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ANTITRUST

Expert Analysis

Uncommon Merger Challenges

By
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Surprising some observers, the new leadership at the Antitrust Division of the Department of Justice has brought a couple of noteworthy merger cases over the last few months. The much-discussed lawsuit to block AT&T from acquiring Time Warner stands out as a renewed approach to fixing perceived anticompetitive effects in vertical mergers. And, in a somewhat less publicized case, the division sought to unwind a transaction involving air fuel filtration long after the conclusion of the waiting period for pre-merger antitrust review. Neither case lacks doctrinal support or precedent, but together they seem to mark a bold approach to merger enforcement.

Video Distribution

AT&T—the largest distributor of subscription television in the United States (through its ownership of DirecTV)—agreed to acquire Time Warner, which owns many popular television networks, including CNN, TNT, TBS and HBO, and the Warner Bros. movie studio. AT&T does not compete head-to-head with Time Warner, but it distributes Time Warner's networks as well as many other networks, such as Disney, FOX, ESPN and MTV. In other words, AT&T has a vertical relationship with Time Warner.

Customarily, vertical mergers have been treated with more deference than horizontal mergers by U.S. antitrust enforcers. In a horizontal transaction, two companies that compete at the same level of distribution, typically selling to the same group of customers, agree to merge. In contrast, a vertical merger involves two companies that buy and sell from one another, like a manufacturer and a distributor.

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Antitrust law, under §7 of the Clayton Act, seeks to prevent mergers that would substantially lessen competition or tend to create a monopoly in a line of commerce. But the inquiry is generally different in vertical mergers compared to horizontal mergers. In a horizontal merger, the concern is that the elimination of competition between the combining firms would harm consumers by, for example, enabling the merged firm to charge higher prices without losing too many customers. Horizontal merger analysis often involves an examination of whether other rivals are likely to discipline price increases by the merged firm. (*See* the discussion below of the air fuel filtration matter.) In a vertical merger, the analysis usually focuses on foreclosure of rivals. In other words, antitrust authorities ask whether the merger would change incentives in a way that would lead the merged company to stop supplying rivals or foreclose rivals from accessing critical inputs or distribution channels.

The complaint, *United States v. AT&T* (D.D.C. Nov. 20, 2017), alleges two theories of harm: first, AT&T may threaten to withhold licensing Time Warner networks, such as CNN and HBO, to rival video distributors. Even though AT&T would lose advertising revenue and monthly fees by cutting off a rival distributor, some of that rival's customers may switch to DirecTV to be able to watch CNN, HBO or TNT. This prospect could, according to the complaint, embolden AT&T in its negotiations with cable companies and other distributors, raising those rivals' costs, which are likely to be passed on to consumers in the form of higher prices.

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Second, the government asserts that AT&T's ownership of these popular networks will position the company to stifle the development of new disruptive video distribution platforms such as Netflix or Amazon Prime. The complaint adds, in an understated reference to Comcast/NBC Universal, that the merger would align the structures of the two largest video distributors, making oligopolistic coordination more likely. The analysis is complicated by the rapid technological and cultural changes in video distribution markets as well as consolidation among content producers, developments that both sides of the litigation may try to use to support their arguments.

These theories echo concerns raised several years ago when the Department of Justice settled charges that Comcast's acquisition of NBC Universal violated antitrust laws. But that settlement did not include divestitures. Instead, Comcast agreed to various behavioral remedies, including a "net neutrality" requirement and an obligation to license programming on online video distributors on competitive terms, with an option to submit the dispute to an arbitrator if they cannot agree. (*United States v. Comcast*, Competitive Impact Statement, D.D.C. Jan. 18, 2011.) Those remedies are set to expire in 2018. In this case, the Antitrust Division must have determined that seemingly similar concerns could not be satisfied with behavioral remedies. In a speech delivered several days before the filings of the AT&T complaint, Makan Delrahim, head of the Antitrust Division, criticized behavioral remedies for supplanting competition with regulation and expressed a preference for structural remedies (i.e., divestitures).

The court will likely have to resolve whether behavioral remedies suffice to address any expected anticompetitive effects, but the trial is not scheduled to start until mid-March, and a decision may not come down until after the merger agreement's expiration date, April 22, 2018. After that date, AT&T may be required to pay Time Warner a $500 million break-up fee, unless the parties agree to extend that deadline. Merger investigations and litigation, complex and consequential to begin with, often face additional pressures from shareholders, markets and other interests involved in consummating a negotiated agreement between public companies.

Air Fuel Filtration

The air fuel filtration merger challenge seems to follow well-established antitrust doctrine in terms of competitive analysis, but it stands out as a rare instance where the government seeks to unwind a transaction that made its way through the pre-merger notification and review process and was not prohibited from closing.

> While the distinction between pre-merger review and the legality of a merger is important to recognize for companies considering a transaction that may be challenged on antitrust grounds, the chance of a post-closing, post-HSR challenge remains low and should be evaluated based on the specific facts of the transaction at issue.

The Antitrust Division of the U.S. Department of Justice (DOJ) filed a complaint in federal court on Sept. 26, 2017 challenging Parker-Hannifin Corporation's acquisition of CLARCOR. The DOJ alleged that the transaction eliminated head-to-head competition between the only two domestic manufacturers of aviation fuel filtration systems and filter elements. Alleging the creation of an unlawful monopoly that would increase prices, reduce innovation, decrease the reliability of delivery times, and lead to less favorable terms of service, the DOJ seeks divestiture of either Parker-Hannifin or Clarcor's aviation fuel filtration assets. Parker-Hannifin agreed to preserve and maintain the two separate aviation fuel filtration assets during the pendency of the lawsuit.

Notably, the DOJ filed its complaint several months after the expiration of the antitrust waiting period applicable to the transaction. The companies entered into a merger agreement in December 2016 and promptly filed the required pre-merger notifications reporting their proposed transaction under the Hart Scott Rodino (HSR) Antitrust Improvements Act, which requires purchasers of voting securities exceeding certain thresholds to notify the DOJ and FTC and observe waiting periods before completing the acquisitions to give the antitrust agencies an opportunity to review the transactions. In January 2017, federal antitrust agencies let the HSR waiting period expire without extending their review. After the closing, however, the DOJ opened an investigation that led to the recent complaint, reportedly as a result of customer complaints.

Although aviation fuel filtration systems constitute a relatively small part of the overall business of the combined company, the competitive concerns arose in that space. Aviation fuel must be filtered before it is considered clean enough for use by commercial or military aircraft, as the failure to filter properly can cause plane engines to stall. To prevent potentially catastrophic consequences, U.S. airlines and the U.S. military mandate use of aviation filtration fuel filtration systems and products that have been subjected to a rigorous series of qualification tests conducted in the presence of an aviation fuel expert from the Energy Institute.

Prior to the merger, Parker-Hannifin and Clarcor were the only suppliers of qualified aviation fuel filtration systems and elements to U.S. customers. The only other manufacturer of such products is located in Germany and has no U.S. facilities or operations. The DOJ alleged it is unlikely that a new manufacturer will enter the market, as securing qualification for aviation fuel filtration products is "expensive, time-consuming, and difficult."

According to the DOJ's complaint, the qualified aviation fuel filtration systems and elements constitute relevant product markets. U.S. customers will accept no substitutes for these systems and elements. Further, a company that controls the systems and/or elements in the United States could profitably raise prices, and in the event of a price increase, customers are unlikely to switch away from the systems or elements.

The complaint asserted that, prior to the merger, Parker-Hannifin and Clarcor were engaged in head-to-head competition in each of the relevant markets. The competition allegedly enabled customers of the products to negotiate better pricing, service and terms and to receive innovative product developments from the two companies. As a result of the merger, however, head-to-head competition is eliminated. As a result, the DOJ asserts that Parker-Hannifin has the power to raise prices without fearing a decrease in the amount of sales.

Second, the DOJ alleged that the merger also reduces non-price competition and innovation. Prior to the merger, Clarcor distinguished itself as the leading provider of services and non-price benefits, such as product improvements, training programs, customer services, and on-time delivery. On the other hand, Parker-Hannifin was weaker on customer service and offered less non-price benefits, according to the complaint. According to the DOJ, following the merger, Parker-Hannifin's incentive to compete with the services and timely delivery offered by Clarcor is eliminated.

Third, the DOJ asserted that the only other firm that manufactures qualified aviation fuel filtration systems and elements is not a realistic option to address the anticompetitive effects of the merger. The company is located in Germany and has no U.S. presence, which would prevent near-term expansion into the United States. In addition, even if such expansion occurred, it would not be timely or sufficient to restore competition and restrain anticompetitive effects. Given the public safety function of aviation fuel filtration products, the DOJ asserts that U.S. customers will be reluctant to switch to a foreign company.

Likely in anticipation of consternation in the business community about challenges to mergers that have gone through the HSR review process successfully, the DOJ included in the pleadings allegations that Parker-Hannifin was aware that it was acquiring its only U.S. competitor for aviation fuel filtration products. Citing internal documents, the complaint asserts that the companies knew that the transaction raised antitrust concerns. In a document created in the weeks before the merger was announced, a Parker-Hannifin executive identified "the notable area of overlap" between the parties in "ground aviation filtration" and asked whether the company should be "forthcoming" about this "aviation antitrust potential." The executive further said the company was preparing for a potential divestiture of Clarcor's aviation fuel filtration business.

Post-closing challenges to transactions that made their way through the HSR process unscathed are exceptional. The instant complaint is only the third such challenge brought by federal antitrust agencies in the past 25 years. While rare, such a challenge highlights an important feature of antitrust law in the United States. Unlike in other countries, the United States adopted an antitrust review process under the HSR Act in the 1970s, long after the 1914 enactment of the Clayton Act, which made anticompetitive acquisitions unlawful. The HSR process provides companies with a significant degree of confidence as to the agencies' intent regarding the transaction, but does not legally prevent federal or state agencies or private citizens from challenging a transaction. Indeed, transactions that are not reportable under the HSR Act may be and have been challenged if the authorities determine competition will be lessened substantially.

While the distinction between pre-merger review and the legality of a merger is important to recognize for companies considering a transaction that may be challenged on antitrust grounds, the chance of a post-closing, post-HSR challenge remains low and should be evaluated based on the specific facts of the transaction at issue. The odds of a post-closing challenge increase if the merging parties may appropriately be characterized as the only head-to-head competitors in a market.