CLIENT ALERT

FTC Orders Consummated Merger To Be Unwound

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On November 1, 2019, the Federal Trade Commission (FTC) issued a unanimous opinion unwinding the consummated acquisition of Freedom Innovations by Otto Bock HealthCare. Although the case involves prosthetic knees, the case offers several important lessons for companies within and outside the health care sector contemplating mergers, particularly companies where innovation is a key aspect of competition.

Background

Otto Bock and Freedom both manufacture a range of prosthetics, including mechanical and microprocessor prosthetic knees (MPKs). Mechanical prosthetic knees use a hinge to replace the knee joint, while MPKs use electronic sensors to adjust the knee's movement and positioning in real time. At the time of the transaction, Otto Bock was the largest, and Freedom the third-largest, manufacturer of MPKs.

In September 2017, Otto Bock closed on its acquisition of Freedom in a transaction that was not reportable under the Hart-Scott-Rodino (HSR) Act. That same month, the FTC began investigating the transaction.

Just three months later, the FTC filed an administrative suit to unwind the transaction, alleging that it would entrench Otto Bock's leading market position for the sale of MPKs, harm competition, and result in higher prices and less innovation.

In May 2019, the Administrative Law Judge ruled for Complaint Counsel (FTC staff), finding that the merger was unlawful, and ordering Otto Bock to divest Freedom entirely. The merging parties appealed to the full five-member Commission.

Commission Decision

The Commission upheld the ALJ's decision and key findings, including the evaluation of the relevant market, competitive effects, failing-firm defense, and remedy.

Product Market Definition

As is often the case, product market definition was critical to the case, because it affects calculation of market share, which at higher levels results in a presumption of the merger's illegality. Here, in an MPK-only market, the merged firm held a share over 80%. The merging parties argued that an MPK-only relevant market was both *too narrow*—because there was "significant technology overlap" with mechanical knees—but also *too broad*, because there was wide variation in the prices, features, and level of microprocessor controls among MPKs.

The Commission defined the market as MPKs because there was much more interchangeability among MPKs than between MPKs and mechanical knees; "practical indicia" of MPKs' particular characteristics, industry recognition, distinct pricing, and

distinct customers supported this market definition; and because of "extensive evidence" of competition between MPKs, but not with other products.

Competitive Effects Analysis

The Commission found that the merger would result in competitive harm in the form of higher prices and less product innovation given the parties' history of head-to-head competition that spurred the parties to lower prices to compete with the other, and spurred product and technology advancements to match or outdo the other. The Commission's conclusion also rested on evidence of high post-merger MPK market concentration; the parties' existing products being next-best choices for each other for a significant fraction of customers; the transaction eliminating *potential* competition from Freedom's forthcoming next-generation product; Otto Bock undertaking the transaction, in part, to keep Freedom's products out of the hands of rivals; and the merger already reducing the parties' incentive to compete with each other.

Financial Condition Defense

Among other defenses, the merging parties argued that the failing-firm defense saved the transaction from antitrust condemnation. The Commission disagreed, finding that the parties had failed to meet the three elements of the defense. Specifically, the Commission concluded that the merging parties could not show Freedom was in "grave danger" of financial failure because a turn-around effort was starting to bear fruit; that the merging parties did not show that the prospects for a successful bankruptcy reorganization were "dim or nonexistent"; and that Freedom had not conducted a "reasonable good faith effort to engage in an alternative, less anticompetitive transaction."

Remedy – Analytical Framework and Sufficiency

The Commission's opinion is particularly notable for explaining how it analyzed Otto Bock's proposed divestiture. Otto Bock argued that the Commission needed to analyze whether Complaint Counsel had made out a *prima facie* case—and whether the transaction was unlawful—considering Otto Bock's proposed divestiture of Freedom's MPK assets. Otto Bock argued that its pledge to divest Freedom's MPK assets meant the transaction would not increase market concentration and was, thus, not unlawful.

The Commission rejected the argument, stating that the proper framework to assess the proposed divestiture was as a remedy returning the market to the pre-acquisition status quo, not as part of a competitive effects analysis as it might when evaluating a case in chief. To reach that determination, the Commission distinguished the cases that the merging parties offered to support the proposition that the divestiture should be analyzed when assessing Complaint Counsel's case in chief of the merger's effects and antitrust liability. The Agency said that the cases evaluating the merger's effect in light of a proposed divestiture involved (1) *unconsummated* mergers that would close at or near the time of the proposed divestiture, and (2) divestiture agreements that were executed prior to or "soon after" the plaintiffs filed complaints challenging those mergers. Here, the transaction was consummated around two years prior and the divestiture had not yet occurred.

Ultimately, the Commission found that divesting the MPK assets alone was insufficient because this remedy failed to include other assets that were important to the continued development and innovation of Freedom's next-generation MPK product, as well as other assets that apparently were combined in promotional offers with Freedom's MPKs, such as prosthetic feet. Thus, the Commission ordered that the entire Freedom business be divested.

Key Takeaways

The case offers several important reminders and lessons:

- The antitrust agencies have increased their scrutiny of transactions involving potential competitors and transactions that may affect merging parties' incentive to innovate.
- This decision appears to indicate that the Commission will analyze proposed divestitures as part of its competitive effects analysis and conclusions as to the deal's lawfulness if the underlying merger is unconsummated and the divestiture proposal is made before or soon after the FTC files suit to challenge the deal. This remains an area to watch since it's not clear that the agency has always litigated cases in federal court under this framework.
- Financial condition defenses, such as the failing firm defense, may sometimes convince agency staff to close *investigations*, but those defenses face a high burden even at that stage of review, and these defenses have failed in all recently *litigated* cases.
- Agency remedies are sometimes broader in scope than the area of overlap between the merging parties that raises competitive concern. Merging parties should consider this when evaluating a proposed transaction and how that would affect a deal's "economics."
- And as yet another reminder, the antitrust agencies can and do investigate, challenge, and unwind consummated and non-HSR-reportable transactions.

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