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Featured Article

Merger Enforcement: Are The Antitrust Agencies on a Collision Course with Wall Street?

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The issue of antitrust enforcement in today's economic crisis continues to percolate, though it has not yet come to a boil. Press reports and opinion pieces commenting on the nomination of Christine Varney as Assistant Attorney General for Antitrust and the selection of Jon Leibowitz as the new Chairman of the Federal Trade Commission would have you believe these appointments will usher in a new era of more aggressive enforcement. But let's put plaudits and politics aside: this economic crisis will force them to balance the administration's enforcement goals against the benefits of consolidation on a faltering economy.

As our new chief antitrust regulators assume their respective roles, their colleagues at the agencies have begun to wade into these challenging waters in earnest. Both Federal Trade Commissioner Tom Rosch and Dr. Ken Heyer, the most senior career economist at the DOJ Antitrust Division, recently offered their thoughts on the issue.[1]

While these initial offerings rightly (if unsurprisingly) maintain that even this historic economic crisis should not repeal the antitrust laws, they do begin to reflect on how antitrust analysis can and will take account of the searing reality many businesses face today. It is clear that this is the most critical issue the antitrust agencies will face in the near term.

Because damage has already been done. The current economic crisis has drastically (in some cases, catastrophically) decreased demand in numerous industries, resulting in excess capacity, idled factories, and widespread layoffs. For example, as part of its latest plea for government help, GM announced that it would eliminate the Hummer and Saturn brands, close additional plants, and terminate thousands of dealerships. These cuts would reverberate throughout the automotive supply chain.

With long-term demand forecasts bleak, and the world economy showing no sign of improvement, business leaders are facing ever-increasing pressure to reduce costs and increase efficiency. One focus is mergers and acquisitions. Strategic transactions often result in significant efficiencies, facilitate the optimization of plants and production, eliminate duplicative functions, and generate other synergies that bolster the bottom line. We already have seen the combination of Bank of America and Merrill Lynch, as well as Wells Fargo and Wachovia. And this is likely just the beginning.

Mergers between existing competitors – typically referred to as "horizontal" mergers – often generate the greatest efficiencies. But they may also raise antitrust concerns by reducing the number of current competitors and increasing market concentration. And they are often politically unpopular, as they can result in job losses and plant closures. Our new antitrust regulators will have to assess these transactions through the prism of today's economic reality.

Can the antitrust laws effectively take this situation into account? And if so, how will our current economic woes affect the merger review process? The answers to these questions lie in the prosecutorial discretion of the enforcement agencies.

The Justice Department and the FTC enforce the Clayton Act, which prohibits transactions that may "substantially lessen competition, or tend to create a monopoly."[2] There is comparatively little case law interpreting this broad language, because few transactions can survive the delay and uncertainty caused by litigation. While an interesting drama, the FTC's seemingly endless battle against Whole Foods' acquisition of Wild Oats was certainly the exception, not the rule.

In this environment, the FTC and DOJ are not just enforcers, but policymakers. Through the issuance of Horizontal Merger Guidelines, commentaries, and policy statements, these agencies have filled out the regulatory framework. What they created is a flexible structure that can readily adapt to different markets and changing conditions.

At one extreme, antitrust law has long recognized the "failing firm" defense. This doctrine is based on the proposition that a merger – even an anticompetitive one – may be preferable to a company's total demise. As the Supreme Court has stated, "the effect on competition and the loss to stockholders and injury to the communities where its plants were operated will be less if a company continues to exist even as a party to a merger than if it disappears entirely from the market."[3]

Historically, the agencies accepted that view only in a very narrow set of circumstances. The Guidelines require that to qualify as failing, a company must not only be unable to meet financial obligations but must also be incapable of successfully reorganizing in bankruptcy.[4] Moreover, the seller must show that it shopped the business and could find no less anticompetitive buyer (at any price), and that if the deal does not go through the assets will exit the market.[5] It's no wonder this defense is rarely tried and even more rarely accepted, because the burden of proof is a significant one.

But the FTC and DOJ have applied analogous principles to weakened and struggling firms as well. Even if not literally failing, a company's financial weakness or other difficulties may well mean that its competitive significance in the future is far less than it was in the past. That would reduce the level of competitive concerns a transaction would otherwise raise.

As both Commissioner Rosch and Dr. Heyer recognize, "if the firm is not likely to be an effective competitor absent the merger, then the merger is unlikely to produce an adverse effect on competition."[6] Of course there is much room for debate over what is an "effective competitor," as the issue can be one of degree, not kind. But this issue nevertheless will be a critical one for consolidation of competitors in industries being transformed by the meltdown.

And examples abound. In several industries the demand has contracted by as much as one-third. That level of reduced demand simply cannot support the current supply base in anything like its current configuration. Even if suppliers do not face extinction, they will have to close plants to eliminate excess capacity and reduce cost. And they will face pressure to exit underperforming product lines as well.

This situation is one good example of why consolidation may be the best solution. Individual suppliers can only maneuver within their existing footprint, and may have to cut more deeply than is ideal to make their current product line (and demand) fit with their asset base. But combining with a competitor provides a broader set of assets to work with and a good fit may well produce a more efficient result than either could acting alone. As Commissioner Rosch recognized, the "merger of two weak and financially struggling firms (though not necessarily on the brink of failure) could result in a stronger competitor," or could "create unique synergies that enhance efficiency."[7]

While these issues typically arise in the context of discrete transactions, there is precedent for their broader application to the consolidation of entire industries. The most recent example is the sharp decline in defense spending in the late 1980s, which triggered a wave of mergers and acquisitions in the military's industrial base. As the defense budget shrank, the Department of Defense (DOD) encouraged (and the FTC and DOJ allowed) many suppliers to consolidate facilities and eliminate excess capacity in order to remain financially viable.

In some sectors, this resulted in levels of concentration that otherwise would certainly have been challenged. For example, the number of fixed wing aircraft manufacturers was reduced from 8 to 2, and the number of tactical missile manufacturers from 13 to 3. This process, which was closely managed by both the DOD and the antitrust agencies, did not approve every proposed transaction, but ultimately resulted in a supply base that reflected the reduced demand.

The obvious parallels between this historic example and today's financial services and automotive industries, among others, provide something of a roadmap. It is of course naïve to think that every deal will be automatically approved. Certainly, no one expects President Obama to suspend the federal antitrust laws (as Roosevelt did during the Great Depression). And the FTC and DOJ will continue to play an active role.

What is clear is that the agencies will take into account the impact of real world economic circumstances on the current and future competitiveness of the merging parties. Where firms can show that their combination would result in a stronger firm that is better able to weather the current crisis, such evidence should be credited.

So what are the key points for parties presenting their case to the FTC or DOJ? First, they should be prepared to demonstrate how the economic crisis has affected, and will continue to affect, their industry. They will also have to show that the transaction will result in meaningful cost savings, greater savings than either company could generate alone. Those savings that will be shared with customers will gain the most credit.

And, finally, parties will have to show that there will continue to be effective competition in the future. At some point, we all hope and assume, this crisis will subside and the U.S. economy will return to historic levels. Consumer demand will increase and companies will respond by ramping up production. Where entry barriers are low, or where existing customers can move significant volumes of business that would enable new entrants, the agencies should be less concerned regarding future competition and more receptive to the arguments discussed above.

Contrary to press reports, the antitrust agencies are unlikely to go to war with Wall Street. Their goal is to foster effective competition now and in the future. Look for the agencies to play an active – and practical – role in the coming months. While their long-term goal is to have a track record of effective antitrust enforcement, they, along with the rest of the administration, must focus first on how they can be part of the solution to the economic crisis we are all facing.

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[1] *See* Remarks of J. Thomas Rosch, *Implications of the Financial Meltdown for the FTC* (Jan. 29, 2009), available at http://www.ftc.gov/speeches/rosch/090129financialcrisisnybarspeech.pdf; Ken Heyer and Sheldon Kimmel, *Merger Review of Firms in Financial Distress* (March 1, 2009), available at http://www.usdoj.gov/atr/public/eag/244098.pdf.
[2] 15 U.S.C. § 18.
[3] *United States v. General Dynamics Corp.*, 415 U.S. 486, 507 (1974).
[4] *See* Guidelines, Sec. 5.1.
[5] *Id.*
[6] *Heyer* at 4; *see also Rosch* at 6–7.
[7] *Rosch* at 9.