

KIRKLAND ALERT

February 23, 2017

FTC Merger Remedy Study

On February 3, 2017, the Federal Trade Commission released a study evaluating the effectiveness of its merger remedies and proposing updated best practices for merging parties and divestiture buyers (the “Merger Remedy Study” or the “Study”).¹ The Study was designed to assess whether past merger remedies have successfully maintained or restored competition, and to identify areas where the FTC can improve the process.²

The Study marks the FTC’s second comprehensive review of merger remedies. The first study, published in 1999 (the “1999 Study”)³, led to significant changes to FTC merger remedy practices, such as:

- requiring upfront buyers (as opposed to post-order buyers) for divestitures of less than an entire ongoing business;
- shortening the time for post-order divestitures from a year or more to six months or less;
- requiring the appointment of independent third parties to monitor complex divestitures more frequently; and
- initiating a program to interview divestiture buyers about their progress within a year after the divestiture purchase.⁴

The 2017 Study not surprisingly confirmed that the FTC’s merger remedy practices (which reflect the above changes) have been effective in maintaining or restoring competition, so the proposed changes are more modest than those from the 1999 Study. That said, the Study provides important guidance for parties that may be required to divest assets to remedy the perceived anticompetitive effects of a transaction, in particular a horizontal transaction (i.e., one involving competitors), as well as for potential divestiture buyers. Namely, moving forward, the FTC will more closely scrutinize:

- proposed divestitures consisting of less than an entire ongoing business unit;
- the divestiture buyer’s financing of the acquisition;
- the short-term support (i.e., back-office functions and transition services) to be provided by the merging parties to the divestiture buyer;
- any customer transition issues;
- the amount of due diligence conducted; and
- any issues relating to the interim operation of the divestiture assets pending the completion of the divestiture.

On February 3, 2017, the FTC released a study evaluating the effectiveness of its merger remedies and proposing updated best practices for merging parties and divestiture buyers.

Merging parties and divestiture buyers should be prepared to engage with an active FTC Staff on these topics.

Key Findings and Practice Tips

Using empirical evidence, the Study concluded that 83% of the 50 FTC consent orders from 2006 to 2012 were either “a success” (meaning that competition remained at pre-merger levels or returned to those levels within two to three years) or a “qualified success” (meaning that competition ultimately was restored to pre-merger levels, but more than two to three years following the order).

However, in 17% percent of the consent orders (and in 19% of consent orders involving horizontal mergers with divestitures), the Study found that the FTC’s remedy failed to maintain or restore competition to pre-merger levels. In addition, only approximately 25% of consent orders in already consummated mergers were considered a success, with approximately 50% considered to be qualified successes and 25% considered to be failures.⁵ The Study examined several factors that may have contributed to these failures, and proposed refinements to the process that the FTC claims it will pursue.

- ***Scope of the Divestiture Package.*** The Study found that buyers of a limited package of divestiture assets have been less successful in maintaining or restoring competition than buyers of an entire ongoing business.⁶ Whereas 100% of divestitures of ongoing businesses have been successful under the FTC’s rubric, the same is true of only approximately 70% of divestitures of selected assets.⁷ Thus, while divestitures of selected assets may be acceptable in some circumstances, the Study cautioned that the FTC will analyze them with a higher level of scrutiny. The FTC also made clear that it will ask merging parties proposing selected asset divestitures to identify at least three approvable potential buyers for FTC review and consideration.

Both merging parties and divestiture buyers should be prepared to submit detailed evidence demonstrating the sufficiency of the divestiture package as well as the divestiture buyer’s ability to effectively maintain or restore competition without an entire business unit.⁸ Merging parties should also be prepared to explain why any potential alternative ongoing business divestiture would be inappropriate or infeasible, how the selected assets can operate as a viable and competitive business, and how the buyer will be able to fill any gaps excluded from the package. Divestiture buyers should anticipate questions about what diligence has been conducted to confirm that the package consists of the “right mix” of assets to replace the competition of the merging parties. Buyers should be prepared to explain to the FTC which assets are not included in the package, but perhaps should be. The FTC may be able to help convince the merging parties to add those assets to the package.

- ***Qualification of the Divestiture Buyer.*** Since the 1999 Study, the FTC has rigorously scrutinized potential divestiture buyers — often requiring a bottom-up eval-

The FTC Study examined several factors that may have contributed to failed remedies and proposed refinements to the process.

uation of their business plan — as part of its approval process.⁹The Study found that the success or failure of a divestiture buyer is often closely tied to the buyer's financing arrangements. As a result, the FTC will inquire more about the financial qualifications used by the merging parties to select the buyer, and about how the buyer proposes to finance the acquisition. For example, the FTC will focus on whether the buyer has sufficient liquidity to invest extra cash into the business if needed (e.g., by calling additional capital if the first six months of sales are lower than projected).

Divestiture buyers should be prepared to explain their financial commitment to the acquisition in detail, including how the financing will allow the buyer to compete effectively in different contingencies. Divestiture buyers with private equity sponsors often have complex financing arrangements that may not be immediately clear to FTC Staff. Such buyers should not assume that the FTC will approve them simply because they have deep pockets, but should rather be prepared to explain the particulars of financing (e.g., sources, uses, structure and any limitations) with an eye toward demonstrating their ability to maintain or restore competition lost due to the transaction. All parties should expect more FTC attention to the particulars of buyer financing, including committed financing and free cash flow, both with respect to the transaction and post-transaction operations.

- ***Transition of Back-Office Functions and Other Key Services.*** The Study also found that some divestiture buyers have experienced unanticipated setbacks in the transfer of critical back-office functions and other services related to the divested assets,¹⁰ and have occasionally needed more time to complete the transition.¹¹ According to the Study, merging parties and divestiture buyers should be prepared to explain in detail to the FTC the back-office functions necessary to compete. If a divestiture buyer does not have or cannot acquire those functions, the divestiture package should include them. If the package does not include back-office functions, the merging parties should be prepared to provide them on a transitional basis to the buyer at or less than cost.¹²

In addition, the Study revealed that some divestiture buyers were unable to attract or retain customers due to the nature of customer relationships, brand loyalty and other factors.¹³The Study therefore suggested that merging parties should be prepared to assist a divestiture buyer in facilitating the transition of customer and other third-party relationships. Among other things, the FTC may require merging parties to provide the potential divestiture buyers with access to customers early in the process, to notify customers of their ability to terminate contracts, to assign contracts or waive contractual restrictions when necessary, and to assist the buyer in obtaining regulatory approvals.

Similarly, per the Study, the FTC may require merging parties to ensure that a divestiture buyer has a sufficient supply of key inputs where such inputs are critical to the business. In those situations, merging parties should be prepared to supply a divestiture buyer with a key product or input, on reasonable terms or at cost, for a sufficient time following the divestiture. The Study noted, however, that the

Divestiture buyers should be prepared to explain their financial commitment to the acquisition in detail, including how the financing will allow the buyer to compete effectively in different contingencies.

FTC “seeks to minimize the time that buyers rely on [merging parties]”¹⁴ because “it is generally inappropriate to allow a buyer to become little more than a distributor for the [merging parties].”¹⁵

In some instances, such as where the risk of customer attrition is acute or where the transition is complicated, a divestiture buyer may require substantial transition services after closing to compete effectively. Although the Study cautioned against excessive entanglements between merging parties and a divestiture buyer, the FTC may agree to a longer transition period and more involved transition services contracts if the parties can demonstrate it will enable the buyer to compete more effectively without becoming reliant on the merged entity.

- **Importance of Due Diligence.** The Study found that some divestiture buyers felt rushed to consummate a divestiture purchase and were not given adequate time, information or access to employees or facilities to conduct proper due diligence.¹⁶ This is of critical importance to the FTC, as the divestiture buyer is expected to become a significant competitor to the merging parties immediately following the closing and must therefore fully understand the business and be ready to compete on Day 1. The Study called on merging parties to provide greater access to information, such as direct access to key employees, information and facilities, and on divestiture buyers to take advantage of the access. The FTC will monitor the due diligence process more carefully going forward, and cautioned that all involved can expect more questions about due diligence.¹⁷ Divestiture buyers are advised to raise any concerns to the FTC, as the Commission Staff can help obtain necessary information from the merging parties.
- **Hold Separate Orders.** According to the Study, some divestiture buyers voiced concern that the independent monitor appointed pursuant to a hold separate order¹⁸ did not, in fact, preserve the viability, marketability and competitiveness of the divestiture assets pending the completion of the divestiture.¹⁹ Some buyers had issues with the manner in which the monitor ran the business in the interim period; others were concerned that uncertainty in the hold separate period led to the loss of key employees. In addition, some merging parties complained about compliance with onerous provisions of the hold separate order, such as the need to segregate and/or sequester information and employees. To allay these potential concerns, merging parties and divestiture buyers should work with FTC Staff and the monitor to optimize the effectiveness of the hold separate business operations.
- **Communication.** Finally, based on feedback from several respondents, the Study found that enhanced communication among FTC Staff, the divestiture buyer and the hold separate monitor would significantly improve the merger remedy process. Some divestiture buyers have failed to raise operational or process concerns with FTC Staff or monitors, which exacerbated problems in those cases. Divestiture buyers should not hesitate to raise any concerns to the FTC Staff or the monitor as they arise. Whether the concern relates to the scope of a divestiture package, the sufficiency of transition services, the adequacy of due diligence, the hold separate agreements, or any other aspect of the merger remedy process, both

The FTC will monitor the due diligence process more carefully going forward, and cautioned that all involved can expect more questions about due diligence.

pre- and post-order, timely communication with the FTC remains key to navigating the process.²⁰

The Merger Remedy Study does not signal a significant departure from the FTC's merger remedy practices. The process of negotiating a consent order with the FTC remains complex, requiring careful planning and a substantial investment in resources and time for all involved, including, most importantly, potential divestiture buyers. That said, the Study provides greater transparency into the FTC's — and, likely the Antitrust Division of the Department of Justice's — evaluation of divestiture proposals. Merging parties and divestiture buyers should continue to expect a thorough and lengthy FTC review, particularly when the divestiture package is less than an ongoing business, and should be prepared to discuss in detail with the FTC buyer financing, short-term transition services provided by the seller, and any issues relating to customer attrition, due diligence and the interim operation of the divestiture assets.

The process of negotiating a consent order with the FTC remains complex, requiring careful planning and a substantial investment in resources and time for all involved.

-
- 1 Fed. Trade Comm'n, *The FTC's Merger Remedies 2006-2012: A Report of the Bureaus of Competition and Economics*, (Jan. 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 (hereinafter "Merger Remedy Study").
 - 2 *Id.* at 7–11. The Study looked at 89 merger consent orders issued by the FTC from 2006 through 2012, which includes 79 divestitures to 121 buyers. Fifty of the 89 orders were analyzed using a case study method; the FTC analyzed sales data from competitors in each market and interviewed market participants (including the merging parties, the divestiture buyer and others). The sales data were used to assess whether the divestiture in fact maintained or preserved competition in the relevant market; the interview responses were used to identify remedy process concerns. In addition, the Study more closely examined 15 FTC orders relating to supermarkets, drug stores, funeral homes, dialysis clinics and other health care facilities. Lastly, the Study evaluated 24 consent orders involving mergers in the pharmaceutical industry (most of which concerned prescription generic drugs).
 - 3 Staff of the Bureau of Competition of the Fed. Trade Comm'n, *A Study of the Commission's Divestiture Process* (Aug. 1999), <https://www.ftc.gov/sites/default/files/attachments/merger-review/divestiture.pdf>.
 - 4 See Dan Ducore and Naomi Licker, Fed. Trade Comm'n, "Looking back (again) at FTC Merger Remedies" (Feb. 3, 2017), https://www.ftc.gov/news-events/blogs/competition-matters/-2017/02/looking-back-again-ftc-merger-remedies?utm_source=govdelivery.
 - 5 Merger Remedy Study at 18-19.
 - 6 *Id.* at 21–23, 32.
 - 7 *Id.* at 22.
 - 8 *Id.* at 22.
 - 9 This level of scrutiny has increased in recent years as the FTC has faced criticism in connection with two failed divestitures. In the first, Haggen acquired supermarket stores divested by Albertsons and Safeway, but shortly after the transaction entered into bankruptcy and sold several of the stores back to Albertsons. See Press Release, FTC Approves Application for Modification of Divestiture Agreement Between Albertsons and Haggen Holdings, LLC (Sept. 25, 2015), <https://www.ftc.gov/news-events/press-releases/2015/09/ftc-approves-application-modification-divestiture-agreement>; Wall Street Journal, Haggen Struggles After Trying to Digest Albertsons

Stores (Oct. 9, 2015), <https://www.wsj.com/articles/haggen-struggles-after-trying-to-digest-alberts-ons-stores-1444410394>. In the second, the divestiture buyer of car rental locations from Hertz and Dollar Thrifty suffered a similar fate, entering bankruptcy and selling some divested locations back to Hertz (as well as some to Avis and the Catalyst Capital Group). *See, e.g.*, Wall Street Journal, How the FTC's Hertz Antitrust Fix Went Flat (Dec. 8, 2013), <https://www.wsj.com/articles/SB10001424052702303330204579246281764302824>.

- 10 “Back-office’ functions refer to a variety of support functions such as legal, finance, accounting and tax, risk, insurance, environmental services, and human resources (and include[] related personnel and books and records). They also encompass information technology systems and databases, used in connection with warehousing, sales, production, and inventory databases, as well as controls, processing, and operations software.” Merger Remedy Study at 10, n.16.
- 11 Merger Remedy Study at 26–27, 33.
- 12 *Id.* at 33.
- 13 *Id.* at 25, 35.
- 14 *Id.* at 36.
- 15 *Id.* at 27.
- 16 *Id.* at 25, 34.
- 17 *Id.* at 2.
- 18 A hold separate order requires the divestiture assets to be operated separately from and independently of the merging parties’ business pending the completion of the divestiture, preventing interim competitive harm and preserving the viability and competitiveness of the assets.
- 19 Merger Remedy Study at 27–28, 36.
- 20 *Id.* at 28–29, 37.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

Ian G. John, P.C.
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/ijohn
+1 212 446-4665

James H. Mutchnik, P.C.
Kirkland & Ellis LLP
300 North LaSalle
Chicago, IL 60654
www.kirkland.com/jmutchnik
+1 312 862-2350

Mark L. Kovner
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
www.kirkland.com/mkovner
+1 202 879-5129

Matthew J. Reilly, P.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
www.kirkland.com/mreilly
+1 202 879 5041

Peter M. McCormack
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
www.kirkland.com/pmccormack
+1 212 446 4981

This communication is distributed with the understanding that the author, publisher and distributor of this communication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this communication may constitute Attorney Advertising.

© 2017 Kirkland & Ellis LLP. All rights reserved.

www.kirkland.com