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The Efficiencies Defense: What Would High Court Do?

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Law360, New York (May 22, 2017, 10:32 AM EDT) -- Over the past two years, Anthem's proposed acquisition of Cigna has generated a seemingly endless series of headlines regarding the companies' antitrust defense, internal power struggles, and, most recently, Anthem's fight to keep the deal alive. Despite filing an appeal to the U.S. Supreme Court — Anthem's last shot at overturning the injunction prohibiting the transaction — Anthem officially called off the $54 billion deal recently, effectively mooting the cert petition. In addition to signaling the end of one of the most watched antitrust litigations in recent memory, the move also leaves unanswered several important questions Anthem had raised regarding the appropriate treatment of efficiencies in a merger challenge.

The cert petition argued that the circuit split on efficiencies, combined with the lower courts' reliance on merger standards announced in the 1960s, made this case an attractive vehicle for the court's resolution. The Third and Ninth Circuits have expressed skepticism that an efficiencies defense exists at all, while the Sixth, Eighth, Eleventh and D.C. Circuits have considered efficiencies as an appropriate factor in merger analysis. Anthem asked the Supreme Court to resolve a circuit split as to whether courts could move beyond concentration statistics and consider efficiencies as a defense when evaluating the legality of the merger, and if efficiencies should be considered, how a court must weigh them in determining the net competitive effect.

In its petition, Anthem asserted that courts should undertake a dollar-for-dollar comparison of the anti- and pro-competitive effects of the merger to quantify the net competitive effect. According to its petition, the D.C. Circuit majority's "failure to consider or weigh Anthem's claimed efficiencies was a particular affront to modern economic analysis." The analysis, Anthem argued, was outdated, as the Supreme Court has not ruled on a Section 7 merger case on the merits since 1975. Anthem argued that the court's holdings from the 1970s did not reflect more recent emphasis on consumer welfare, nor did it reflect a modern understanding of economics and commercial realities, particularly in light of the developing recognition of merger efficiencies in the U.S. Department of Justice's and the Federal Trade Commission's Horizontal Merger Guidelines.

Lower Court Decisions

On July 21, 2016, the United States, 11 states and the District of Columbia sued to enjoin the merger of Anthem and Cigna, alleging that the merger would substantially lessen competition in violation of the Clayton Act in the markets for the sale of health insurance to national accounts and to large group employers in 35 local markets, as well as for the purchase of services from health care providers. Following a six-week bench trial, the district court permanently enjoined the merger, holding that the combination of the second- and third-largest sellers of health insurance to national accounts and large group employers in the U.S. was likely to result in substantial anti-competitive effects.

Anthem did not appeal the district court's finding that the merger would have anti-competitive effects, but instead challenged the decision on the grounds that the court improperly declined to consider its efficiencies defense. Anthem's efficiency defense argued that the merger would result in billions of dollars in claimed efficiencies, because the merger would yield "a superior Cigna product at Anthem's lower rates." Anthem argued that the benefits would reduce consumer costs, and that the cost savings outweighed any potential harm.

The D.C. Circuit court applied the Baker Hughes three-part, burden-shifting framework to analyze the merger's impact on competition. In the first step, the court found that the government carried its burden to establish that the transaction would likely result in anti-competitive effects by using increase-in-concentration statistics under the Horizontal Merger Guidelines. In step two, Anthem successfully rebutted the presumption of anti-competitive effects with evidence showing that Cigna was not its primary competitor and that customer sophistication and market dynamics would thwart any attempt to increase price, and the combined company would be more likely to innovate. In step three, the court found that the government carried its burden to show that the reduction in the number of health insurance carriers was anti-competitive.

In evaluating Anthem's efficiency defense, the majority opinion of a divided three-judge panel openly questioned whether an efficiencies defense exists in light of the Supreme Court's 1967 decision in FTC v. Proctor & Gamble Co., 386 U.S. 568. In that case, the court enjoined a merger without considering evidence that the combined company could purchase advertising at a lower rate, holding that "[p]ossible economies cannot be used as a defense to illegality. Congress was aware that some mergers which lessen competition may also result in economics but it struck the balance in favor of protecting competition." The D.C. Circuit, along with the Eighth and Eleventh circuits, have previously recognized the use of an efficiencies evidence to rebut a prima facie case, but they have not gone so far as to recognize such evidence as an ultimate defense to a Section 7 illegality claim. Based on the expedited nature of the appeal, the D.C. Circuit declined to determine whether an efficiencies defense could save an otherwise illegal merger.

The D.C. Circuit proceeded to review the efficiencies evidence on the assumption that it could be a defense under the Baker Hughes "totality of the circumstances" approach because Anthem had failed to show that the district court had clearly erred in rejecting an efficiencies defense. The D.C. Circuit utilized the Horizontal Merger Guidelines and determined that the district court did not err when it rejected Anthem's efficiencies evidence as not merger-specific and not verifiable. With respect to merger specificity, the court found that Anthem's arguments that the combined company could introduce new products incorporating Cigna's attractive programs and Anthem's lower rates was not merger-specific because Anthem could do the same thing on its own by offering an improved product. The D.C. Circuit also rejected Anthem's argument that the $2.4 billion in projected post-merger savings had been

verified by two independent sources, criticizing the mechanisms by which Anthem proposed to achieve the savings as too speculative given the practice business realities of provider contracting and product development.

The D.C. Circuit upheld the permanent injunction, finding that the district court reasonably determined that Anthem had failed to show the "extraordinary efficiencies" needed to constrain the likely price increases and the threat to innovation in this highly concentrated market. Anthem's argument that the district court failed to balance the merger's likely benefits against its potential harm "rings hollow" in light of the evidence.

Judge Brett Kavanaugh, in dissent, weighed the claimed efficiencies and anti-competitive effects, and found that "the record decisively demonstrates that this merger would be beneficial to the employer-customers who obtain insurance services from Anthem and Cigna." He emphasized that the government agreed that the merger would allow Anthem-Cigna to obtain lower provider rates, and found that the evidence "overwhelmingly" demonstrates that the savings would be passed through to consumers.

The Utility of Efficiencies in Mergers Going Forward — What Does United States v. Anthem Inc. Mean for Your Transaction?

The D.C. Circuit's opinion seems to call into question the use of efficiencies evidence in litigated merger cases, going out of its way to cite and explain FTC v. Procter & Gamble Co., 386 U.S. 568 (1967), as controlling, despite several circuit courts accepting efficiencies as relevant to the analysis. The majority went so far as to chide the dissent in strident terms, saying it was applying the law as "he wishes it were, not as it currently is" in relying on efficiencies as pro-competitive. See, Slip Op. at 15. However, despite the colorful language, a careful reading reveals that the D.C. Circuit allowed that efficiencies could be used to rebut a prima facie showing while not being a complete legal defense under Section 7. Slip Op. at 17. The rebuttal evidence here relied on a factual analysis of the type of efficiencies evidence presented. That approach falls in line with numerous other opinions that have skirted answering the ultimate legal question of whether efficiencies evidence can provide a defense to a Section 7 illegality claim. The petition to the Supreme Court hoped to bring the question of whether efficiencies can save an otherwise anti-competitive merger to a conclusion.

United States v. Anthem Inc. also provides an important reminder: Efficiencies are an important consideration for the FTC and the Antitrust Division in case selection, but under the current case law, is a difficult issue for defendants in court. As Anthem's cert petition argued, lower courts "remain haunted by Supreme Court precedents from a bygone era of per se rules and structural presumptions," but since Procter & Gamble, six sets of merger guidelines have recognized merger efficiencies, and a proper merger analysis accounts for both upward and downward pricing pressure that may result from the transaction. Courts like the D.C. and Ninth Circuits continue to cite Procter & Gamble as binding, perhaps allowing efficiencies evidence as part of a rebuttal case but in a hostile fashion and not allowing for the merger guidelines' more integrated approach to assessing competitive effects, one that looks to more discerning and sophisticated economics instead of concentration statistics that governed five decades ago.

So, efficiencies evidence may allow you to proceed with your transaction, but as a practical matter, only before the case gets to court. This dichotomy of court and agency practice underscores an important practice point: It may be best and most persuasive to provide efficiencies evidence clearly and from the start of a potentially challenging transaction. If you are already entrenched in litigation the evidence required to carry a burden has proven elusive. In contrast, the agencies have committed to analyzing

efficiencies. The fact that many mergers with some level of anti-competitive effects never make it to court may reflect the agencies' crediting of efficiencies as a counterbalance to anti-competitive effects. Regardless, the history shows that it is best to present such evidence early, as part of rebuttal evidence, and again, look to the merger guidelines for a framework of how best to construct it.

Until 1974, merger cases could be appealed from the district courts directly to the Supreme Court under the Expediting Act. That direct appeal was changed by the Tunney Act in 1974, and the Supreme Court has not reviewed a merger case on the merits since. The lower courts look to the merger guidelines as authoritative standards for legality in the absence of Supreme Court guidance, in part because the case law is in dire need of updating. Most transactions cannot survive long enough for Supreme Court review, which is unfortunate. The Anthem case had nicely advanced the efficiencies issue and the cert petition laid out the reasons why such review was in the public interest. In the absence of Anthem, the business community and the antitrust bar will continue to advance efficiencies arguments to the federal agencies and wait for more clarity from the courts.

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