

SHEARMAN & STERLING_{LLP}



Bay Area Antitrust Seminar Series

Antitrust Risks in M&A Transactions

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The Four Seasons Hotel
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1.5 California CLE Credits

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Dealing with antitrust risk

- Assess the substantive antitrust risk
- Predict possible agency demands for remedies
- Allocate the antitrust risk in the purchase agreement



Assessing Substantive Antitrust Risk



Clayton Act 7

- Provides the U.S. antitrust standard for mergers

No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.

- *Simple summary*: Prohibits transactions that—
 - may substantially lessen competition or create a monopoly
 - in any line of commerce (product market)
 - in any part of the country (geographic market)



“Tend to substantially lessen competition”

- Transaction threatens to hurt an **identifiable set of customers** through:
 - Increased prices
 - Reduced product or service quality
 - Reduced rate of technological innovation or product improvement
 - (Maybe) reduced product diversity



Theories of anticompetitive harm—Major theories

- Elimination of horizontal competition among current rivals
 - *Unilateral effects*: Merger of uniquely close competitors
 - *Coordinated effects*: Merger of significant competitors where customers have few realistic alternatives

- Vertical harm—Major in EU/gaining traction in U.S.
 - Foreclosure of competitors (upstream or downstream)
 - Raising costs to rivals
 - Anticompetitive information access



Theories of anticompetitive harm—Dormant theories

- Elimination of potential rival entrants
 - Rarely invoked
 - But could be used

- Conglomerate effects
 - Have not seen in United States since 1960s
 - Used to block GE/Honeywell in the EU



Important evidence

- Company documents
- Company data (especially win-loss data)
- Company interviews and depositions
- Customer interviews
- Competitor interviews



Important questions

- Are prices likely to increase postmerger?
- Are the merging companies strong and uniquely close competitors with one another?
- How many other effective competitors does each merging party have?
- Do customers play the merging parties off of one another to get better prices or other deal terms?
- How high are barriers to entry, expansion and repositioning?



Important questions

- Is the rate of innovation or product improvement likely to decrease postmerger?
- Will the merged firm discontinue a product or product family?
 - If so, how will this affect current and future customers in the space?
 - If so, do the companies have a plan to support legacy products?



Important questions

- What is the business model behind the transaction?
 - What does the business model say about likely competitive effects?
 - How does the buyer expect to recoup any premium paid for the target?

- What are the operational plans for the combined company?
 - Fixed cost savings?
 - Marginal cost savings?
 - Product line integration and migration plans?
 - Changes in investment or direction of R&D activities?



Basic defenses in horizontal transactions

(in decreasing order of strength)

- Parties do not compete with one another
- Parties compete only tangentially
- Parties compete but have significant other close and effective competitors
- Parties do compete, have few existing competitors, but movement into market
 - is easy (no barriers to entry or repositioning), and
 - would occur quickly if merged company acted anticompetitively
- Some other reason deal is not likely to harm customers

How many effective competitors are enough?

- 5 → 4** Almost always clears absent
- significant customer opposition, and
 - no bad documents
- 4 → 3** Close case but can clear with:
- a strong procompetitive justification
 - significant customer support and little customer opposition, and
 - no bad documents
- 3 → 2** Usually challenged, but can clear with
- a compelling procompetitive justification,
 - strong customer support and no material customer opposition, and
 - no bad documents
- 2 → 1** Always challenged; no efficiency defense



Best defense is a good offense

Customers will benefit from the merger

- Requires consistency between:
 - The business model motivating the transaction, and
 - The predicated customer benefits



Typical customer benefits

- Lower costs of production, distribution, or marketing make merged firm more competitive
 - Elimination of redundant facilities and personnel
 - Economies of scale or scope

- Complementary product lines
 - Broader product offering desired by customers
 - Better integration between merging products further enhances customer value



Typical customer benefits

- Accelerated R&D and product improvement
 - Greater combined R&D assets (researchers, patents, know-how)
 - Complementaries in R&D assets
 - Greater sales base over which to spread R&D costs

- Better service and product support
 - More sales representatives
 - More technical service support



Predicting Agency Demands for Remedies



Agency perspectives

- Solution must—
 - fix the agency's competitive concern
 - be workable in practice
 - Must not involve the agency in continuous oversight



Adjudicated relief/consent decrees

- Usual outcome: Overwhelmingly consent relief
 - Rare for merger cases to go to court

- But—
 - Agency starting point:
 - Consent solutions should match adjudicated permanent injunctive relief, assuming that agency establishes a violation
 - Agency negotiates consent relief—
 - Not only to remediate competitive concern with the immediate deal
 - But also with an eye to implications for consent decree negotiations in future deals

- Upshot
 - Agencies have found that they do not have to give much away in negotiations



Horizontal remedies—Agency requirements

- Almost always require the sale of a complete “business”
 - Agency: Essential to the effectiveness/viability of the solution
 - *Exceptions:*
 - Divestiture buyer has necessary infrastructure and limited divestiture assets will enable rapid and effective entry into divestiture business
 - Divestiture assets are commonly traded (e.g., grocery stores)
- Will permit “trade up” solutions
 - Buyer may sell its own business in order to purchase a larger business



Horizontal remedies—Agency starting point

- *Everything* associated with the divested business must go
 - Agency will negotiate exclusions
 - But must be convinced that the exclusions will not undermine the effectiveness or viability of the solution



Horizontal remedies—Elements

- Divest physical assets
 - Production plants, distribution facilities, sales office, R&D operations
 - All associated equipment
 - Leases/property from which business operated

- Divest IP
 - Sale of any IP rights used exclusively in the divestiture business
 - Sale and license back/license of IP rights used in both retained and divested operations
 - Divestiture buyer must have ability to develop and own future IP



Horizontal remedies—Elements

- Make “key” employees available for hire by divestiture buyer
 - All employees necessary for
 - production,
 - R&D,
 - sales & marketing, and
 - any other specific function connected with the divestiture business
 - Must facilitate access to employees
- Cannot make counteroffer or offer other inducement to prevent defection



Horizontal remedies—Elements

- Assign/release customer contracts and revenues
 - If not assignable, offer customers ability to terminate with no penalties in order to rebid business
- Transfer business information
 - Especially customer-related information
- Provide transition services and support



Horizontal remedies—Agency right of approval

- Agency will demand right of approval over divestiture buyer
 - In agency's sole discretion
 - Remedy must eliminate agency's antitrust concerns
 - Buyer must have no antitrust problem in acquiring divested business
 - Buyer must be capable of replacing competition lost as a result of the acquisition

Horizontal remedies—Divestiture deadlines

- Agency will require a very tight deadline for closing the divestiture
 - May require a buyer “up front”
 - Almost always results in a “fire sale”

Practice note:

Unless protected by attorney-client privilege or the work doctrine, business documents and financial modeling of possible divestitures will be disclosable in response to the second request.



Vertical remedies

- To remedy foreclosure concerns
 - Non-discriminatory access undertakings
 - Undertakings to maintain open systems to enable interoperability (e.g., *Intel/McAfee*)
- To remedy anticompetitive information access
 - Information firewalls



Panasonic/Sanyo—Horizontal

- FTC concern
 - Merging parties produce the highest quality NiMH batteries and are closest competitors – effectively control the market

- Consent decree—Divestiture of Sanyo’s NiMH assets
 - Buyer upfront—Fujitsu

 - Divestiture package
 - Manufacturing facility in Takasaki, Japan
 - Supply agreement for NiMH battery sizes not produced at Takasaki
 - All Sanyo IP, including patents and licenses related to portable NiMH batteries
 - Access to identified “key” employees
 - Financial incentives to employees (up to 20% of salary) to move to divestiture buyer
 - Transition services and support for 12 months



Comcast/NBCU—Vertical

- DOJ concern
 - JV between Comcast, NBCU and GE would give Comcast control over NBCU's video programming

- Consent decree
 - Continue to license NBCU programming content to competing multichannel video programming distributors
 - License the JV's programming to emerging online video distributor competitors
 - Commercial arbitration if cannot reach agreement on license terms
 - Prevents restrictive licensing practices
 - Hulu
 - Comcast to relinquish voting and other governance rights in Hulu
 - Comcast precluded from receiving confidential or competitively sensitive information about Hulu's operations



Allocating Antitrust Risk in Purchase Agreements



Relevant contract provisions

- Merger control filings
- Litigation closing condition
- Litigation covenant
- Restructuring obligations
- Payments
- Timing provisions

Merger control filings

- Where do merger control filings need to be made?
 - Over 80 jurisdictions have merger control filing requirements
 - Most are mandatory and suspensory—cannot close without filing and obtaining clearance
 - A few are voluntary (e.g., U.K., Australia, New Zealand, Singapore)
 - A few are not suspensory (e.g., Brazil)
- When do the merger filings have to be made?
 - Two considerations
 - Starting the clock as quickly as possible
 - Allowing sufficient time for preparation of defense and customer contacts
- Which clearances will be incorporated in the closing conditions?
 - Major jurisdictions almost always specifically identified
 - *Query:* What if the closing conditions do not include clearance in a suspensory jurisdiction in which a filing is required?



Litigation closing condition

- *Common formulation:* No threatened or pending litigation
 - Typically provides that no government action is pending or threatened that seeks to delay or prevent consummation of the transaction
 - *Question:* What constitutes a “threat” of litigation?
 - *Question:* What about private party actions?

- *Alternative:* No order
 - “If you can close, you must close”
 - Typically provides that no restraint, preliminary or permanent injunction or other order or prohibition preventing the consummation of the transaction shall be in effect



Litigation covenant

- Are the parties committed to litigate in the event of an antitrust challenge?
 - May be imposed on buyer alone or on both parties
 - Obligation may be to litigate through to a final, non-appealable judgment, or something less
- Interactions with—
 - Any obligation to accept remedies in order to obtain clearance
 - The drop-dead date
 - Should the drop-dead date automatically be extended?
 - Should the unilateral right to terminate be symmetrical?



Restructuring obligations

- Can arise in two provisions
 - Specific covenant to offer and accept remedies
 - “Efforts” covenant

Specific covenant re remedies

- Unqualified “hell or high water” provision
 - Requires seller to offer whatever remedy is necessary to obtain antitrust clearance
 - Includes divestitures, licenses, behavioral undertakings, and hold separates
 - Theoretically could require divestiture of entire target business
 - If remedy is embodied in a consent decree, agency must agree
 - In some deals, agency will not accept any consent decree

- Qualified remedies obligations
 - Limited to certain business, product lines, or assets
 - Limited by revenue, EBITDA or materiality cap

- “Road map” problem
 - Informs agency of issues and remedies available for the asking
 - *Query*: Can the joint defense privilege or work product doctrine shield a risk-shifting provision from a reporting requirement?



Efforts covenant

- Sets standard for obligations to obtain antitrust clearances
- Unqualified “best efforts” provision
 - Usually taken to imply an obligation to offer or accept restructuring relief if necessary to obtain antitrust clearance
 - Often coupled with express risk-shifting provision
- “Reasonable best efforts”/“commercially reasonable best efforts”
 - Something less than best efforts/something more than reasonable efforts
 - Most common formulation in antitrust covenants
 - Obligation *not* well defined by courts
 - Usually chosen precisely for this reason
 - *Conventional wisdom*: Does not imply an obligation to offer or accept material restructuring relief to obtain antitrust clearance
 - Can add express proviso to make explicit or limit obligation



Payments

- Reverse breakup fee with an antitrust trigger
 - Payable by the buyer to the seller where:
 - the transaction does not close before the purchase agreement is terminated, and
 - the only conditions not satisfied are the antitrust clearance conditions
 - Relatively rare
 - Sellers usually negotiate some form of remedy obligation and/or higher purchase price to avoid reverse breakup fee
 - Size of fee—Vary widely
 - Percentage of transaction value
 - Large: 39.81% (Monsanto acquisition of Delta and Pine Land)
 - Small: 0.11% (CapitalSource's proposed acquisition of TierOne)
 - Absolute magnitude
 - \$700 million (J&J's proposed acquisition of Guidant) (2.8%)

Payments

- Reverse breakup fees—Examples

Acquiror Name	Target	Status	Equity Value (\$M)	Reverse Break Fee (\$M)	Reverse Break Fee (%)	Announcement Date
Boston Scientific	Guidant	Completed	\$26,544	\$800.00	3.0%	12/5/2005
Dow Chemical	Rohm and Haas	Completed	\$15,051	\$750.00	5.0%	7/10/2008
Johnson & Johnson	Guidant	Failed	\$24,589	\$700.00	2.8%	12/15/2004
EchoStar	Hughes	Failed	\$18,000	\$600.00	3.3%	10/28/2001
Monsanto	Delta and Pine	Completed	\$1,507	\$600.00	39.8%	8/15/2006
Oracle	BEA Systems	Completed	\$8,056	\$500.00	6.2%	10/12/2007
Microsoft	aQuantive Inc	Completed	\$5,265	\$500.00	9.5%	5/18/2007
Verizon Wireless	Alltel Corp	Completed	\$28,100	\$500.00	1.8%	6/5/2008
Symantec	Veritas Software	Completed	\$13,520	\$440.00	3.3%	12/16/2004
Seagate	Maxtor	Completed	\$1,900	\$300.00	16.3%	12/21/2005
Whirlpool	Maytag	Completed	\$1,674	\$120.00	7.2%	7/17/2005
Flextronics	Solectron	Completed	\$3,675	\$100.00	2.7%	6/4/2007
Safran	L-1 Identity Solutions	Pending	\$1,118	\$75.00	6.7%	9/19/2010
Brocade Commun'cs	McDATA	Completed	\$732	\$60.00	8.2%	8/8/2006
QUALCOMM	Flarion Technologies	Completed	\$805	\$50.00	6.2%	8/11/2005
Northrop Grumman	Essex	Completed	\$521	\$1.00	0.2%	11/8/2006



Payments

- Ticking fees
 - Require buyer to pay interest on purchase price if transaction not closed by particular date
 - Aim to motivate buyer to obtain regulatory clearances quickly
 - Relatively rare in public transactions
 - Dow Chemical/Rohm and Hass: 5% of equity value
 - Boston Scientific/Guidant: 3% of equity value
- Nonrefundable partial payments
 - Like a ticking fee but requires more than the payment of interest
 - Payable on a specified schedule
- “Take or pay” clauses



Cooperation covenants

- Specifies level of cooperation by parties in obtaining antitrust clearances
- Typical requirements
 - Advance notice and review of communications and submissions with agency
 - Right to attend meetings/conferences with agency
 - Subject to agreement by agency
 - Right to review 4(c) and second request documents
- Party interests
 - Buyer usually want to control process and not have seller operating independently with governmental authorities
 - Seller wants to know what is going on to ensure buyer is fulfilling efforts obligations
 - Both want to maximize knowledge of the evidence submitted to the agency



Timing provisions

- Timing for filings
 - Often “as promptly as possible”
 - But some delay (5-10 business days) may be desirable to permit:
 - Indepth substantive analysis
 - Customer rollout
 - Coordination in submitting required merger filings

- Other timing-related provisions
 - Provisions agreeing not to withdraw filings, extend waiting periods or enter into timing agreement without consent of other party
 - Seller may want to impose a specific deadline on second request compliance

Summary

	Buyer-friendly	←————→	Seller-friendly
Level of efforts	Commercially reasonable efforts	Reasonable best efforts	Best efforts
Obligation to make divestitures	Silent/expressly excluded	Divestitures up to cap – measured in asset or revenue terms or MAC applying to part or all of acquired or merged business	Obligation to make any and all divestitures necessary to gain clearance no matter how much or what impact is (HOHW)
Timing for other aspects of regulatory review	Silent/may be deadline for submission of HSR filing	Silent/may be deadline for submission of HSR filing	Express timing for submission of filing, Second Request compliance and other milestones
Timing for offering divestitures	Silent	Silent	Express timing for offering remedies to obtain clearance
Control of regulatory process	Buyer controls; require cooperation from Seller and may give access and information	Buyer leads; Seller entitled to be present at meetings, calls; obligation on Buyer to communicate certain matters to Seller	Full involvement of Buyer in negotiations with regulators; Seller prohibited from communicating without Buyer (except as required by law)
Obligation to litigate	Silent/expressly exclude/litigate at buyer's option	Silent/expressly exclude	Obligation to litigate if regulators block exercisable at seller's option; does not relieve buyer of obligations to make divestitures
Termination provisions	Open-ended, extendable at buyer's option	Tolling at either party's option	Tolling at seller's option
Reverse break-up fee	None	Possible	Substantial fee; provision for interim payments and interest
Time to termination date	As long as buyer anticipates needing to fully defend transaction on merits, plus ability to extend at buyer's option	Tolling at either party's option	Tolling at seller's option at specified inflection points (e.g., second request compliance, commencement of litigation)
"Take or pay" provision	None	None	Requires payment of full purchase price by termination date even if transaction cannot close