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Expert Analysis

A Moment of Repose: The FTC's Merger Remedy Study

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In the wake of two successful merger challenges by the Department of Justice Antitrust Division, the Federal Trade Commission (FTC) has released a study on merger remedies, providing some lessons that parties to future proposed mergers would be wise to heed.

On Jan. 19, 2017, the Federal Trade Commission issued Merger Remedies 2006-2012: A Report of the Bureaus of Competition and Economics. This report analyzed the effectiveness of recent FTC merger orders, using a case study method to review 89 such orders including 79 divestitures to 121 buyers. The case study method used by the FTC mainly relied on responses from market participants (buyers, respondents, competitors, and customers) willing to share their experiences and views on commission remedies and the remedies' impacts on competition in the relevant market. The study defined a successful remedy as one that maintained competition at its pre-merger level or returned competition to that level within a two to three year period post-order.

The FTC has announced that it plans to update its Statement on Negotiating Merger Remedies in light of some best practices identified by the study, and it already has a track record for using such studies to guide future policy.[1] In the late 1990s, the FTC evaluated 35 merger orders for divestitures from 1990 through 1994.[2] In 1999, the staff released this study, which prompted a number of changes to the FTC's merger remedy approach. Because of that study, the FTC increased its requirements of having upfront buyers identified, limited the default divestiture period for post-order buyers to six months, enhanced the use of third-party monitors for complex industries and transactions, and focused on more follow-up interviews with divestiture buyers to assess their progress and competition levels.[3]

Parties should certainly assume that, in future merger orders, the FTC will apply the best practices gleaned from this updated study of merger remedies. Thus, merging parties and their counsel have gained some insight into what factors the agencies (and courts hearing cases brought under the Clayton Act and the FTC Act, no doubt) may find compelling with respect to divestitures proposed as fixes to merger investigations.

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The study focused on several areas of analysis through which the FTC will evaluate proposed remedies moving forward. The first and likely most important factor is the structure of the divestiture. The study found that divestitures of ongoing businesses generally succeeded in maintaining or restoring competition, while buyers of limited asset packages were more likely to struggle.[4] This data tended to confirm a current point of

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FTC merger order strategy: Divestitures of ongoing businesses are more likely to successfully address competitive concerns stemming from a merger. As a "best practice" moving forward, one should assume that the FTC will only accept selected asset divestitures if both the merging parties and the identified buyer show that divesting that limited asset package is likely to maintain or restore competition. Choice of buyer will usually play into this likelihood, as the study found that asset divestitures were more likely to succeed for buyers with similar existing operations, relevant market knowledge, relevant customer relationships.

This asset package analysis also led to the conclusion that parties proposing divestitures should transfer adequate back-office assets and functions to successfully support the divested business, or ensure that the buyer can readily acquire said functions from a third party.[5] These back-office issues are "often more important and more complicated than parties anticipate." For that reason the FTC might require divestiture of assets supporting those functions or provision of those assets for the buyer during a transitional period of the sale. In addition, the FTC will require full disclosure of the extent of these back-office functions and the related costs to both the agency and any potential buyers.

The study also noted one obvious factor of importance: the proposed buyer.[6] In particular, when reviewing the proposed buyer, the commission will scrutinize more closely the buyer's funding, both with respect to paying for the proposed divestiture as well as with respect to running the business in a viable and competitive manner. Thus buyers (and merging parties) should be prepared to show buyer funding sources and be ready to propose a business plan showing sustained viability, along with backup plans. This ties in with the abovementioned focus on any potential buyer's expertise or experience in the relevant market.

Divestiture implementation was identified as another area where an otherwise promising divestiture transaction can go off the tracks.[7] Proper due diligence, similar to that of a typical asset purchase, should be allowed in all merger remedy divestitures. This means appropriate lengths of time and direct access to key employees of the divesting firm will need to be afforded to the buyer. Customer and third-party relationships should be adequately facilitated by the divesting party, just as with the transition of back-office functions. Transition services and supply agreements with merging parties should be crafted to provide the buyer a sufficient period to achieve viability as a competitive option without allowing the buyer to become dependent on the merged firm to the buyer's detriment. And any time a hold separate is required, the divesting firm should allow the hold separate manager open access to the FTC staff, and should have a plan in place that allows the hold separate manager to freely and efficiently compete in the market.

> Overall, the FTC study provides some basic guidelines for parties to follow in proposing divestitures, but the goal of these divestitures remains to remedy the harm to competition resulting from the original transaction in question.

In essence, these proposed best practices for merger remedies boil down to the same rule that the FTC has employed in past merger orders and that courts have used in reviewing proposed divestitures: Proposed divestitures must not just replace a competitor, but rather must remedy the merger's harm to competition in general. In 2015, the U.S. District Court for the District of Columbia employed a similar rule in *FTC v. Sysco*, touching on many of the same factors the FTC delineated in its recent study (although arguably requiring even more certainty than the agencies would).

There, Sysco and US Foods attempted to obtain approval of their merger of the two largest foodservice distributors in the United States by proposing a divestiture of 11 distribution centers to Performance Food Group (PFG), the companies' next largest rival.[8] The divestiture arguably would have expanded PFG's geographic reach and customer access. As part of the deal, PFG would also receive all assets, employees, and customers of those distribution centers, and under a transition services agreement would have the right to use US Foods private label products for up to three years.[9]

In reviewing the adequacy of this proposed divestiture to maintain or restore competition, the court looked to factors similar to those addressed by the recent FTC study. The court's main concern was that this limited asset divestiture to a much smaller competitor would not be adequate to replace the lost competition. Although it noted PFG's business acumen and solid funding base, the court found that, geographically, PFG would still have considerable gaps in its footprint in the western United States. And national customer sales projections for five years out were under half of US Foods' current sales, and that was only if PFG's primary business plan was successful and if integration of the new centers went smoothly.[10]

In addition, the court questioned some of the business-plan implementation factors that might allow pre-merger competition to return.[11] The court found that PFG, as a smaller operation, may struggle competitively due to higher product acquisition costs and fewer SKUs offered. And although PFG would receive all distribution center employees, the court expressed concerns about the employees transitioning to PFG. The transaction would leave PFG with significantly fewer national sales representatives than US Foods had, and would leave PFG at a disadvantage with respect to employee expertise in value-added services, like health care foodservices.

The court similarly took issue with the specifics of the transition services agreement.[12] The merging parties agreed to provide PFG access to US Foods private labels for three years, likely attempting to promote its growth as a competitor during integration of the new distribution centers and new nationwide growth. However, the court considered this a roadblock on PFG's path to becoming an independent competitor due to the extended reliance PFG would have on the merged firm for the access to those private labels.

In many respects, the court's analysis in *Sysco* took a very inflexible view of divestiture remedies, especially in light of past agency practice. But, certainly, if Sysco and US Foods had proposed a divestiture more in line with the takeaways from the recent merger study, they may have been able to resolve many of the problems with which the court took issue. If the parties insisted on divesting a larger asset package of distribution centers, perhaps a broader distribution footprint could have carried the day. And, at least for the court, a more thorough integration plan showing how the limited assets would make PFG an effective and viable nationwide competitor and provider to nationwide customers, along with contingency business plans, may have alleviated the court's concerns. And parties need to do a better job explaining to courts why transition services agreements are *positive* parts of an asset sale that will restore competition, even if that may not be ideal as a "best practice."

Overall, the FTC study provides some basic guidelines for parties to follow in proposing divestitures (and that the FTC will certainly follow in doing the same), but the goal of these divestitures remains to remedy the harm to competition resulting from the original transaction in question. And, irrespective of who ends up leading the agencies, parties should seriously consider these guidelines when attempting to remedy an otherwise suspect merger.

1. Dan Ducore and Naomi Licker, "Looking back (again) at FTC merger remedies," FTC Bureau of Competition (Feb. 3, 2017).

2. "A Study of the Commission's Divestiture Process," FTC Bureau of Competition (August 1999).

3. "Merger Remedies 2006-2012: A Report of the Bureaus of Competition and Economics," 2-3, FTC Bureaus of Competition and Economics (January 2017), https://www.ftc.gov/system/files/documents/reports/ftcs-merger-remedies-2006-2012-report-bureaus-competition-economics/p143100_ftc_merger_remedies_2006-2012.pdf.

4. 2017 Report, at 21-23.

5. Id. at 33.

6. Id. at 24.

7. Id. at 34-36.

8. *Fed. Trade Comm'n v. Sysco*, 113 F. Supp. 3d 1, 21 (D.D.C. 2015). Skadden represented PFG in the matter.

9. Id.

10. Id. at 73-75. The court also credited internal PFG documents claiming the limited asset divestiture would not be sufficient to allow it to compete with the merged firm.

11. Id. at 76.

12. Id. at 77.