Conduct Remedies: A Major Change In DOJ Merger Cases

Law360, New York (October 04, 2012, 5:09 PM ET) -- What a difference an administration makes. The U.S. Department of Justice Antitrust Division for decades has evinced a strong preference for structural remedies (mainly divestitures of overlapping businesses) over conduct remedies (like pricing or other behavioral commitments).[1] This long-standing policy reflected not only the DOJ’s preference for certainty and avoidance of costly government entanglement in business, but also its lack of resources dedicated to monitoring post-closing compliance by merging parties.[2]

Over the years, the DOJ has disfavored conduct remedies because it believed they potentially suffered from at least four substantial costs that a structural remedy could avoid. These costs included (1) additional monitoring and enforcement, (2) the merged firm’s efforts to evade the remedy’s “spirit,” (3) the remedy’s potential restraint of pro-competitive behavior, and (4) the inability of the merged firm to efficiently respond to changing market conditions without violating the remedy.[3]

This preference for structural remedies could result in tension with another DOJ policy that held that its remedies in merger cases should “be no more intrusive on market structure and conduct than necessary to cure the competitive harm.”[4] Until recently, that tension had been resolved, for the most part, in favor of structural remedies. Indeed, the 2004 Policy Guide to Merger Remedies explained that “stand-alone conduct relief is only appropriate when full-stop prohibition of the merger would sacrifice significant efficiencies and a structural remedy would similarly eliminate such efficiencies or is simply infeasible.” Even then, “the costs of the conduct relief must be acceptable in light of the expected benefits.”[5]

During the past few years, we have witnessed a significant change in the DOJ’s merger remedies policy. Increasingly, conduct remedies are seen as a “valuable tool for the Division” that “can be a particularly effective option when a structural remedy would eliminate [a] merger’s potential efficiencies.”[6]

The previous preference for structural relief now appears to be limited to horizontal merger challenges, and the current Policy Guide to Merger Remedies still explains that “the Division will pursue a divestiture remedy in the vast majority” of such cases.[7] Several recent merger cases, however, reveal just how far the DOJ’s use of conduct remedies, particularly in the form of contractual requirements, has come in both horizontal and vertical mergers. Moreover, they highlight new tools for parties seeking to settle a merger challenge.

Modification of Existing Contracts and Future Contracts

In at least three waste industry cases since 2000, the DOJ has required contract modification as part of settlement agreements. When Allied Waste Industries Inc. and Republic Services agreed to exchange certain waste-hauling and disposal assets, the DOJ alleged the two companies were two of only a few providers of waste collection or disposal services in certain local geographies.[8] In addition to divestitures, the DOJ also required both Allied and Republic to alter the contracts each used with its commercial customers in certain geographies.
In several geographies, modification of customer contracts formed the sole remedy under the final judgment. The parties were required to offer existing and new customers contracts that would have shorter initial and renewal terms, shorter notice periods for termination, and lower liquidated damages clauses.[9] These modifications, which would allow customers to more easily switch providers of waste hauling and disposal services, were a sufficient remedy because they would lower entry barriers by making it easier for competing firms to expand if price increases occurred.[10]

The DOJ imposed nearly identical contractual remedies in 2003 when Waste Management Inc. acquired waste-hauling and disposal assets from Allied Waste Industries,[11] and again in 2005 following Waste Industries USA’s acquisition of certain waste-hauling assets from Allied Waste Industries.[12]

Outside of the waste industry, the DOJ also imposed contract modifications when Graftech International Ltd. acquired a majority interest in Seadrift Coke LP in 2010.[13] Graftech was one of the largest producers of graphite electrodes in the world. Seadrift was one of two domestic manufacturers of petroleum needle coke, which is the primary input in the production of graphite electrodes.[14] At the time of the acquisition, Graftech sourced the majority of its petroleum needle coke from one of Seadrift’s competitors, ConocoPhillips, through long-term supply agreements containing most-favored nation ("MFN") clauses.

Under the supply agreements, Graftech and ConocoPhillips had the right to audit each other’s books to ensure compliance with the MFN clauses. Therefore, the acquisition of Seadrift by Graftech resulted in two competitors having access to each other’s information regarding costs, pricing, production volume and other commercially sensitive information.[15] The DOJ alleged such information access could enhance the ability of the parties to coordinate prices and output.[16]

To remedy the alleged potential harm, the DOJ and the parties agreed that Graftech would modify its current supply agreements with ConocoPhillips to strike the audit and MFN clauses, (and that Graftech would not include in future contracts with ConocoPhillips any term that conveys an audit right, MFN pricing, or otherwise allows the exchange of third-party production, pricing and related commercial information between Graftech and ConocoPhillips). Additionally, the settlement imposed certain reporting and firewall requirements that complemented the requirement to modify supply agreements.[17]

In addition to imposing requirements to modify existing contracts, the waste industry cases and Graftech/Seadrift discussed above further required that the parties would not enter contracts for a period of years that contained terms similar to those struck from existing contracts. The Google/ITA and Comcast/NBC Universal transactions discussed below can also be viewed as examples where certain types of future contracting practices were prohibited.

**Honor, Extend and Renew Current Contracts**

Concern about vertical mergers resulting in a combined firm that may have the ability to foreclose competition from its customers also can be resolved with contractual remedies. For example, Google Inc. decided to launch a comparative flight search website (or online travel intermediary, “OTI”) and agreed to acquire ITA Software Inc., a leading provider of airfare pricing and shopping systems that enable OTIs to operate.

The DOJ alleged that the transaction would allow Google to foreclose competition from other OTIs by degrading or withholding access to ITA’s current and future software, which was considered a critical input to many competing OTIs.[18] Google and ITA resolved the DOJ’s concerns regarding existing customers by agreeing to honor existing licenses with OTIs and to renew licenses under terms similar to those contained in existing contracts.[19]
The DOJ required extension of customer contracts more recently when United Technologies Corp. acquired Goodrich Corp. There, the DOJ required UTC to extend the term of certain customer contracts for a period of 30 days after the divestiture of Goodrich’s engine controls business. While divestiture still was required in this case, the contract extensions further illustrate the DOJ’s willingness to use contractual remedies to prevent vertically integrated companies from impeding a competing customer’s access to necessary products, even if the contractual remedy is intended only to prevent such foreclosure prior to required divestitures.

**Contract With New Customers on Fair, Reasonable and Nondiscriminatory Terms**

Beyond protecting existing OTI customers in the Google/ITA merger, the settlement protected potential OTI customers by requiring the combined firm to offer licenses to any OTI not currently under contract on fair, reasonable and nondiscriminatory terms, judged in reference to similarly situated entities. Further, the DOJ required Google to make available to OTIs ordinary course software upgrades at the same price those upgrades are made available to other customers and to offer licenses to a new search product. Each of these remedies helped resolve DOJ’s concern that Google would have the ability and incentive post transaction to weaken its competitors by denying or degrading their access to ITA’s software.

Like in the waste industry cases and Graftech/Seadrift, the DOJ prohibited certain terms in future contracts. For example, Google could not enter into any new ITA license agreement that would prevent an OTI from using alternative flight search products, thus allowing for the emergence of competitive software offerings during the term of the final judgment. Google also could not enter into agreements with airlines inappropriately restricting the airlines’ right to share seat and booking class information with Google’s competitors.

Such agreements were prohibited because access to such information is a critical input to the software powering competitive flight search offerings. And, finally, Google could not condition the provision of ITA’s services on whether or how much an OTI spends on other products or services sold by Google, thus preventing Google from leveraging its market power to gain an unfair advantage in the market for comparative flight search products.

Google/ITA is not unique. The DOJ imposed similar contractual remedies when Comcast Corp. and NBC Universal Media LLC entered a joint venture agreement in 2009 to combine each party’s video programming assets into a Comcast controlled entity. This transaction raised similar foreclosure concerns since the resulting entity would have less incentive to distribute NBC programming to Comcast’s video distribution rivals.

To resolve the DOJ’s concerns, the parties agreed to license programming to emerging online rivals on terms “economically equivalent” to the terms provided to traditional video programming distributors. Comcast also was prohibited, with certain narrow exceptions, from requiring programmers or video distributors to agree to licensing terms that seek to limit online distributors’ access to content and retaliating against suppliers of content similar to NBC.

Of note in both Google/ITA and Comcast/NBC Universal were requirements to submit disputes with customers to arbitration under certain circumstances, which provided additional incentive to reach arms-length agreements without additional government or judicial oversight.
Looking Ahead

It is evident from the variety of contractual remedies the DOJ has accepted, as well as the types of alleged harms such remedies are intended to resolve, that the DOJ has become far more receptive to contractual remedies in a broad range of circumstances. Viewed together, these cases show the DOJ is willing to resolve concerns stemming from both horizontal and vertical mergers using contractual remedies. Such remedies may require modification of existing contracts and/or prohibit certain terms in future contracts.

Similarly, they may impose requirements to honor, extend and renew current contracts, or to contract with new customers on fair, reasonable, and nondiscriminatory terms. The DOJ has used these terms to adjust the contractual relationships with customers as well as suppliers (especially those customers or suppliers that happen also to become competitors post-merger). And further, it has used these types of contractual remedies to prohibit foreclosure and facilitate entry and customer switching on one hand, and prevent coordinated activity on the other.

It appears safe to assume that the cases where the DOJ agrees to contractual remedies are not outliers. In fact, these cases and recent statements and changes at the DOJ indicate it now views these types of conduct remedies as consistent with the long-standing goals of avoiding uncertainty and costly government entanglement in business. Foregoing structural remedies, the DOJ believed that modification of contracts was an acceptable substitute for divestitures in certain geographies to facilitate entry in the waste industry cases and contractual modifications resolved concerns about potential coordinated activity in the Graftech/Seadrift transaction.

It appears that the DOJ believed that these types of contractual remedies, which set the state of play between customers, suppliers and competitors by prescribing and proscribing certain terms, function as effectively as structural remedies in certain circumstances.

Further, the DOJ has addressed directly the criticism that contractual remedies result in costly government entanglement in business. In the Comcast/NBC Universal transaction, the DOJ rejected the American Antitrust Institute’s criticism that the imposed licensing provisions “require ongoing oversight, monitoring, and compliance” that antitrust enforcers and courts are “woefully” equipped to handle. The DOJ explained that incorporating an arbitration mechanism to resolve any disputes over whether the joint venture was meeting its obligations to license content to competitors is a common mechanism to resolve such disputes and that arbitration will prevent DOJ or the court from “becoming unnecessarily embroiled in difficult issues.”

Moreover, it stressed that the imposed arbitration framework was a “backstop” and that “[a]rms-length negotiations should resolve most issues regarding” licensing terms. Because the required arbitration is binding, the DOJ explained that the parties will have an increased incentive to reach commercial agreement without intervention by a third-party arbitrator. Even if the DOJ must take a greater oversight and enforcement role during the term of final judgments, it has made clear that it will devote appropriate resources through its recently created Office of General Counsel to ensure that such remedies are monitored and enforced.

The news for parties considering settlement options therefore is that contractual remedies can be the scalpel that replaces the ax of injunctions and divestitures in certain merger enforcement actions. Properly constructed, they resolve anti-competitive concerns, allowing mergers to proceed and efficiencies to be realized without diminution caused by divestiture of significant business assets. If recent history is any indication, contractual remedies can be expected to continue to play an important role in settling DOJ merger enforcement actions.
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[2] Id. at 8-9.
[3] Id.
[4] Id. at 4.
[5] Id. at 18 & 20.
[7] Id. at 5.
[20] The authors represented United Technologies in its acquisition of Goodrich.
[34] Id.
[35] Id.
[36] Id.

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