramatic downturn in technology markets, have reduced by nearly 70% the number of HSR filings with the FTC and DoJ. In one recent week, the FTC received only fifteen HSR notifications, down from a pace of over 90 per week in 2000. The US antitrust agencies, as a consequence, now have far greater resources available for merger enforcement. Like water seeking its level, those resources are finding small technology mergers whether or not they are reportable under the HSR Act. In fact, the authors recently represented one software company that operated in a market generating less than $100 million in worldwide revenues; the target company generated less than $2 million in revenue in its last fiscal year. The DoJ nevertheless vigorously investigated our client's acquisition of that small competitor, at a cost exceeding the acquired company's annual profits.

THE PECULIAR IRRELEVANCE OF SIZE IN HIGH TECHNOLOGY TRANSACTIONS

Even before the relaxed HSR filing requirements, the US antitrust agencies had evinced a special interest in technology industry mergers, many of which involve miniscule or nascent product markets. In a widely reported January 29 1998 speech before the New York State Bar Association, then head of the Antitrust Division of the DoJ Joel Klein noted that "the economic qualities that tend to characterize market behavior in high-tech industries are such that we will almost certainly see companies come to enjoy very significant market power, which in turn is likely to lead to antitrust scrutiny".

US antitrust statutes and agency guidelines, of course, apply to small technology mergers no less than to transactions announced above the fold in the Financial Times. At the core of any antitrust analysis is Section 7 of the Clayton Act, which proscribes those mergers or acquisitions whose effect "may be substantially to lessen competition, or to tend to create a monopoly" in a relevant market. If a merger likely will lead to a less competitive market - one susceptible to higher prices, reduced output or lessened innovation - the government will use its enforcement powers to block the transaction, regardless of its size.

The joint FTC/DoJ 1992 Horizontal Merger Guidelines describe the agencies' competitive analysis of mergers and acquisitions. This analysis is theoretically agnostic to the industry in question - whether chewing tobacco, retail stores, pharmaceuticals, food service glassware or computers. But two aspects of the Merger Guidelines analysis - market definition and ease of entry - tend to embroil a large number of technology mergers in extended investigations or enforcement action. Under a Merger Guidelines approach, the agencies first must define the relevant market. This requires the government to consider which products act as competitive substitutes to the product sold by the merged entities, and which companies sell (or could quickly reposition to sell) such products. The agencies inquire where consumers could turn if the merged company instituted a "small but significant (5%), non-transitory increase in price".

After defining the contours of the relevant market, the agencies are charged with considering whether the merger likely will either result in coordinated anticompetitive effects or endow the combined entity with "market power" - that is, the power unilaterally to control price, output or innovation in the relevant market. If the combined companies' market share is high, and the market is concentrated, market power may be inferred. Then the inquiry shifts to whether other market factors may offset the likelihood of post-merger anticompetitive effects. The most significant question in that analysis is whether entry is easy. Under the Merger Guidelines, ease of entry is a complete defence to a claim that a merger is anticompetitive, because easy entry can "deter or counteract the competitive effects of concern". Entry is
easy where it is timely (within two years), likely (profitable), and sufficient in magnitude, character, and scope to deter anticompetitive effects.

High-technology mergers, even those appearing small and insignificant, can be problematic under a Merger Guidelines analysis. The very lynchpin of the analysis - defining the relevant market - is especially difficult where new, rapidly changing and poorly understood technologies are at issue. The safe default for the US competition agencies in such circumstances is to issue a Second Request, launching a formal investigation that can last several months. Equally troublesome is the agencies' tendency, at the outset or when in doubt, to assume that each product overlap between the merging companies constitutes a separate relevant market.

For example, in its October 2001 challenge to two small 1999 acquisitions by MSC.Software Corporation, the FTC defined a tiny, $60 million market consisting of "Nastran finite-element analysis solver" software, rejecting MSC.Software's argument that the market included other (non-Nastran) types of finite-element analysis solvers that performed similar product stress simulation functions. Had those alternatives been included in the relevant market, MSC.Software's shares would have been far less troubling. Likewise, in 1995, the DoJ challenged Computer Associates' acquisition of Legent Corporation. Both parties developed software for mainframe computers. The government's complaint defined six separate relevant product markets - one for each product overlap between the parties. No product market was larger than $10 million; several were less than $5 million.

Once trapped in an extremely narrow market with resulting high market shares, merging technology companies frequently find ease of entry their only defence. Carrying the burden of proof in an ease-of-entry analysis is not a trivial task, and parties can seldom demonstrate easy entry during the initial 30-day waiting period. Lengthy and expensive formal investigations are often the consequence, with little agency pity that "in the ant's house, the dew is a flood". (Persian proverb).

Historically, nearly two-thirds of all formal Second Request investigations in the US lead to either a negotiated consent decree or abandonment of the transaction. This painful progression explains why technology companies contemplating even smaller transactions should carefully assess the likelihood of extended investigation or antitrust challenge by the US agencies.

**RECENT CHALLENGES TO SMALL TECHNOLOGY DEALS**

Apart from market definition and entry issues, technology mergers can raise a number of other competitive concerns, as illustrated by recent enforcement actions. These actions highlight the impact of intellectual property rights on merger analysis, the competitive significance of high switching costs, and the US agencies' focus on potential and innovation competition in many sophisticated high-technology markets.

**The importance of intellectual property rights**

The US antitrust agencies have increasingly focused on the role of intellectual property (IP) rights in the analysis of antitrust issues. In 1995, the DoJ and FTC issued their Joint Guidelines for the Licensing of Intellectual Property. Today, the intersection of IP and antitrust remains a hot topic. In a February 6 2002, speech that marked the opening of a series of FTC-DoJ joint panels addressing IP and antitrust issues, Charles A James, the head of the DoJ's Antitrust Division, identified some of the IP tensions in merger antitrust policy:

"What weight should the agencies give to existing market conditions in situations where there are numerous firms competing - notwithstanding a claimed IP blocking position? Or suppose that significant questions exist about the breadth of a firm's patent position. The patents may not completely block the field, but no one knows for sure. In determining the ease and likelihood of entry
into that relevant market, should we assess a potential entrant's risk of infringement and the cost of defending a possible infringement action? Does potential rivalry mean the ability to compete free from risk of infringement liability?"

The agencies’ concern with the role of IP rights in merger analysis extends beyond the theoretical. In June 2001, the DoJ challenged and required the parties to substantially alter a merger involving the relatively small market for rapid prototyping systems (which transform a computer design into a three-dimensional prototype or model). In that deal, 3D Systems had agreed to purchase its primary competitor, DTM Corporation, for $45 million in cash. 3D Systems had annual worldwide sales of $110 million; DTM's sales totaled only $40 million. After a substantial investigation, the DoJ filed suit to block the merger.

Why the worry over such a small acquisition? In part, the DoJ was concerned that the merger would have reduced the number of competitors in the US market for rapid prototyping devices from three to two. Equally important, the combined patent portfolio of these two companies would have made it impossible for either existing foreign competitors or "greenfield entrants" to enter into competition in the US. In settling the DoJ's challenge, the parties were required to grant a third party a perpetual, assignable, transferable, and non-exclusive licence to sell and distribute rapid prototyping machines in the United States, and precluded from asserting against the acquirer of the licence any claims for patent or copyright infringement.

**Significant switching costs**

High customer switching costs often affect entry into high-technology markets, raising yet another concern in some small transactions. High switching costs make it unlikely that consumers - even when faced with an increased price or reduced innovation - will switch to apparent substitutes or new entrants.

It is expensive, for example, for customers to switch their enterprise software products. The decision to switch extremely complex, enterprise-level software (such as enterprise resource planning software) or software programs integrated into a larger suite of products (for example, a software router that is part of a synthesis and layout design suite for electronics design automation), often implicates other purchasing decisions, such as the need to purchase additional enterprise-wide servers for the new software product. Other software switching costs might include the need to:

- change the server operating system that runs the software (for example, from a Unix-based operating system to NT);
- retrain technical staff on use of the software;
- translate file formats for historical documents (such as from WordPerfect to Word); and
- write code to make the new software product interoperable with the overall system environment. The antitrust agencies will scrutinize switching costs in evaluating ease of entry and in defining how narrow the relevant market really is.

In its administrative complaint against MSC.Software, 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). The FTC complaint alleged that entry by others would be difficult because of the substantial cost and time needed to develop an advanced version of Nastran, validate the program's simulation results and establish its reputation for reliability. The FTC also alleged that switching costs were high, noting that each Nastran program required unique computer code and file formats that made it difficult for a user to switch after developing files on one platform. The
government therefore concluded that new entry was unlikely, and the combined company might be free to raise prices or slow innovation.

Potential competition and innovation markets

The US antitrust agencies have focused recently on numerous transactions in which the acquiring party was the dominant market participant and the acquisition target was a small start-up, with little or no revenue or even a product yet in production. Such transactions can give rise to various potential competition concerns. For example:

The target's product-in-development constrains anticompetitive conduct by the acquiror and other competitors through the mere expectation that it will soon enter the marketplace;

The target is poised to enter the competitive arena and, but for the merger, will pose real competition to the acquiring company in the near future; or

The target has developed disruptive technology that threatens to leapfrog entirely the acquiror's products or launch a new market or set of applications (for example, the introduction of the PC, the Netscape internet browser, and digital video discs).

An acquisition removes these sources of potential competition, and with them what may be the acquiring company's only incentive to innovate aggressively.

Antitrust economists and enforcers have long struggled with the policy articulations appropriate to deal with perceived or actual potential competition - particularly in the technology age where products and markets change so quickly, new competitors may spring up overnight and innovation plays such a critical competitive role. One manifestation of this concern is the US agencies' 1995 IP Licensing Guidelines, which officially endorsed the concept of innovation markets. Under the IP Licensing Guidelines, the agencies will analyze and protect innovation markets as vigorously as product or goods markets.

Potential competition theory has a checkered past, and the concept of innovation markets has been roundly criticized as unnecessary and confusing. However, beyond the rhetoric and theory there have been several notable enforcement actions based in part on potential competition concerns or the threatened reduction of innovation. For example, in a complaint filed by the FTC to block Boston Scientific Corporation's acquisition of small competitors CVIS and SCIMED in 1995, the FTC alleged that the acquisition eliminated "the most likely potential entrant" and "an actual potential competitor" in a highly concentrated market for intravascular ultrasound catheters. Boston Scientific ultimately agreed to license the technology acquired from CVIS to a third party.

Similarly, in 1997, the FTC ordered Autodesk to divest Softdesk's computer-aided-design (CAD) engine to a third party, even though Softdesk's product had not yet been introduced. According to the FTC complaint, Softdesk's product represented the most significant future competitive threat to Autodesk's then-dominant position in the CAD engine market.

Just last year, Varian Medical Systems abandoned its attempt to purchase IMPAC Medical Systems in the wake of significant DoJ opposition. Although IMPAC had a scant $21 million in annual revenues, the DoJ contended that the two companies competed directly in terms of innovation, quality and price for the sales of radiation oncology management systems software used with linear accelerators. A significant factor in the agency's opposition was Varian's decision, made before the merger announcement, to develop software that would in future compete directly with IMPAC's.

CONCLUSION
It is natural for businesspeople, and even for competition lawyers, to worry less about small, low-visibility mergers. If the deal is not even reportable - and certainly if it already has been consummated - the antitrust risk traditionally has been negligible. We tend to presume that companies with modest revenues or unfinished products will not raise serious competitive issues, or that the government will fail to spot the nuanced problem.

Unfortunately, life in the world of global technology transactions is not so simple. In recent years, the US competition agencies have become keenly aware of the special issues raised in high-technology mergers. They understand well the importance of intellectual property in the marketplace and have successfully tackled difficult issues of network effects, switching costs and potential competition. At the same time, aggrieved customers or competitors have become far more ready to proactively assist the authorities in their inquiries involving technology mergers, large or small. Merging companies may ignore these new realities only at their own peril. It is crucial to consider industry dynamics as well as the competitive effects of even non-reportable deals, and prepare from the outset any possible defences to a government challenge.

* Wilson Sonsini Goodrich & Rosati served as antitrust co-counsel for Hewlett-Packard in the successful defence of the merger before US and European antitrust authorities.