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CLIENT ADVISORY

RECENT FTC MERGER REVIEW DEVELOPMENTS

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The end of 2008 brought a number of noteworthy developments in the Federal Trade Commission's (FTC) evolving approach to merger review:

- The FTC is litigating three merger challenges: one challenge to a consummated merger in federal district court (*Ovation*), and two cases in which the FTC is seeking only preliminary injunctive relief in district court while pursuing permanent injunctive relief in administrative proceedings (*Red Sky* and *CCC Holdings*).
- In *Ovation* the Commission is seeking not only a divestiture, but disgorgement of profits as well.
- Two Commissioners concurred in the decision to file the *Ovation* case, arguing that the FTC should have challenged another earlier acquisition by Ovation, even though that acquisition did not raise either horizontal or vertical merger concerns.
- The FTC has announced final interim rules governing administrative proceedings.
- The FTC has released its latest merger challenge data, updating the analysis to include transactions through 2007.
- The FTC has increased the size-of-transaction threshold under the Hart-Scott-Rodino (HSR) Act to US$65.2 million effective in approximately 45 days.

We summarize these developments below.

A. THE *OVATION* CASE

In mid-December, the FTC filed a complaint in federal district court challenging Ovation Pharmaceuticals, Inc.'s consummated acquisition from Abbott Laboratories of NeoProfen, a drug used to treat a serious congenital heart defect in newborns known as PDA.[1] The FTC's complaint alleges that the acquisition was a merger to monopoly in a market for drugs used to treat PDA, and that as a result of the acquisition Ovation raised prices on its own drug, Indocin, by nearly 1,300%. In addition to seeking a divestiture, the complaint also seeks disgorgement of Ovation's alleged "unlawfully obtained profits" on the two drugs. Ovation's 2006 acquisition was not reportable under the HSR Act.

Other than the request for disgorgement, there is little remarkable about the complaint the FTC filed, which alleges both a violation of Section 7 of the Clayton Act (which outlaws mergers that may "substantially lessen competition") and

1 Case 0:2008cv06379 (D. Minn. Dec. 16, 2003). PDA is an abbreviation of "patent ductus arteriosus."

monopolization of a market for drugs used to treat PDA in violation of Section 5 of the FTC Act. If, as the FTC alleges, NeoProfen and Indocin are substitutes and the only two drugs approved to treat PDA, the challenge fits well within the contours of traditional merger analysis.

Far more interesting is the concurrence by Commissioner Tom Rosch to the Commission's decision approving filing of the complaint (and Commissioner Leibowitz's statement that he supported Commissioner Rosch's approach).[2] Commissioner Rosch supported the complaint challenge to the acquisition of NeoProfen, but argued that the Commission should have challenged Ovation's acquisition of Indocin, the first PDA drug on the market, as well.

The acquisition of Indocin did not "lessen competition" or "tend to create a monopoly" in the usual sense. Ovation was not in the PDA market at the time of that first acquisition and had no drugs for PDA in development, so the merger was not a horizontal merger involving actual or potential competition. Nor was Ovation in any vertically-related market (as a customer of PDA drugs or as a supplier of ingredients used in PDA drugs), so traditional vertical merger analysis would not apply either. Rather, Commissioner Rosch believed that Section 7 was implicated because Ovation raised the price of Indocin substantially after acquiring the drug from Merck. Believing that Merck likely kept the price of Indocin below monopoly levels because of reputational concerns, he concluded that Section 7 was implicated because "Merck's sale of Indocin to Ovation had the effect of enabling Ovation to exercise monopoly power in its pricing of Indocin, which Merck could not profitably do prior to the transaction."

This is a virtually unprecedented view of the scope of Section 7, and certainly out of step with the approach to Section 7 analysis over the last 30 years. In support of the theory, Commissioner Rosch pointed to old conglomerate merger cases:

> It could be seen as a variant of a number of Supreme Court and lower federal court cases that have held that a transaction that may result in a substantial lessening of competition or create a monopoly due to considerations neither horizontal or vertical in nature will violate Section 7. *See*, e.g., *FTC* v. *Procter & Gamble*, 386 U.S. 568, 577 (1967) ("All mergers are within the reach of § 7, and all must be tested by the same standard, whether they are classified as horizontal, vertical, conglomerate, or other."); *Ekco Products Co.* v. *FTC,* 347 F.2d 745 (7th Cir. 1965) (acquisition of firm with a monopoly by a firm that did not compete in the monopoly market held to violate Section 7 when the acquiring firm protected the monopoly power it acquired by purchasing a new entrant that the acquired firm would not have purchased).[3]

While virtually all commentators believe that these cases have been discredited, Commissioner Rosch cites the Areeda and Hovenkamp treatise for the proposition that this "precedent…has not been overruled."[4] But even the old conglomerate merger cases generally involved structural concerns such as entrenching a dominant firm (as was the case in Procter & Gamble) or potential competition (as in Ekco Products). Ovation, in contrast, involved only the acquisition of a product by a firm that would choose to exercise its lawfully-acquired monopoly power.

It seems difficult to fit the Ovation's acquisition of Indocin within even the broad language of Section 7. The acquisition did not "lessen competition" or "create a monopoly" because, as the only FDA-approved

2 Concurring Statement of Commissioner J. Thomas Rosch, *Federal Trade Commission* v. *Ovation Pharmaceuticals, Inc. (Dec. 16, 2008), available at* http://www.ftc.gov/os/caselist/0810156/081216ovationroschstmt.pdf. *See also* Concurring Statement of Commissioner Jon Leibowitz, *Federal Trade Commission* v. *Ovation Pharmaceuticals, Inc. (Dec. 16, 2008) (noting that he "*would have supported the approach proposed by Commissioner Rosch"), *available at* http://www.ftc.gov/os/caselist/0810156/081216ovationleibowitzstmt.pdf.

3 *Id.*

4 *Id.* (citing PHILLIP E. AREEDA AND HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION, ¶ 1140.1 (2nd and 3rd Ed. 1998-2007 and supplemented 8/08)).

drug, Indocin faced no competition and already had a monopoly. The limits of the Rosch/Leibowitz approach are also far from clear. Would the theory apply only where structural factors (such as Merck's ownership of other drugs and thus its reputational concerns) limit pricing, or could the theory apply to the acquisition of products from lawful monopolists that are simply incompetent at exercising their monopoly power? Commissioner Rosch appeared to place great weight on the fact that the case involved a consummated acquisition, and thus there was no need for speculation as to likely price effects. While that may provide some comfort to merging firms, the full contours of the *Ovation* theory must await further developments at the Commission and in the courts.

B. RECENT ENFORCEMENT ACTIONS

In two recent litigated mergers that were subject to HSR review, following its new practice the FTC has sought only preliminary injunctive relief in district court, instead electing to pursue permanent injunctions in administrative proceedings. (The FTC is presumably pursuing the *Ovation* case in district court because it seeks disgorgement pursuant to the injunctive relief provisions of Section 13(b) of the FTC Act, 15 U.S.C. § 53(b), which only allows "suit in a district court.")

In *FTC* v. *Red Sky Holdings LP, CCS Corporation and Newpark Resources,*[5] the FTC claimed the merging parties are "two of only three providers of waste disposal services to the offshore oil and natural gas exploration and production industry in the Gulf Coast region of the United States." Not only would the transaction create a duopoly, the Commission argued, but "for many large customers, CCS and Newpark are their first and second choices."[6] Two aspects of the complaint are noteworthy. First, the Commission alleged that defendants could not establish the requirements of a "failing firm" or "failing division" defense in that they could not show that (i) either firm would be unable to meet its financial obligations, (ii) they had made efforts to find alternative buyers, or (iii) absent the transaction, the assets would exit the market. Second, the FTC discussed what it called "CCS's alleged plans to 'shut down its operations in the Gulf.'"[7] The complaint notes that "hours after the FTC informed defendant CCS that it had serious concerns" about the transaction, CCS "hatched a plan" to exit the market and informed FTC staff that it was ceasing operations in the Gulf. The Commission further argued that nothing in CCS's files supported the arguments that CCS's Gulf Coast business was not viable or that CCS had to acquire Newpark to survive.[8] A month later, Newpark announced it was terminating its merger agreement with CCS before the preliminary injunction hearing had occurred.

In *FTC* v. *CCC Holdings Inc., and Aurora Equity Partners, III L.P.*,[9] the Commission challenged a merger involving two of the three companies that sell computer software and data services used by automobile repair shops and insurance companies to estimate, e.g., vehicle repair costs. As in *Red Sky*, the FTC characterized the transaction as reducing the number of significant players from three to two and creating a "duopoly." There was nothing unusual about this complaint, which recited the usual concerns about anticompetitive effects that would likely arise from the merger and why entry and efficiencies would be insufficient to counter those effects.

C. ADMINISTRATIVE LITIGATION DEVELOPMENTS

Following a 30-day comment period on an initial set of rule change proposals, the Commission recently announced interim rules governing administrative proceedings.[10] Among other things, these rules set certain deadlines for completion of parts of the proceeding, change aspects of discovery, and allow the Commission to decide dispositive motions. These rule changes were made despite significant criticism that they reduced the role of the independent

5 Case 4:08-cv-03147 (S.D. Texas, Oct. 23, 2008).

6 Complaint at 2.

7 Complaint at 29-30.

8 *Id.*

9 Case 1:08-cv-02043-RMC (D.D.C., Nov. 26, 2008).

10 http://www1.ftc.gov/opa/2008/12/part3.shtm

administrative law judge and appeared designed to give the FTC certain procedural advantage. The FTC is now seeking comments on these interim rules in response to concerns that the time period for initial comment on the rules was too short.

D. HORIZONTAL MERGER INVESTIGATION DATA

The Commission issued a new update of its Horizontal Merger Investigation Data Report which describes its enforcement record with respect to transactions occurring in fiscal years 1996-2007.[11] Encompassed by the report are results from several hundred merger investigations covering 1,154 markets. The key findings are as follows:

- Of 384 second requests, 210 examined a theory of harm arising from a horizontal combination, 25 involved a vertical theory, 17 involved theories of potential competition, nine involved buyer power (monopsony) theory, eight involved miscellaneous theories, 73 filings were withdrawn during the investigation, and 42 investigations were closed after a quick look.
- Unsurprisingly, the more concentrated the market pre-merger and the greater the change in concentration, the more likely was a challenge. For transactions where the post-merger Herfindahl-Hirschman Index (HHI) was 5000 or more, there were challenges in 408 markets, compared to only 30 markets in which the investigation was closed.
- The number of significant competitors remaining post-merger was also a meaningful predictor of enforcement activity. In markets where five or more competitors remained, the Commission was almost three times more likely to clear the transaction than to challenge it. But where the number of competitors was four or fewer, the Commission was much more likely to challenge—674 challenges to 123 closed investigations. Nearly all 2 to 1 transactions and the vast majority of 3 to 2s were challenged. Nearly 75% of the 4 to 3 transactions were challenged and nearly two-thirds of the 5 to 4 transactions were challenged.
- Where "hot documents"—those predicting anticompetitive effects—were identified, the transaction was almost always challenged (22 enforcements; three closings) but the absence of hot documents was less predictive (109 enforcements; 64 closings).
- Similarly, strong customer complaints lead almost inevitably to enforcement actions (83 enforcements; two closings) regardless of the concentration level in the industry.
- Finally, and unsurprisingly, if the Commission found entry was easy, it always closed the investigation, but difficult entry conditions do not automatically doom a transaction. In 31 of the 162 markets where the Commission found entry to be difficult, it nonetheless closed the investigation.

E. CHANGE IN HSR ACT THRESHOLDS

Under the HSR Act, the Commission is required to change certain thresholds under the Act every year based on changes in the Gross National Product. The most relevant of those changes relates to the size of transactions which must be notified under the HSR Act. That amount has been increased to US$65.2 million, effective 30 days after publication in the Federal Register.

If you would like more information about any of the cases discussed, please contact your Arnold & Porter attorney or:

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11 http://www.ftc.gov/opa/2008/12/horizmerger.shtm