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DOJ PREVAILS IN UNPRECEDENTED ARBITRATION IN MERGER CHALLENGE, SIGNALING MORE ARBITRATION IN FUTURE MERGER CHALLENGES

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For the first time in history, DOJ's Antitrust Division used binding arbitration to resolve a central dispute in a merger challenge. As part of its lawsuit to block Novelis Inc.'s proposed acquisition of Aleris Corporation, the parties and DOJ agreed to resolve the issue of market definition through binding arbitration. DOJ implemented the relevant order and regulations for Alternative Dispute Resolution ("ADR") in the mid-1990s,[1] but this marks the first time DOJ has used its arbitration authority.

This successful foray means that DOJ leadership is likely to offer arbitration to resolve narrow disputes in future merger investigations. Arbitration may facilitate faster resolution of critical issues without incurring the time and expense of full court litigation. Increased use of arbitration also implicates public policy issues, including deciding what matters will be used to shape precedent.

The Proposed Merger and Challenge

Novelis, a flat-rolled aluminum producer, agreed to acquire Aleris, a relatively new producer of flat-rolled aluminum, in July 2018. More than a year later, DOJ filed a complaint in the Northern District of Ohio seeking to block the acquisition.[2]

The Novelis complaint alleges that the acquisition would combine two of only four North American producers of aluminum auto body sheet ("ABS"), providing the combined entity with 60% of total production capacity and allowing it to raise

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prices, reduce innovation, and provide less favorable terms of service to automakers. Automakers are increasingly using aluminum ABS to develop vehicles that are lighter and more fuel-efficient.

The complaint quotes internal party documents to support DOJ's theories, including that Novelis was worried Aleris could be sold to a "new market entrant in the U.S. with lower pricing discipline" and that an "alternative buyer [was] likely to bid aggressively and negatively impact pricing" in the market.[3]

In announcing the challenge, DOJ promoted the use of arbitration as allowing it to "resolve the dispositive issue of market definition in this case efficiently and effectively, saving taxpayer resources."[4] In 1995, Attorney General Janet Reno ordered the entire DOJ (not just the Antitrust Division) to undertake greater use of ADR "in appropriate cases."[5] In 1996, the Antitrust Division published policy guidance, including on case selection criteria, different ADR techniques such as arbitration and mediation, and factors favoring or disfavoring ADR. This guidance notably provides:

> Because of the time constraints imposed by the [Hart-Scott-Rodino Antitrust Improvements Act of 1976] and the exigencies of the merger review process in general, ADR techniques will likely be difficult to apply during the course of merger investigations. On the other hand, nonmerger investigations often have more timing flexibility.[6]

In *Novelis*, DOJ filed a notice with the court stating that "because this merger challenge would turn on a single dispositive issue [product market definition], the parties have agreed to refer this issue to binding arbitration . . . to lessen the burden on the Court and reduce litigation costs."[7] The notice included a redacted term sheet governing the parties' agreement to arbitrate.[8] According to that document:

- The parties and DOJ "must work in good faith to commence the arbitral hearing" within 120 days of the filing of the answer, assuming DOJ has not accepted a remedy. Arbitration had to be completed within 21 days, and the decision made within 14 days of the hearing.
- If DOJ and the parties could not agree on a

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single arbitrator, a panel of three arbitrators would be selected.

- The arbitral decision was limited to five pages.
- If the arbitrator determined that the relevant market is broader than DOJ alleged, the complaint would be promptly dismissed. If the arbitrator agreed with DOJ, the parties would be forced to divest certain assets and pay DOJ's fees and costs, including expert fees.
- If the arbitrator did not rule for DOJ prior to December 20, 2019, and the arbitration was still pending as of that date (which occurred), the parties could close the transaction subject to holding the potentially divested assets separate from the rest of the business.[9]

The Arbitrator's Decision

In a March 2020 DOJ press release, DOJ announced that it had prevailed in the arbitration and, as a result, Novelis must divest Aleris' aluminum ABS operations in North America.[10] Assistant Attorney General for the Antitrust Division ("AAG") Makan Delrahim stated that DOJ supports increasing use of arbitration "in the right circumstances." In this case, arbitration "proved to be an effective procedure for the streamlined adjudication of a dispositive issue in a merger challenge" and that DOJ "look[s] forward to applying the learning from this case to future matters."[11]

The arbitrator's five-page decision "relied upon the evidentiary record, the 2010 Merger Guidelines, as well as relevant case law and other authorities." He concluded that, while steel and aluminum ABS suppliers may "aggressively compete" at some stages of the automobile manufacturers' design process, the evidence supported the DOJ's product market because steel did not compete with aluminum ABS at later stages where "actual and dynamic pricing occurs."[12] Notably, the arbitrator dismissed both parties' experts' quantitative evidence because "the underlying data used by both economists was not sufficiently verifiable to be definitively relied upon."[13]

The arbitrator found that steel producers did not constrain the pricing of aluminum ABS in a way that would support a product market that included both steel and aluminum ABS. The government and merging parties diverged over when and how to analyze the significance of price competition, for example, at the procurement phase only (DOJ position) or at the design and procurement phases (merging parties' position). According to the arbitrator, the parties also "would leave the exercise of looking at pricing discipline to competitive effects analysis," urging a more "holistic view" of the evidence that "focus[es] on the entire equation." However, the arbitrator explained:

> It would be odd if the parties agreed to have the outcome in the Arbitration depend on what stage, in merger analysis, price effects are analyzed, and particularly so because the two stages (market definition and competitive effects) are so closely interrelated that the choice could be serendipitous: "[e]vidence of competitive effects can inform market definition, just as market definition can be informative regarding competitive effects."[14]

This statement highlights a common issue over the intersection of market definition and competitive effects analysis in merger investigations and litigation. The analytical spillover between the two concepts potentially serves as a cautionary tale for companies considering whether to pursue arbitration, and on what basis.

Court Approval and Divestiture

DOJ will next file a proposed final judgment with the court requiring Novelis to divest Aleris' entire aluminum ABS operations in North America to preserve competition in the relevant market. Under the Tunney Act, DOJ must publish the order in the Federal Register, and cause a summary of the contents of the order to be published in a newspaper, allowing 60 days for public comments.[15] The parties may close before completing the divestiture, but they are also awaiting resolution of foreign merger review before they can close.[16]

Potential Benefits of Arbitration

Novelis illustrates how arbitration provides DOJ and merging parties with more control over when and how a case will be resolved. Arbitration gives the parties latitude to define the rules of the game. Typically, a judge in a civil matter has significant discretion over how she manages trials, including when hearings will occur, how long discovery will be, and when to issue a decision. With arbitration, DOJ and merging parties can agree on the schedule they believe makes sense without being limited by a court's other matters.

From a process perspective, arbitration is a win for merging parties. Although in *Novelis*, the arbitration schedule was similar to a typical merger litigation, *i.e.*, four months for pretrial discovery overseen by the court and three weeks for the arbitration hearing, parties in other cases could decide on a more condensed schedule depending on the scope of the issue presented. Additionally, if the parties agree on a narrow question for arbitration, the amount of discovery needed may be greatly reduced as compared to typical merger litigation. This could save both time and resources for all involved (including potential third parties who would otherwise be required to respond to subpoenas). This, in turn, can reduce the cost and length of the arbitration by decreasing the number witnesses and exhibits presented.

Likewise, putting a deadline on when a decision has to be entered (here, within 14 days of the hearing's conclusion) gives companies greater certainty for when the process will resolve. Although federal judges often strive to issue opinions in merger challenges in a timely manner (and often much quicker than decisions issued in the non-merger context), parties have no ability to force a judge to render judgment by a certain date. This is not the case with arbitration. As a service provider hired by the parties to focus on their specific issue, requiring decision by a date certain is an option.

Perhaps the biggest advantage of arbitration over traditional litigation is the ability to choose the arbitrator. Unlike litigation in which judges are randomly assigned, arbitration allows the government and merging parties to agree on the decision maker. The DOJ and merging parties will have to decide on a process to decide on an arbitrator. In *Novelis*, the two sides agreed that, if they could not agree on a single arbitrator, a panel of three arbitrators would be selected. While this system worked in *Novelis*, it is certainly not the only option. Another approach parties could explore is allowing each side to pick one arbitrator and allowing those arbitrators to pick a third to complete the panel. Still another is having one party choose three arbitrators it would be happy with and the other side selecting the one that will ultimately arbitrate the matter. The key point: there is substantial flexibility in how an arbitrator can be selected.

This flexibility is key because the identity of the arbitrator may be just as important as the scope of the question arbitrated. Here, AAG Delrahim commended the arbitrator as "a highly-respected and experienced antitrust lawyer and former Director of the Federal Trade Commission's Bureau of Competition" who also served in private practice.[17] If arbitration becomes a more common tool for resolving antitrust investigations, there will be increasing demand for arbitrators who possess antitrust expertise. Companies will need to vet candidates carefully. An arbitrator who has extensive antitrust experience will likely make the challenge process easier for the parties. An arbitrator who lacks antitrust experience, however, may impede the process and require the parties to expend additional resources to bring the arbitrator up to speed.

DOJ's Future Use of Arbitration

While DOJ supports using ADR to resolve future merger challenges in the "right circumstances," there is limited guidance as to what constitutes such circumstances. AAG Delrahim explained that DOJ would consider three factors when determining whether to use arbitration:

- efficiency gains,
- clarity of the question the arbitrator would resolve, and
- potential lost opportunity to create legal precedent.

AAG Delrahim added that DOJ also would consider the identity of the arbitrator, how costs would be allocated, and the arbitration process, which would be agreed by DOJ and the parties "likely before filing suit."[18]

DOJ stated arbitration might be appropriate if there is agreement between DOJ and companies on a clear question for the arbitrator. Identifying and reaching agreement on this point may prove challenging in many cases, including on the discrete issue of market definition when, as in this case, there may be aspects of the separate—and non-arbitrable—competitive effects analysis that potentially support the companies' arguments. This is especially so given that DOJ anticipates these agreements on the scope of arbitration occurring prior to filing suit.

Finally, it is possible that arbitration could hinder the development of antitrust precedent. Mindful of public policy concerns, DOJ has warned that it will not pursue arbitration if it means a lost opportunity to create valuable legal precedent.[19] DOJ may not want to use arbitration in cases that involve high-profile industries or companies, or that implicate important policy considerations. In these situations, the government is more likely to pursue litigation that creates valuable legal precedent over arbitration, where the outcome and reasons for it will be less transparent and determinative of future cases. Still, DOJ may selectively offer or agree to arbitration in challenging matters where it faces difficult facts. By sidelining these matters, DOJ could skew court precedent—strategically or unintentionally—in its favor, ultimately leading to more pro-enforcement case law.

ENDNOTES:

[1]*See* Administrative Dispute Resolution Act of 1996, 5 U.S.C.A. § 571 et seq.; 61 Fed. Reg. 36,896 (July 15, 1996) (Antitrust Division's implementing regulations).

[2]Complaint, *United States v. Novelis, Inc. et al.*, No. 19 Civ. 2033 (N.D. Ohio Sept. 4, 2019), *available at* https://www.justice.gov/atr/case-doc

ument/file/1199461/download.

[3]*Id.* at 7.

[4]Press Release, U.S. Dep't of Justice, Justice Department Sues to Block Novelis's Acquisition of Aleris (Sept. 4, 2019), https://www.justice.gov/opa/pr/justice-department-sues-block-noveliss-acquisition-aleris-1.

[5]U.S. Dep't of Justice, Policy on the Use of Alternative Dispute Resolution and Case Identification Criteria for Alternative Dispute Resolution, 136 Fed. Reg. 36,895 (July 15, 1996).

[6]*Id.* at 36,896.

[7]Plaintiff United States' Explanation of Plan to Refer this Matter to Arbitration, *United States v. Novelis, Inc. et al.*, No. 19 Civ. 2033 (N.D. Ohio Sept. 9, 2019), *available at* https://www.justice.gov/atr/case-document/file/1200821/download.

[8]Term Sheet, *United States v. Novelis, Inc. et al.*, No. 19 Civ. 2033 (N.D. Ohio Sept. 9, 2019), *available at* https://www.justice.gov/atr/case-document/file/1200806/download.

[9]*Id.*

[10]Press Release, U.S. Dep't of Justice, Justice Department Wins Historic Arbitration of a Merger Dispute (Mar. 9, 2020), https://www.justice.gov/opa/pr/justice-department-wins-historic-arbitration-merger-dispute.

[11]*Id.*

[12]Arbitration Decision, *United States v. Novelis, Inc. et al.*, No. 19 Civ. 2033 (N.D. Ohio Sept. 9, 2019), *available at* https://www.justice.gov/atr/case-document/file/1257031/download.

[13]*Id.*

[14]*Id.* (citing U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (2010)).

[15]Antitrust Procedures and Penalties Act of 1974, 15 U.S.C. § 16(b)-(h) (the "Tunney Act").

[16]Press Release, U.S. Dep't of Justice, Justice Department Wins Historic Arbitration of a Merger Dispute (Mar. 9, 2020), https://www.justice.gov/opa/pr/justice-department-wins-historic-arbitration-merger-dispute.

[17]*Id.*

[18]Makan Delrahim, Ass't Att'y Gen., Antitrust Div., U.S. Dep't of Justice, Assistant Attorney General Makan Delrahim Delivers Remarks at the 7th Bill Kovacic Antitrust Salon (Sept. 9, 2019), *available at* https://www.justice.gov/opa/speech/assistant-attorney-general-makan-delrahim-delivers-remarks-7th-bill-kovacic-antitrust.

[19]*Id.*

THE BLENDING OF PRIVATE EQUITY AND ACTIVISM

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A trend is emerging in the world of alternative investments that is defying decades of tradition. There is a noticeable blending of activism and private equity, intrinsically separate investment strategies that once occupied two distinct arenas, into a hybrid space in which private equity firms are making minority investments and hedge funds are acquiring whole companies. While certain activist investors such as Paul Singer and Carl Icahn have long been selectively acquisitive due to their size, other activist investors are also starting to employ private equity-like strategies. For their part, some private equity firms have recently taken up their own form of activist investing.

Differences Between Activists and Private Equity

Activist investors and private equity firms share a common goal: to acquire an ownership stake in a company they consider to be undervalued, effect certain changes at the company designed to boost value, and then realize a return on their original investment by exiting the company at a higher valuation. Historically, however, activist investors and private equity firms have employed fundamentally different means to reach this similar end. Specifically, activists and private equity firms have distinct philosophies with respect to control and publicity, which in turn influences both structure and strategy.

Even though activists and private equity firms both wish to implement change within a company, their respective approaches in doing this differ significantly. Private equity firms, either acting alone or as part of a consortium, purchase whole companies which they go on to operate over the course of several years. Activist investors take a more indirect approach by purchasing minority stakes in order to exert influence through board representation. This contrast of economic versus *de facto* control is the most fundamental difference separating activism from private equity and greatly influences how firms in each space are structured. For example, private equity's long-term strategy requires lengthy lock-up periods. Activists move much more quickly and therefore can offer investors significantly shorter lock-up periods, which facilitates fundraising for activist hedge funds.

Activist investors depend on publicity and utilize it effectively to gain significant influence over a public company through small ownership stakes. In order to implement their desired changes at a company, activists generally launch proxy contests for board representation and other business proposals. Activists launch public campaigns to garner support from institutional investors and other large shareholders, as well as proxy advisory firms such as ISS and Glass Lewis, for their director candidates and other proposals. The risk of engaging in a public campaign also encourages companies to engage directly and productively with the activist.

On the other hand, private equity firms generally operate outside the public eye. One reason for this is due to the typical investor base on which private equity relies. Government and private pension funds usually have little to no appetite for the kind of public attention that hedge funds often utilize. More importantly, private equity firms are ultimately seeking actual control, which is difficult to obtain without the support of the board and management. Private equity firms also depend on management to facilitate access to the information required to commit to purchasing, and ultimately operating, whole companies.

Recent Evidence of Convergence

Recently, however, the once-clear dividing line between activism and private equity has started to fade. For reasons articulated in greater detail below, hedge funds and private equity firms have been taking pages out of each other's playbooks. For example, in January 2020 KKR announced a 6.3% stake in Dave & Buster's Entertainment Inc. ("D&B"), which KKR has since increased to 8.3%. While KKR's stake in D&B could lead to a future sale of the restaurant and arcade company, there is little indication at this point that KKR plans to be the ultimate acquirer. Instead, KKR has stated its intention to engage with D&B management in a constructive manner.

D&B, as a restaurant and arcade operator, is particularly susceptible to the impact of the novel coronavirus known as COVID-19. On March 19, 2020, after its shares dropped nearly 90% as compared to one month prior, D&B announced that it had adopted a shareholder rights plan, more commonly known as a "poison pill." While it is in effect, the rights plan will have the effect of preventing KKR from acquiring more than 15% of D&B's outstanding shares.

KKR's move into activism goes beyond D&B, suggesting that minority investments have a place within the private equity stalwart's broader strategy. In 2018, KKR acquired a 1.6% stake in LogMeIn Inc., which was later sold to Elliott Management Corp.'s private equity arm and Francisco Partners Management LLC. Other significant minority positions acquired and later sold by KKR include stakes in BroadSoft Inc., Buffalo Wild Wings Inc., Marvell Technology Group Ltd., Amedisys Inc. and LiveRamp Holdings Inc.

KKR is not the only private equity firm acting like an activist. TPG is reportedly raising a new "Strategic Capital Fund" designed to amass minority stakes in public companies and press for change in a "management-friendly" manner. While KKR and TPG's emerging brand of activism is consistent with private equity doctrine with respect to management engagement, other private equity firms have not shied away from taking a more hostile approach. For example, in early January 2020, private equity firms Atlas Holdings and Blue Wolf Capital kicked off a proxy contest for board seats at paper manufacturer Verso Corporation. The proxy fight ended in a settlement at the end of January, pursuant to which Atlas and Blue Wolf gained three out of Verso's seven board seats. Likewise, after Red Robin Gourmet Burgers, Inc. rejected Vintage Capital's takeover attempt in September 2019, the private equity firm vowed to conduct a "thorough review of [Red Robin's] books and records as permitted by applicable law" and to "further assess [Vintage's] options as to the replacement of all or a portion of the Board. . ."

While private equity's foray into activism is more recently picking up steam, hedge funds were in fact the first movers in the ongoing imitation game. Perhaps the most notable example is Elliott's founding of a private equity arm, Evergreen Coast Capital, in 2015. Reportedly established in response to a failed 2014 bidding war for Riverbed Technology, launching Evergreen represented a fundamental shift for Elliott. Since its founding, Evergreen has made several large acquisitions, often in concert with more established private equity players. Evergreen's notable buyouts include the 2017 purchase of software company Gigamon for $1.6 billion, the 2018 purchase of Athenahealth (partnering with Veritas Capital) for $5.7 billion, the 2019 purchase of Travelport (partnering with Siris Capital) for $4.4 billion and the previously-discussed 2019 purchase of LogMeIn Inc. for $4.3 billion. Many of Evergreen's deals highlight how Elliott has been able to leverage its activism expertise in connection with acquiring public companies. Before purchasing Athenahealth and Travelport, Elliott waged activist campaigns against both companies. Elliott also previously held a board seat at LogMeIn, although the activist had exited the stock two years prior to Evergreen's buyout.

Outside of Elliott, other activists are beginning to employ similar private equity-like tactics. For example, in 2019 Starboard Value LP made a $200 million investment in Papa John's International Inc. Unlike Starboard's usual activist plays, the Papa John's investment was heavily negotiated and is strategic in nature. Arriving in the wake of a rumored failed auction process that included Trian Partners Management LP, another hedge fund, and beating out a competing bid from "Papa" John Schnatter himself, Starboard's winning bid earned the activist newly-issued shares of convertible preferred stock and at least two board seats.

One of those seats included the chairmanship, which was assumed by Starboard CEO and founder Jeffrey Smith. Since making its initial investment, Starboard has recruited a replacement CEO for Papa John's and has exercised an option to purchase an additional $50 million of preferred shares.

Drivers of Blending

Despite their historical differences, there are areas where private equity and activism share common ground. As discussed previously, hedge funds and private equity firms share the same ultimate objectives. They also often have similar types of investors, and there is value in being able to offer investors a broader spectrum of alternative investment products. Some of these investors include active pension funds that partner with and invest alongside of both private equity firms and hedge funds, serving to further bridge the gap between the two strategies. There is also an ongoing battle between hedge funds and private equity firms over talent. Hedge funds have heavily recruited former private equity-trained individuals who bring with them years of experience, strategies, and tendencies founded in private equity.

Separately, the arrival of new competition in both the private equity and activism spaces may force the established players in each area to expand into new territory. Private equity firms and activist hedge funds often compete with each other over the same investor base. As activist investors begin to also offer in-house private equity investment opportunities, private equity firms may be forced to broaden their own offerings to include minority investments.

In addition to drivers shared by both activists and private equity firms, each has its own specific motivations for crossing into the other's domain. For activists, private equity-like strategies may be a natural progression for investors who already work to identify a company's weaknesses and develop strategies to improve, and therefore capitalize on, those weaknesses. Combine this with the fact that activist hedge funds have more financial resources to deploy and are becoming increasingly institutionalized with growing research staffs, and it is not surprising to see their resources being applied to varying strategies.

In addition, companies are beginning to practice the art of "thinking like an activist" and are proactively addressing vulnerabilities that historically were low-hanging fruit for activists. With fewer ill-prepared companies to target, activists need to identify other types of targets and employ alternate methods for putting their large amounts of capital to work. Fortunately for hedge funds, the increased frequency of auctions in a maturing private equity market has brought increased transparency, allowing activists, as relative newcomers, to hold their own against more experienced players.

Expanding into private equity also nicely complements activism's traditional strategies in a number of ways. Indeed, the most certain way for an activist to implement changes and unlock value in a company may be to take full control and buy it outright. Further, hedge funds that have completed buyouts in the past have more legitimacy when making demands for change. This is especially true when an activist proposes an M&A transaction, which has become an increasingly prevalent strategy for activist investors. Even when the activist does not truly intend to be the ultimate purchaser of the company, it can immediately put a company in play by making a bid as a purely strategic move to establish a starting point for other potential acquirers.

For private equity firms, one major driver of their foray into activism is volume. The private equity space has simply become too crowded for many firms not to branch out into unfamiliar territory in order to make use of their so-called "dry powder," which according to a recent Bain & Company study sits at around $1.5 trillion. Similar to how hedge funds have evolved their strategies, expanding into activism has become a natural next step for many private equity firms as they are beginning to see value in effecting change through board representation. Further, the commitments that private equity firms make to research and diligence can be applied to activist situations just as well as to traditional buyouts.

Private equity firms are also beginning to come around to taking a more aggressive stance towards management. Proxy fights are still uncommon in private equity, in part due to the aforementioned contractual restrictions implemented by large investors. However, there is a growing sentiment that private equity firms can still work constructively with management to ultimately get a deal done even after a hostile or contentious initial engagement.

Potential Impact of COVID-19

The disruptive effect that COVID-19 has had on markets throughout March 2020 could potentially accelerate the convergence of activism and private equity. As market volatility increases and stock prices continue to decline, the risk of hostile takeovers and shareholder activist activity naturally increases. Public companies with reduced equity values have suddenly become vulnerable because it is now less costly for new investors to quickly accumulate large stakes and for existing investors to increase their levels of ownership. While many investors are exiting their positions, some activist hedge funds are in fact doubling down on their previous bets. For example, Carl Icahn increased his stake in Occidental Petroleum from 2.5% to 9.6% as oil prices plummeted, a move which will bolster his ongoing bid to control Occidental's board. While the recent downturn has resulted in a mix of activity from traditional activists, it remains to be seen whether these activists will use this opportunity to conduct additional buyouts rather than minority investments.

The recent market slide may also cause more private equity firms to move even further into activism. As discussed previously, private equity as a whole has a significant amount of dry powder, which now has increased purchasing power. However, despite record levels of capital, private equity firms still depend on debt markets, which are now beginning to tighten. As a result, private equity firms may seek to deploy less capital per investment, potentially through acquiring minority stakes in public companies.

Conclusion

While COVID-19 has led to volatility and uncertainty, the blending of private equity and activism is likely to continue through 2020, as both activists and private equity firms dedicate significant time and capital toward new strategies. Time will tell, however, whether this trend is part of a permanent shift in alternative investments. How successful private equity firms and hedge funds are at adopting each other's methods could dictate whether more and other types of firms try their hand at something new. Further, in February 2020, it was reported that Vanguard Group was launching its own private equity fund. It is possible that other traditionally passive investors could also seek to establish themselves in private markets, paving the way for further convergence of investment strategies.

TO ADOPT OR NOT TO ADOPT: POISON PILLS IN THE WAKE OF COVID-19

By Robert A. Profusek, Randi Lesnick, Lizanne Thomas, James P. Dougherty and Lyle Ganske

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As boards convene to discuss the implications of the current situation on, among other things, their employees, supply chain, finances, and overall business, takeover preparedness should be evaluated. Given huge declines in stock prices, many companies believe that they may be vulnerable to coercive or abusive takeover practices or activist programs and are considering defensive measures. In the week of March 23 alone, six companies adopted shareholder rights plans, or "poison pills"; many more put them "on the shelf."

Avoiding Premature Adoption of a Shareholder Rights Plan

Companies with market capitalizations over $2 billion have a measure of protection through HSR Act filing requirements that smaller companies do not have, at least with respect to potential opportunistic takeover bids. While big cap companies can be vulnerable to activist accumulations given techniques available to certain investors, their size alone provides a measure of protection, at least until today's record volatility levels subside. Big cap and all other companies would, we believe, be well advised to ramp up stock watch programs to closely monitor their shareholder base, trading patterns, and share accumulations and maintain open lines of communication with their shareholders. Lastly, boards of big caps should be prepared to adopt a rights plan on short notice if it is warranted by an activist intervention or other event. This so-called "shelf" rights plan approach means educating or refreshing the board on what rights plans are and how they work, but not actually adopting a plan until specific circumstances warrant.

Considering Adoption of a Shareholder Rights Plan

Companies with market capitalizations under $2 billion should consider adopting a shareholder rights plan if they are confronted with an accumulator or if other circumstances warrant and, at a minimum, should go through the "shelf" rights plan process. Medium to smaller companies are generally not afforded the advance notice protections provided by HSR filings.

Even if unaware of such activity in its stock, a smaller cap company with a sufficiently depressed share price may still reasonably determine that there is a credible threat of such activity materializing and could adopt a plan.

The specific terms of a plan (duration, trigger percentage, grandfathering, etc.) cannot be determined in the abstract but depend on a company's particular circumstances, including whether or not an accumulator is known to be at work.

Don't Forget About the Proxy Advisors

ISS and Glass Lewis have historically been highly critical of rights plans and recommended "withhold" votes for directors/nominees if a board adopted a rights plan without shareholder approval. However, with sufficient justification from the company and a commitment to put any renewal to a shareholder vote, both ISS and Glass Lewis can be amenable to plans with a duration of less than one year.

Whether or not proxy advisors will recommend for or against a rights plan without a commitment to put it to a shareholder vote will depend on the particular circumstances at hand—whether the company has an accumulator, how long a period until the company's annual shareholder meeting, and the terms of the plan. In this regard, messaging is critical. Accompanying press releases and Form 8-Ks must emphasize the company's intent to prevent an abusive or coercive takeover, not an intent to prevent an activist from accumulating a stake. Furthermore, the short duration of the plan should be emphasized, and, if applicable, a commitment to put the plan to a vote at the upcoming annual meeting or prior to any renewal should be made.

Two Key Takeaways

- Shareholder rights plans may be effective for certain companies in light of current market conditions, but companies also have other steps that should be considered available to them.
- Companies adopting shareholder rights plans should be purposeful and customize their plans according to their current circumstances, specifically with respect to duration, trigger, and shareholder approval.

COVID-19: ONGOING M&A/PE ISSUES AND DEVELOPMENTS

By Gail Weinstein, Philip Richter, Steven Epstein, and Warren S. de Wied

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Level of activity. Business and market disruption and uncertainty is expected to lead to a marked slowdown in M&A activity. Depressed stock prices and general dislocation may lead to an increase in unsolicited bids for companies; and supply chain disruptions may increase restructuring activity. As of late March, we see most pending deals moving forward. One reported exception has been Xerox's postponement of its $34 billion unsolicited pursuit of HP, with Xerox stating that all of its focus right now will be on the health and safety of its various stakeholders. On the activism front, there may be new activism-focused funds formed to take advantage of the business and market dislocations, and activists may take advantage of depressed prices to accumulate shares and offer plans for recovery.

Due diligence. Due diligence protocols are being updated to seek to assess the potential impact of the pandemic on target companies. There has been a focus on target company contingency planning, business interruption insurance, supply chain issues, the status of existing contracts and business relationships, and pandemic-related vulnerabilities concerning restrictions on travel and gatherings, ability to work remotely, and the like.

Banker valuations. Banker valuations and fairness committee processes are being updated to take into account the potential impact of the pandemic. One issue of note is that, with declining interest rates resulting in a lower discount rate input to a discounted cash flow (DCF) analysis, the DCF result is higher than it would be if the interest rate were higher—even though the company's value has declined. Bankers need to take into account and explain this anomalous result.

Definition of a MAC. In pending deals, parties are considering whether the pandemic, or the government's response to it, is potentially covered by the definition of a MAC; how to value the potential impact; and whether the durational significance of the impact would or would not trigger the MAC-based condition or right to terminate. An area of focus has been the standard exclusion from most MAC clauses of changes that do not disproportionately affect the company from others in its industry. We have seen in some very recently executed merger agreements a specific exclusion from the MAC definition of the impact of the pandemic.

Other merger agreement issues. Other merger agreement issues include the potential impact of the pandemic (and the governmental responses to it) on (i) the bring-down at closing of representations and warranties; (ii) operation of the business pending closing; (iii) the availability (and cost) of acquisition financing (and remedies for a failure to obtain financing if related to the pandemic); (iv) protection of key executives and continuation of employee-related policies and benefits adopted in light of the pandemic; (v) impact on the timing of the "end date" for closing; and (vi) in the private company context, inclusions or carve-outs from post-closing indemnification. Companies will have to consider when and how to communicate coronavirus-related developments at the company to their merger agreement counterparty.

Logistics. Logistics will be a challenge requiring significant planning and adaptation, including with respect to conducting due diligence, negotiations, board meetings, litigation, regulatory filings, etc. Health safety concerns, widespread and extended school and daycare closings, government-imposed or recommended travel or other restrictions, and the counterparty's views and policies all will have to be taken into account. Backup plans should be in place in the event key persons involved become unavailable and delays may be inevitable. Of note, the Department of Justice and the Federal Trade Commission have announced that, due to health concerns relating to the pandemic, they will not be accepting hard copies of any premerger notification documents and have put in place a temporary e-filing system. With respect to litigation, we note that in many cases court appearances have been delayed or moved to conference calls. The Delaware Court of Chancery has set guidelines for how trials will proceed if there are issues about personal appearances.

Also, citing concerns about the large number of spectators expected for a trial that was to begin relating to stockholder claims against Elon Musk in connection with Tesla's acquisition of Solar City, Vice Chancellor Slights postponed the trial until after pandemic concerns have resolved.

Sponsors' ongoing and new fundraising. Most major sponsors are continuing closings in ongoing offerings and, to the extent possible, accelerating timing to close where they have final investor documents in hand, rather than holding documents to aggregate them for a larger close. For sponsors ramping up to launch new funds, generally activity has not slowed. However, given the anxiety in the markets and around the overall impacts of the pandemic, many are revising their anticipated timing for first closings to the summer or early in the fall. In limited circumstances, sponsors are seeking to accelerate new fundraising for mandates for which there is a view that there may be buying opportunities in this period of uncertainty or as we emerge from it. In other cases, where their mandates are particularly challenged by the current environment, we have seen sponsors take a pause on current fundraising or delay plans to launch new products.

Fund agreements. *Force majeure* or similar contract avoidance clauses are not broadly incorporated into fund agreements. We have not seen investors seeking to incorporate such triggers into documents being negotiated now. Where such provisions do appear, an examination of their relevance is fact-specific and depends on the application of the relevant governing law.

Financial contracts. Market participants need to evaluate how events stemming from the pandemic are dealt with under trading agreements governing derivatives and other financial instruments. In addition to force majeure clauses, market disruption provisions and fallbacks in those contracts may be triggered. Scheduled valuation dates or dates for making payments and deliveries may be postponed due to business interruption and unscheduled holidays. In addition, large and sudden fluctuations in financial markets may trigger demands for collateral. Parties to OTC derivatives and other similar transactions need to monitor and manage their liquidity to ensure they are prepared to meet such collateral posting requirements.

Liquidity concerns. In light of the tremendous turmoil in global markets during the last month resulting from the pandemic and the plunge in oil prices, many companies are focused on ensuring that they have sufficient liquidity to support their operations during a potentially prolonged economic downturn. Major corporate borrowers have been upsizing revolvers and some companies have considered drawing down under existing revolving or term credit facilities and "banking" the funds to ensure that cash remains available to them. Each borrower will need to make a business judgment and weigh the additional costs of borrowing prophylactically against macroeconomic market risks and risks that may affect the particular borrower differently from the overall market because of its industry or particular situation.

Credit agreements. When considering additional borrowing, it should be kept in mind that borrowers are generally required to bring down credit agreement representations and warranties (in all material respects) in connection with a revolving credit facility borrowing. Borrowers should focus in particular on the language of their "no material adverse change" and solvency representations, including whether the MAC rep covers a material adverse change in the Borrower's business "prospects," and whether the solvency representation is limited to historical solvency (at the time of an LBO, for example) or pro forma for the borrowing being made. Borrowers should review their credit agreements for *force majeure* or similar provisions that might excuse a revolving lender's obligation to lend in bad economic environments. (Generally in our experience, committed facilities do not include such provisions.)

Counterparty credit risk. Borrowers should remember that, notwithstanding the language of their respective contracts, they remain subject to counterparty credit risk. For the time being, the risk is even greater for lenders in China, Italy, and other countries with severe travel and work restrictions.

Financial covenants. Many sponsor-backed borrowers have financial covenants applicable only to their revolving credit facility that are triggered when the revolving credit facility is drawn in excess of certain thresholds (generally between 30-40%). Often, certain items (*e.g.*, undrawn letters of credit) are excluded subject to a cap. Borrowers should refamiliarize themselves with these covenants (what the levels are, when the covenant is tested, updated compliance projections, etc.).

Oversight responsibility. A board must exercise appropriate oversight with respect to material risks facing the company. COVID-19 may well constitute such a risk for many companies given the global scale, novelty, and potential direct impact on numerous business areas (personnel, supply chain, customers, financing, and so on). We note that the SEC recently has emphasized the need for disclosure of material risks and the extent of the board-level oversight. A board should ensure that it receives relevant and timely updates from management to understand how the company is being affected, as well as the most recent guidance from health organizations.

Meetings. Companies are considering whether to make changes to hold virtual-only or virtual-and-in-person meetings (including annual shareholder meetings) and events. Staples, Inc. has announced that its annual meeting this year will be virtual. Before changing to a virtual annual meeting, companies should consider the company's corporate governance documents, state corporate law, stock exchange requirements, proxy advisory firm policies, and proxy statement disclosure. Companies also should take into account the investor relations impact and should consider engaging with major shareholders about making the change.

Contingency planning. Many companies are forming task forces comprised of senior management to coordinate COVID-19-related issues. A company should develop a comprehensive communications plan to provide consistent messaging to all corporate constituents, including shareholders, lenders and employees. Companies should assess the existing and potential impact of the pandemic on their existing commercial agreements—including whether the pandemic would trigger: a material adverse change or *force majeure* provision or another provision relating to a right to delay performance; a right to revise the terms or terminate the agreement; or a notice requirement. In addition, the potential of an inability to perform by the company or the counterparty should be considered, the potential impact assessed, and next steps considered. When entering into new contracts or business arrangements, the company should evaluate whatever pandemic-related risks are foreseen at that time and consider whether and how those (and unknown) risks should be addressed.

Insurance. Companies should consider whether their insurance policies cover the effects of the pandemic, including any business interruption. Business interruption due to the pandemic may not be covered under a company's classic business interruption policy (which often covers only damages that result from physical damage to the insured's property). Business interruption losses may, however, be covered as an add-on to the company's property or umbrella insurance (although typically there is a force majeure exception to the coverage). It is important to be aware of the specific conditions or exclusions, and the usually strict notice requirements, under these policies. Many current business interruption policies exclude bacterial and/ or viral events from coverage. Companies should consider whether to expand their business interruption insurance going forward to cover losses resulting from epidemics or public health emergencies.

REFLECTIONS ON THE 2020 DRAFT VERTICAL MERGER GUIDELINES AND COMMENTS FROM STAKEHOLDERS

By Christine Wilson

Christine Wilson is the Commissioner of the Federal Trade Commission. The following is excerpted and edited from remarks that she gave at the DOJ Workshop on Draft Vertical Merger Guidelines in Washington, D.C., on March 11, 2020.

Any time the subject of new guidelines comes up, it is natural to wonder what the Agencies hope to accomplish by issuing guidelines. My own views on guidelines are shaped by excellent papers written by Greg Werden and Paul Yde.[1] My reading of their papers suggests at least four reasons why the antitrust agencies issue guidelines. First, the agencies may use guidelines as a way to summarize the law, just as the American Law Institute issues Restatements of the laws of contracts, property, and other topics.

Second, the agencies may use guidelines to clarify how they intend to approach topics on which there is no clear binding precedent. For example, Werden explains that the 1968 Horizontal Merger Guidelines "were a measured response" designed to address the "cloud of uncertainty" that hung over federal merger law following the Supreme Court decisions in Vons Grocery, Pabst Brewing, and Procter & Gamble.[2]

Third, guidelines may disclose and formalize an approach the agencies have heretofore used informally. For example, Werden notes that the 1992 Horizontal Merger Guidelines formally "codified" several unilateral effects analyses the Antitrust Division of the Department of Justice had been using for years.[3] Fourth, the agencies may use guidelines to advance new analytic techniques. For example, the 1982 Horizontal Merger Guidelines adopted, and subsequently popularized, the hypothetical monopolist test. The 2010 Guidelines likewise sought to popularize GUPPIs.[4]

I was prompted to reflect on these potential rationales for issuing guidelines by Professor Michael A. Salinger's submission that asked if the DVMGs are intended to announce a shift in policy towards challenging more vertical mergers.[5] Given that vertical merger competitive effects modelling is still more art than science, and given that vertical merger case law is scant, I believe that Vertical Merger Guidelines will be most effective if they codify existing enforcement practices. On average, the Agencies closely review roughly two or three vertical mergers, and challenge one vertical merger, each year.[6]

With respect to the specific issue raised in Salinger's submission, I would note the following. To be sure, our understanding of vertical mergers has changed since the 1984 Guidelines were issued. And at the FTC's Hearings on Competition and Consumer Protection in the 21st Century, participants on our vertical merger panels agreed essentially unanimously that the 1984 Guidelines are outdated.[7] However, I'm not aware of legal or empirical economic scholarship that would merit an across-the-board increase in vertical merger enforcement above current levels.

Relationship Between EDM and Raising Rivals' Costs

Some commenters[8] called for the elimination of double marginalization ("EDM") to be treated like a cost-saving efficiency. Others[9] called for the discussion of EDM to be incorporated into the unilateral effects section, emphasizing the interdependence between EDM and potential harms. I found compelling the perspective of those commenters[10] who asserted that EDM arises from the same economic incentives as the leading vertical theory of harm, raising rivals' cost ("RRC"). Just to recap, RRC occurs when the merged firm increases price to other downstream firms to drive sales to itself, while EDM occurs when the merged firm sells to itself at cost, resulting in lower prices to its customers.

Both EDM and RRC result from changed economic incentives generated by the merger, as opposed to cost-saving efficiencies that might be generated by, say, the combination of complementary productive assets. In other words, EDM occurs even in the absence of cost-saving efficiencies. Several comments[11] pointed to recent economics papers emphasizing that RRC effects and EDM effects are correlated in size, across a variety of market shares and concentration levels. Indeed, these commenters provided compelling arguments that EDM is a determinant of the size of RRC. As one comment[12] pointed out, a large EDM effect can even cause the merged firm to lower the price it charges to other downstream firms.

Consequently, my view is that any RRC analysis must simultaneously—and symmetrically—address EDM. Evidence, whether qualitative or quantitative, that a merger is likely to generate large RRC effects is unavailing without a concurrent EDM analysis. The vertical analysis I've seen from FTC staff and outside experts *does* reflect a symmetric approach to EDM and RRC. Since these DVMGs will be useful only to the extent they codify existing practices, it is important that they treat EDM and RRC symmetrically.

"Demonstration" of EDM

The Draft Guidelines state that "the agencies generally rely on the parties to identify and demonstrate whether and how the merger eliminates double marginalization." This sentence generated many comments about what this reliance might look like.[13] My experience has been that FTC staff rely on parties' information to conduct competitive effects analyses. For example, in a horizontal merger, parties' business documents or transactions data obtained via Second Request may inform assessments of the degree of substitutability between merging firms.

In a vertical context, naturally, assessments of both RRC and EDM will depend in part on information provided by the parties. For example, information on pre-merger markups would inform analysis of the magnitude of EDM and RRC. Under a symmetric approach to RRC and EDM, requiring parties to "demonstrate" a merger's EDM would amount to demanding a full competitive effects analysis from merging parties—not, I think, the appropriate way to proceed. My view is that for any effects analysis, merging parties have a burden of production, but the Agencies bear the burden of proof. Given the many comments relating to the burden of EDM, it appears that this concept would benefit from clarification in the DVMGs.

EDM and Merger Specificity

Regardless of *how* one allocates the burden of demonstrating EDM, many commenters observed that meeting the burden depends on the *standard* for merger specificity of EDM.[14] At issue is the possibility that two unintegrated firms can achieve the same benefits of EDM via contract. For example, such a contract could obligate the upstream firm to sell its product at cost in exchange for an upfront payment from the downstream firm. I agree that if pre-merger contracting eliminates all or nearly all of one margin, a vertical merger is unlikely to result in procompetitive EDM.

However, I would not have our competitive effects analysis hinge on the possibility of efficient contracting outside of a merger. Contracting is hard. As one comment[15] observed, mergers "solve coordination problems that are solved less well, or not at all, by contracts." Another[16] stated that "a merger is the only realistic and practical way to eliminate double marginalization . . . It is simply not realistic that arm's length parties could sufficiently align their incentives to eliminate double marginalization." Factors like demand uncertainty, risk aversion, information asymmetries, or transaction costs make efficient contracting difficult or impossible.[17] Another of my mentors, Professor Roger Blair, spent a decade of his fruitful career writing about the relative benefits and drawbacks of vertical integration through contract and merger. Roger argued that because there are transactions costs and other inefficiencies associated with vertical contracting, many vertical mergers produce merger-specific EDM.[18]

For me, the relevant question is whether the firms *did* achieve efficient contracting before merging, not whether they *could*. In my view, only in the former case should we alter our competitive effects analysis. Suppose (for the sake of argument) that the Agencies were to dismiss EDM when they believe parties could contract more efficiently absent merging. Such a regime would raise several questions. First, how do we square a finding that such contracting would be profitable with the plain fact that the parties were unable to implement efficient contracts prior to merging? Second, why would parties incur the expense, time, and uncertainty of HSR review if the same benefits were available to them via contract? Third, how are the Agencies to distinguish those firms that could realize EDM via contract from those that could not? And finally, would the Agencies treat RRC effects, which could be achieved by contract, symmetrically?[19]

As a practical matter, the FTC routinely collects data and documents relating to firms' supply contracts in the course of its antitrust investigations. I cannot recall an instance in which a firm had managed to fully eliminate double marginalization by contract. The most likely explanation for not observing EDM among unintegrated firms in the real world is that contracting costs preclude effective EDM. Of course, we do see various forms of nonlinear pricing, such as two-part tariffs, in the real world. However, I agree with the comment that noted that "the mere existence of a contract capable of mitigating double marginalization does not tell us about its efficacy compared to vertical integrations."[20]

In summary, I think it is completely appropriate to assess the nature of pre-merger contracting as part of a competitive effects analysis, but I would base competitive effects analysis only on what the market *actually* looks like, and not what the Agencies *think* the market should look like.

Safe Harbors and Share Screens

Perhaps no aspect of the Draft Guidelines provoked more comments than its statement that the Agencies are unlikely to challenge a merger in which both upstream and downstream shares are below 20%. Some commenters expressed concern that the screen may miss problematic mergers.[21] Other commenters expressed concern that the screen will inappropriately develop into a structural presumption.[22] Few, if any, comments defended the 20/20 screen. In fact, an array of commenters expressed highly negative views, characterizing it as "arbitrary and unprincipled"[23] and "ineffective and useless,"[24] and stating that it "does not provide much certainty"[25] and "has no basis in the social science literature."[26]

I hear these concerns loud and clear. My view is that any screen would have only one purpose: to rule out harm at an early stage, before staff resources are consumed. Line drawing is potentially a useful resource allocation tool, provided we draw lines based on precedent and empirical results. I'm not sure the 20 percent screen in the DVMGs meets this standard. I would prefer to either remove this screen or, with the benefits of international harmonization in mind, adjust it to match the 30 percent screen used by the European Commission.[27] I fully agree with commenters that neither law nor economics support an inference of illegality on the sole basis of shares, particularly for a vertical merger.

Stepping back, our instinct to use market shares to analyze vertical mergers likely derives from well-honed techniques for horizontal merger analysis, ranging from humble delta HHIs to state-of-the-art merger simulation models, each of which depends on shares. But we should employ caution in applying horizontal logic to vertical mergers. If horizontal merger analysis weighs anticompetitive effects against cost-saving efficiencies, vertical analysis adds a third and procompetitive factor, EDM, to the mix.

As I described earlier, economic analysis indicates that procompetitive EDM and anticompetitive harm tend to increase or decrease in concert across different levels of market concentration. Consequently, we cannot rely on concentration screens in the vertical merger context as we do with horizontal mergers. For example, high upstream and downstream shares bring us closer to the textbook case of successive monopolies, often used as an illustration of a merger with EDM but no adverse effects.[28] Further, the correlation between EDM and RRC implies that mergers that are more likely to result in anticompetitive RRC are also more likely to result in procompetitive EDM.[29] As drafted, this share threshold clearly causes more consternation than clarity, which runs counter to the rationale for issuing the DVMGs. The Agencies will need to think carefully about how to address the concerns expressed in the comments.

The Relative Likelihood of Harm from Vertical Transactions

Economists have conducted a number of retrospective studies of vertical mergers. Most suggest that consumers benefit. For example, LaFontaine and Slade found in a 2007 survey that "efficiency considerations overwhelm anticompetitive motives in most contexts."[30] A 2005 survey by four

FTC economists found similar results.[31] So did a 2018 survey by economists at the Global Antitrust Institute.[32] I would love to see more vertical merger retrospectives, regardless of the result. If we are missing harmful vertical mergers, I want to know about them.

Given the current state of the empirical literature, I agree with the comment that observed a "deafening silence" concerning "the Agencies' general attitude towards vertical mergers."[33] This silence is particularly noticeable when viewed within the context of other guidance documents. For example, the 1984 Guidelines state that vertical mergers are less likely to be problematic than horizontal mergers.[34] So do the European Commission's 2008 guidelines.[35]

Has anything changed between when those guidelines were issued and now that would make such a disclaimer inappropriate for our DVMGs? I do not think so. The vast weight of economic scholarship continues to find that most vertical mergers benefit consumers. The frequency of Agency scrutiny of vertical mergers remains roughly constant. As noted above, one comment observed that the Agencies have only conducted detailed investigations of "at most 2-3 vertical mergers per year," with only about one per year resulting in a remedy.[36] (Granted, we're above that run rate during my tenure at the Commission.)

I believe it would be constructive—for agency staff, practitioners, and the business community—to include this kind of language in any vertical merger guidelines. Doing so would provide useful guidance on how the Agencies view vertical mergers *vis a vis* their horizontal counterparts and best reflect what we can learn from the empirical economic literature.

On a related note, one comment observed that Section 8 of the Draft Guidelines states that vertical mergers have "the potential to create cognizable efficiencies." Specifically, the comment noted that this language appears to signal a retreat from the 2010 Horizontal Merger Guidelines, which state that "a primary benefit of mergers to the economy is their potential to generate significant efficiencies and thus enhance the merged firm's ability and incentive to compete."[37] To avoid creating the false impression that the Agencies have changed their approach to efficiencies since 2010, the DVMGs should more clearly state the ways in which vertical mergers can generate efficiencies.

Conclusion

Thank you, once again, to all who submitted such thoughtful and insightful comments on the DVMGs. I believe the excellent public comments we have received chart a constructive course forward as we seek to move this initiative across the finish line. I encourage the DOJ and the FTC to carefully consider the thoughtful input we have received from stakeholders, and to continue speaking with one voice in offering clear guidance on vertical enforcement practices.

ENDNOTES:

[1]*See* Gregory J. Werden, Should the Agencies Issue New Merger Guidelines?, 16 GEO.MASON L. REV. 839 (2009); Paul Yde, Non-Horizontal Merger Guidelines: A Solution in Search of a Problem?, ANTITRUST, Fall 2007, at 74.

[2]Werden, *supra* note 2, at 841.

[3]Id. at 842.

[4]*See, e.g.*, Serge Moresi, The Use of Upward Price Pressure Indices in Merger Analysis, ANTITRUST SOURCE, Feb. 2010, at 1 (tracing the development of the Upward Pricing Pressure (UPP) model—which has since become

GUPPI—to academic work that Professors Farrell and Shapiro conducted before they "became chief economists at the FTC and DOJ"); U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 6.1 (issued Aug. 19, 2010) (adopting, during the tenure of Professors Farrell and Shapiro, the UPP analysis "[w]here sufficient data are available" and noting UPP merger simulations "need not rely on market definition or the calculation of market shares and concentration").

[5]Michael A Salinger, Comments on the DOJ and FTC Draft Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger- guidelines/salinger_comments_on_doj_and_ftc_draft_vertical_merger_guidelines_-_february_2020.pdf, at 1 (Feb. 2020) (the Draft Guidelines "appear to be announcing a dramatic shift in policy in which the Agencies will challenge vertical mergers more frequently than they have in the past.").

[6]Chamber of Commerce, Regarding Draft 2020 Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg9_us_chamber_comment.pdf, at 2 (Feb. 14, 2020) ("Over roughly the past quarter century, the FTC and DOJ conducted detailed investigations of at most 2-3 vertical mergers per year. . . Of the vertical investigations that resulted in remedies—only about one per year—nearly all were settled by consent decrees.") (citing Steven C. Salop & Daniel P. Culley, Vertical Merger Enforcement Actions: 1994-July 2018, Georgetown University Law School Working Paper (Aug. 23, 2018) and Koren Wong-Ervin, Antitrust Analysis of Vertical Mergers: Recent Developments and Economic Teachings, ANTITRUST SOURCE, Feb. 2019, at 3-5).

[7]For example, Steve Salop said "DOJ no longer thinks what they thought in 1984," Carl Shapiro said they were "badly out of date," and Paul Yde said "nobody pays any attention to the '84 guidelines anymore." *See* Transcript at 32, 56, 109, FTC Hearings on Competition and Consumer Protection in the 21st Century, Hearing #5, *available at* https://www.ftc.gov/system/files/documents/public_events/1415284/ftc_hearings_session_5_transcript_11-1-18_0.pdf (Nov. 1, 2018).

[8]Jonathan B. Baker et al., Recommendations and Comments on the Draft Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg21_baker_rose_salop_scott_morton_comments.pdf, at 30 (Feb. 24, 2020) ("We recommend that EDM be treated the same way as other efficiencies and that this section be incorporated into the efficiencies discussion (Section 8)."). *See also* Martin Gaynor, Comments on Draft Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/gaynor_comment_vmg_feb_26_2020.pdf, at 2 (Feb. 26, 2020) ("it's unclear why [EDM] should be considered separately from any other efficiency, or accorded any special status.").

[9]Global Antitrust Institute, DOJ/FTC Draft 2020 Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg8_gai_comment.pdf, at 5 (Feb. 7, 2020) ("EDM is indistinguishable from the unilateral effects that may create an incentive to raise price, as discussed in Section 5 of the VMGs").

[10]Gopal Das Varma and Martino DeStefano, Draft Vertical Merger Guidelines issued by the Department of Justice and Federal Trade Commission for Public Comment, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/comments_on_draft_vertical_merger_guidelines_das_varma_destefano.pdf, at 3 (Feb. 26, 2020) ("Recent research, however, has shown that RRC and EDM are not two separate phenomena.").

[11]Id. ("the size of EDM, through its effect on the merged entity's share of the relevant market, affects the strength of the merged entity's RRC incentive. This makes EDM to be a determinant of RRC, not just a stand-alone competitive benefit to be weighed against RRC."). *See also* Koren W. Wong-Ervin, U.S. Vertical Merger Guidelines: Recommendations and Thoughts on EDM and Merger Specificity, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/wong-ervin_vmg_article_1-21-20_final.pdf, at 2 (Jan. 21, 2020) ("For example, if you take the model from Sheu & Taragin (2017) and perform comparative statics (*e.g.*, asked what if the diversion ratio between downstream firms increased?), you would find that the changes that increase RRC

also increase EDM.").

[12]Salinger, supra note 6, at 3 (constructing an example in which an unintegrated downstream firm receives a lower input price following a vertical merger involving its supplier and its rival).

[13]Chamber of Commerce, supra note 7, at 8 ("Section 6 appears to place the EDM burden of proof on the parties. This is an unjustified departure from the seemingly burden-neutral list of factors in Section 4"). *See also* NetChoice, Comments of NetChoice on DOJ & FTC Draft Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg16_netchoice_comment.pdf, at 5 (Feb. 20, 2020) ("But the Agencies undercut this benefit [of EDM] by placing the burden on the merging parties."). *See also* Steven J. Cernak, Who Bears the Burden on Elimination of Double Marginalization in the Draft Vertical Merger Guidelines?, Truth on the Market, https://truthonthemarket.com/?s=cernak&orderby=relevanceℴ=DESC, (Feb. 7, 2020) ("it seems to follow that the Agencies would have the burden to factor EDM into the rest of their competitive analysis to show what the potential overall net effect of the merger would be.").

[14]Carl Shapiro, Comment on DOJ/FTC Draft Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/shapiro_comment_on_draft_vmgs.pdf, at 3 (March 3, 2020) ("As with other efficiencies, EDM must be shown to be merger specific to be credited."). *See also* Baker, supra note 9, at 31 ("The DVMGs recognize that the benefits of EDM are low when the firms previously partially eliminated double marginalization contractually. But this section does not make clear that EDM claims must always be tested for merger-specificity."). *See also* Geoffrey A. Manne and Kristian Stout, Comments of ICLE on the Draft Vertical Merger Guidelines (Matter Number P810034), https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/icle_-_vmg_draft_comments_0.pdf, at 1 (Feb. 2020) ("the agencies should clearly disavow . . . the implications of the presumed functional equivalence of vertical integration by contract and by merger").

[15]Gregory J. Werden and Luke M. Froeb, Comments on Proposed Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg5_werden_froeb_comments_on_vertical_merger_guidelines.pdf, at 1 (2020).

[16]Canadian Bar Association Competition Law Section, Draft 2020 Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/cba_vmg_2020_submission.pdf, at 4 (Feb. 2020).

[17]Wong-Ervin, supra note 14, at (quoting Benjamin Klein, Robert G. Crawford, and Armen A. Alchian, Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J. L. & ECON. 297 (1978) ("Due to uncertainty and the difficulty of specifying all elements of performance in a contractually enforceable way, contracts will necessarily be incomplete to one degree of another."). *See also* Francine LaFontaine, Transcript at 73, FTC Hearings on Competition and Consumer Protection in the 21st Century, Hearing #5, available at https://www.ftc.gov/system/files/documents/public_events/1415284/ftc_hearings_session_5_transcript_11-1-18_0.pdf ("quantity forcing and two-part tariffs do not easily generate the same outcome as what a vertical merger could do because of demand uncertainty, risk aversion, information asymmetries, all sort of incentive problems.").

[18]*See* Roger D. Blair & David L. Kaserman, Vertical Integration, Tying, and Alternative Vertical Control Mechanisms, 20 CONN. L. REV. 523 (1988) at 540-45

[19]Werden & Froeb, supra note 22, at 5 (". . .most of the anticompetitive effects that could follow from a merger, especially raising rivals' costs, also might have been achieved without a merger.").

[20]Global Antitrust Institute, supra note 11, at 7 (citing Daniel P. O'Brien, The Antitrust Treatment of Vertical Restraints: Beyond the Possibility Theorems, in REPORT: THE PROS AND CONS OF VERTICAL RESTRAINTS 40, 51 (2008) ("The use of nonlinear contracts can mitigate double-marginalization, but it does not necessarily eliminate it.").

[21]NET Institute, Comments on the DOJ/FTC

Draft Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg14_economides_comment.pdf, at 6 (Feb. 2020) (". . .there is no support offered in the Draft Guidelines for its arbitrary safe harbor threshold. As a caution, one of us has found numerous anticompetitive horizontal mergers within its 20 percent safe harbor."). *See also* Richard M. Scheffler et al, Comments on the Draft Vertical Merger Guidelines with Special Consideration to Health Care, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg20_scheffler_arnold_brown_et_al_comments.pdf, at 6 (Feb. 24, 2020) ("In health care, hospital acquisitions of physician practices regularly fall under 20%, but research has shown that hospital acquisitions of physician practices often leads to higher prices without commensurate improvements in quality").

[22]Global Antitrust Institute, supra note 11, at 8 (". . .there is a significant risk the 20 percent figure will be interpreted by counsel or courts as a trigger for competitive concerns."). *See also* Jan Rybnicek, The Draft Vertical Merger Guidelines Would Do More Harm Than Good, Truth on the Market, https://truthonthemarket.com/?s=Rybnicek&orderby=relevanceℴ=DESC (Feb. 7, 2020) ("It is likely that agency staff will soon interpret (despite language stating otherwise) the 20% market share as the minimum necessary condition to open an in-depth investigation and to pursue an enforcement action.").

[23]Sean P. Sullivan and Henry C. Su, Public Comments on the U.S. Department of Justice and the Federal Trade Commission Draft Vertical Merger Guidelines Released for Public Comment on January 10, 2020, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/sullivan_su_-_comments_on_draft_vmgs.pdf, at 6 (Feb. 25, 2020).

[24]Werden & Froeb, supra note 22, at 3 ("The separation would be ineffective and useless if, for example, a small minority of mergers on both sides of the line posed significant competitive problems.").

[25]Kenneth Edelson and Jonathan Jacobson, Vertical Mergers 2020, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg4_totm_blog_-_vertical_mergers.pdf, at 2 (2020).

[26]Sanjukta Paul and Marshall Steinbaum, DOJ-FTC Proposed Vertical Merger Guidelines, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/vmg3_proposed_vertical_merger_guidelines_comment_final_2_2020.pdf, at 2 (Feb. 2020) ("There is no basis in the social science literature for the 20% market share, which presupposes that markets can even be properly defined at the time of a merger.").

[27]European Union, Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings, ¶ 25, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008XC1018(03)&from=EN (2008) ("The Commission is unlikely to find concern in non-horizontal mergers . . . where the market share post-merger of the new entity in each of the markets concerned is below 30 %").

[28]*See* Thomas W. Ross, On the Vertical Integration of Successive Monopolies, 7 REV. INDUS. ORG. 375, 378 (1992) considering vertical integration with successive monopolies, "it is interesting to consider the effect of integration on the final retail price. Can it ever rise? The answer is no; as long as the merger is profitable it will result in a lower price").

[29]Gopal Das Varma and Martino DeStefano, Draft Vertical Merger Guidelines issued by the Department of Justice and the Federal Trade Commission for Public Comment, https://www.ftc.gov/system/files/attachments/798-draft-vertical-merger-guidelines/comments_on_draft_vertical_merger_guidelines_das_varma_destefano.pdf, at 5 (Feb. 26, 2020) ("when EDM and RRC are considered simultaneously (rather than each in isolation), the size of EDM can significantly influence the extent of RRC.").

[30]Francine LaFontaine & Margaret Slade, Vertical Integration and Firm Boundaries: The Evidence, 45 J. ECON. LIT. 629, 677 (2007) (". . .overall a fairly clear empirical picture emerges. The data appear to be telling us that efficiency considerations overwhelm anticompetitive motives in most contexts. Furthermore, even when we limit attention to natural monopolies or tight

oligopolies, the evidence of anticompetitive harm is not strong.").

[31]James C. Cooper et al., Vertical antitrust policy as a problem of inference, 23 INT'L J. INDUS. ORG. 639, 658 (2005) (surveying 22 empirical papers and finding most "find evidence that vertical restraints/vertical integration are pro-competitive.")

[32]Global Antitrust Institute, Comment on The Federal Trade Commission's Hearings on Competition and Consumer Protection in the 21st Century: Vertical Mergers, https://gai.gmu.edu/wp-content/uploads/sites/27/2018/09/GAI-Comment-on-Vertical-Mergers.pdf, at 6-7 (Sept. 6, 2018) (finding that of eleven papers written since 2008 identifying welfare implications of vertical integration, six found positive welfare changes, four found "no change, a mixed change, or no economically meaningful change" and "only one (or perhaps two) had results that are consistent with a negative impact").

[33]Werden & Froeb, supra note 22, at 1 ("The Guidelines' most conspicuous silence concerns the Agencies' general attitude toward vertical mergers, and on how vertical and horizontal mergers differ. This silence is deafening. . .").

[34]U.S. Department of Justice 1984 Merger Guidelines § 4.0 ("Although non-horizontal mergers are less likely than horizontal mergers to create competitive problems, they are not invariably innocuous.")

[35]European Union, supra note 36, ¶ 11 ("Non-horizontal mergers are generally less likely to significantly impede effective competition than horizontal mergers.").

[36]Chamber of Commerce, supra note 7, at 2 ("Over roughly the past quarter century, the FTC and DOJ only conducted detailed investigations of at most 2-3 vertical mergers per year, a tiny fraction of the thousands of transactions reported annually under the Hart-Scott-Rodino ("HSR") Act of 1976.").

[37]Id. at 8 ("Section 8 contains only a cursory discussion of the many varieties of efficiencies from vertical mergers. . . Even the HMGs appear to go farther than this").

FROM THE EDITOR

COVID-19 and M&A: The Crisis In Its First Weeks

In March 2020, the world changed. In the time between the previous issue of *The M&A Lawyer* and this one, the COVID-19 pandemic caused much of North America and Europe to go into lockdown. Whatever plans that companies had for acquisitions in spring 2020 are all up in the air.

During late March, ***The M&A Lawyer*** talked to lawyers in the U.S., Canada and the UK to get a sense of how the pandemic was affecting such areas as M&A, corporate governance, and antitrust. The lawyers said they were both heartened by signs of perseverance and cooperation but they also felt as if an ice age had hit without warning.

Grant McGlaughlin, a partner in the Toronto office of Fasken, described the mid-March period as "the brakes getting put on—becoming difficult to do negotiations and due diligence. Sellers are not going to come to market right now, and there are a number of deals are close to the finish line where buyers are having second thoughts, or using this time to renegotiate."

"A lot of legal diligence can be done remotely but there's still a lot of on-site diligence for a lot of companies, depending on the nature of the company," he added. "A buyer may need to determine if there are environmental issues with a seller's properties: there's a bunch of different things they have to assess."

In the first days of the crisis, when states and cities started issuing stay-in-place orders, "there were a number of deals in the pipeline and on the buy side where we had 30 to 40 person virtual due diligence calls," one head of an M&A legal practice said. "Then everything basically came to a halt in the middle of last week [March 18-20]. That said, it's a bit surprising there are still a fair number of deals out there, with term sheets being discussed. For many companies with deals in progress, the situation is currently similar to the 2008 financial crisis, in that there is now a tremendous focus on the ability or rights of parties to terminate a deal."

Michael Sirkin, a partner at Ross, Aronstam & Moritz in Wilmington, DE, said he thought "one real challenge to come is, if as expected, a lot of parties that are currently negotiating transactions, who are between signing and closing, are now looking at their MAE provisions. Those are the kind of cases that, if they get litigated, they have to be litigated really fast. Determining how that kind of case could be accommodated right now could put some stress on the system. But it likely could be done—doing many depositions by video, for example, or having a skeleton crew [of lawyers] show up at the courthouse and talk to witnesses by video."

Valuations and financing are now potentially deal-killing variables. "The leveraged loan markets and high-yield markets have dried up, so unless you've got a buyer with a significant amount of cash, or a private equity buyer, it's going to be hard to pursue a deal at this point," the M&A practice head said. "Most of those companies who are still engaged in discussions appear to hope that we will hit a peak in the next month and then there will be some greater sense of order in the capital markets."

"There's a significant focus on liquidity and for companies being able to forecast, if possible, what the liquidity needs of their business will be. My sense is the level of preparedness among companies has varied dramatically. Some have gone out and tapped their revolvers, with the perspective that we really don't have a great sense of what things will look like three to six weeks from now. So while there are borrowing costs, at the end of the day having that cash and paying interest is a relatively cheap insurance policy."

Proxy season is another question mark, with many companies scrambling to hold virtual meetings and getting the board and/or regulatory approval to do so. Simon Beddow, a partner in the London office of Bryan Cave Leighton Paisner, said the pandemic hit right "at the start of three or four months when most of the listed companies on the LSE have to have their annual general meetings. So there has been a lot of activity with law firms all across the UK, getting together with various professional bodies and the government and working out how you can hold a shareholder meeting when you can't have more than two people meeting in one place. There's been a bit of firefighting."

That said, the widespread use of video conferencing technology and virtual deal rooms makes conducting a remote meeting far more feasible today. "If this had happened even 10 years ago, it would have been much different," Beddow noted.

Areas of Continuity

Sirkin noted that as of late March, "the Delaware courts remain remarkably open. While municipal court buildings are now closed to the public, many cases can still proceed, if virtually. In so much of Delaware litigation, we agree to schedules and discovery and for the most part in a lot of Delaware cases, you don't have to involve the court all that often in order to move the case along. The courts have been well functioning and they have been hearing motions telephonically."

"In dispositive motions you would normally have an in-person hearing, so those are a bit of an adjustment," he added. "And adjustments are also needed for cases that get into the heavy deposition stage. While there are remote solutions available, our depositions typically tend to be in person—lawyers travel to witnesses. No one's traveling now and no one's sitting in the same room. The other area where cases could still get bogged down are those that are ready to be tried. I can't imagine doing a trial without having a lot of people physically in the same place."

John Welge, a partner in the St. Louis office of Bryan Cave Leighton Paisner, said at the end of March that "while deals have been slowed down, I'm surprised that there is still some level of activity that continues to go on. Several deals are still proceeding towards closing. There is activity going on, if at a much slower pace and at a lower level."

Uncertainty is one thing, perhaps the only thing, that we can be sure of in the next few months. *The M&A Lawyer* wishes for all its readers to be safe. All best to you and your families.

Chris O'Leary

Managing Editor

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