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Commentary: Kenneth Davidson, The Reports on Divestiture Remedies of the US FTC and EU DG Comp

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COMMENTARY

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THE REPORTS ON DIVESTITURE REMEDIES AT THE US FTC AND EU DG COMP: ARE THERE SIGNIFICANT DIFFERENCES?

In 1999, the staff of the U. S. Federal Trade Commission's Bureau of Competition published *A STUDY OF THE COMMISSION'S DIVESTITURE PROCESS.* <www.ftc.gov/os/1999/08/divestiture.pdf> In 2005, the staff of the European Union's Competition Directorate-General published the *MERGER REMEDIES STUDY*. <europa.eu.int/comm/competition/mergers/others/remedies_study.pdf> As one of the FTC staff who designed and conducted the FTC Study, and as the co-author, with Naomi Licker, of the FTC staff report, I have personal views about the two studies and the presentation of their results. Overall, the studies were conducted in a similar manner and came to essentially similar conclusions. They agreed on the strengths and weaknesses of merger orders that required divestitures as remedies for mergers or acquisitions that would otherwise have been challenged as unlawful in the absence of an order. There are, of course, some differences in the way the orders were developed under different laws, the ways in which the divestitures were implemented and the ways in which the results of studies were presented. I found only one major difference in the way the agencies approached divestiture remedies, that is, the role that the two agencies grant to the buyer of divested assets in the formulation of remedial orders. The FTC, with many misgivings and qualifications, gives prospective buyers a major role in the formulation of divestiture orders. The EU does not.

This is a general Commentary on what the two agencies have learned about divestiture remedies from looking at a sample of past merger orders. I think that, despite significant differences in merger investigational procedures and some differences in merger substantive law, the data produced by the studies is remarkably similar. The formats of the two reports are very different. That may be simply a matter of taste or tradition. American cuts of beef produce sirloin, porterhouse and rib steaks. European butchers offer filet mignon and faux filet. I have tried to highlight some of the presentations that differ and some of the differences in conclusions (or assumptions) to examine whether they provide reasons to modify our current ideas about remedies. In both studies, the remedial theories now in use are quite different, as a result of the studies, from those in place when the studied cases were decided.

There have also been numerous changes of procedures in the two jurisdictions. The US has raised the dollar value of reportable proposed transactions and thereby reduced the number reported. It has also granted procedural rights to persons who object to Second Requests on the grounds that they are unnecessarily burdensome. The EU has recast its merger enforcement program in so many ways that it is not easily summarized. John Parisi, Counsel for European Affairs, International Antitrust Division at the FTC, has compiled *A Simple Guide to the EC Merger Regulation of* 2004 that tries to summarize the changes. It is available on the Antitrust Source website, www.abanet/antitrustsource/01-05_Jan05_parisi.pdf, and is linked to the principal EU documents. In addition, the websites of the FTC and the EU do a good job of explaining the operation of the notification programs and policies concerning merger remedies. Both agencies insist that the lessons learned in their merger studies remain relevant despite the changes of law.

Methodology and Inferences

One reason for avoiding much discussion of the detail in the two studies is that the range of data from the interviews is so similar. Another is that both studies used case study methodologies to arrive at their conclusions. Case studies can be enormously valuable resources for understanding how a phenomenon works, but the details are just clues for researchers seeking a general pattern. Every case has its own unique features that may have influenced the outcomes of the divestitures. The inquiry for each study was the same: Did the divestiture work? If not, why did it fail? If it succeeded, are there identifiable features of the order that made success more likely?

Briefly stated, both studies found that the divestitures were most likely to work if the order required the sale of a "stand alone" business or a sale to a joint venture partner. Divestitures were less likely to work if only parts of business, e.g., a product line, a trademark or patent, access to technology or resources, or machinery were sold. Unfortunately, stand-alone businesses were the exception rather than the rule in the matters studied. Both studies concluded that, in the absence of the sale of a stand-alone business, it was frequently necessary to also order technical assistance or transfers of key personnel to establish the buyer as a viable competitor. The inference is clear that buyers sometimes did not know how to operate the business they were buying and if they did not obtain a stand-alone business the buyer might be unable or less able to operate the divested assets as a business.

The way the studies present these conclusions reflects some differences in methodology between the studies and the reports. In a 2002 speech, Competition Commissioner Mario Monti reported that the EU study of merger remedies was influenced by the FTC study. The EU staff appears to have followed closely the methods of the FTC, even to the point of beginning with a trial study of nine merger orders, but then seems to have tried to go further in two respects: they interviewed more types of knowledgeable participants, not only the buyer of the divested assets and the divesting respondents, but also some competitors, suppliers, distributors and trustees; and, in addition, they obtained some sales data about the retained and the divested businesses. The FTC staff had sought interviews with many of these sources but found consistent cooperation only from the buyers of divested assets. The additional EU information may permit greater inferences as to the extent to when competition was maintained; whereas the FTC data is more limited to whether the buyer established a viable business not whether competition was fully maintained.

Having noted this difference, I can say that we at the FTC were aware and interested in the extent to which competition was maintained and gained a good deal of information on these subjects. We know that some buyers took a long time to establish themselves as going entities and others were up and running immediately. In some cases, the buyers needed extensive technical assistance and took a long time to get into business; in others, the buyers ignored the research they were given, initiated new products and procedures on their own and, as a consequence, grew market shares much more quickly than the divesting company. Our information was not sufficient to make these factors part of our numerical data set; however, the information was sufficient to include in the descriptions of interview responses and to help form hypotheses about why some divestitures worked and others didn't.

The Presentation of Study Results

Despite these similarities, the presentations of the two studies are different. The EU emphasized the consequences of different characteristics of mergers and merger remedies; whereas the FTC focused on identification of risk factors in the process of formulating orders and what strategies might lessen these risks. For example, the EU looked at: mergers involving horizontal mergers, mergers involving horizontal and vertical issues, and mergers involving vertical issues; remedies that involved the divestiture of stand alone businesses versus "carve-out"remedies; carve-out remedies that required the divestiture of assets comprising just the overlap business, more than the overlap assets, and less than the overlap assets; remedies that involved only licensing of technology or access to technology or assets; remedies that involved the rights of third parties; remedies that provided for the protection of to-be-divested assets; and remedies that required the appointment of trustees.

This detailed analysis of a matrix of order characteristics provides interesting results. The study finds a correlation between the scope of the divestiture order and the success of the divestiture. In carve-out remedies, where more than the overlap assets were divested, the success rate was significantly higher than remedies that divested only overlap assets, and where fewer than the overlap assets were divested, the success rate was significantly less than remedies that included all the overlap assets. Success was recorded in 86% of the cases where more assets were divested; whereas the results of divesting fewer assets showed success was doubtful in 72% of those remedies. An analysis of these results showed the most common problem for all three types of remedies was upstream supply problems or downstream production or distribution problems (although less of a problem where more than the overlap assets were divested). Business size or scale was much more likely to be a problem for buyers who received just the overlap, or fewer, assets.

Looking at similar responses, the FTC study focused more on the relationship between the appropriateness of assets for particular buyers and placed less emphasis on quantitative distinctions about the amount of assets divested. To be sure, we found that the divestitures of stand-alone businesses were likely to succeed and divestitures that lacked essential assets were likely to fail. But, as the EU study confirmed, the FTC staff found that including unrelated assets can both improve the chances of finding a buyer and the chances that that buyer will be more interested in the non overlap assets and less interested in competing in the overlap market. Furthermore, some buyers that intend to compete in the overlap market may have not have any interest in some of the relevant overlap assets, for example, if the buyer already has a distribution system that already covers the customers, or has more modern manufacturing capacity that is adaptable and currently underused. Such buyers would be disadvantaged by taking all of the relevant assets. So the FTC analysis emphasized more the fit between the divested assets and the capacities of the buyer and less on the quantity of related and unrelated assets. While I believe that the FTC focus was correct, the EU data is interesting, because, as we shall see, it is often difficult to determine what assets are necessary; consequently, the EU data may correctly indicate that because buyers and competition agencies lack adequate information on what assets are necessary to constitute a "fit," the larger asset package is more likely to succeed because it may include assets whose significance was not fully understood..

Difficulties in Implementing Remedies

The EU Study also discusses complications arising from remedies that affect the rights of third parties. They focus on two particularly troublesome arrangements, ones in which the production process requires the transfer of a patent license or the sale of a joint venture where the JV partner has a right of first refusal. The FTC staff also faced problems with third parties who did not want to transfer their existing relationship to a new one with the buyer of the divested assets. These problems appear to arise in different contexts in the two jurisdictions. It appears that the EU problems arise at the stage of implementing a remedy order; whereas in the United States the issue more commonly arises in discussions about whether a remedy is possible. Prior to the issuance of the remedial order, the respondent is less vulnerable to unreasonable demands by third parties. It can abandon the merger or recommend divesting assets of the business it intended to retain. Once it is locked in to the merger and by order required to obtain permissions of identifiable third parties, its bargaining power with those third parties is greatly weakened.

The EU discussion of interim measures to maintain the to-be-divested assets is somewhat more explicit than that of the FTC although the conclusions are essentially the same: that it is necessary to protect the viability of the to-be-divested assets and fence out the respondent from learning about operational decisions in the interim pending the divestiture. Like the FTC, the EU sees oversight by trustees as a critical role in maintaining the to-be-divested business.

The Role of Buyers in Formulating EU Divestiture Remedies

Only after evaluation of these and other characteristics of divestiture remedies does the EU Study examine how the divestiture process works. It is here where we find what seem to be the most significant differences between the two agencies. The EU Study characterizes:

> The underlying issue is the extent to which the precise scope of the accepted remedy must be known by prospective purchasers. (EU Study at 68)

In one remedy studied:

> "The seller argued that the veiling of the specific plants to be divested was necessary for a fair sales process and was also beneficial in terms of interim operations and preservation of viability of the divested plants (as the knowledge of divestment may have de-motivated the workforce). The seller argued that otherwise the few suitable buyers would have had an undue advantage which could have had a very negative impact on the sales price . . . ." (*Ibid*.)

The effort to minimize the information to prospective buyers is directly contrary to FTC practice for reasons that the EU Study mentions: "potential purchasers need to receive accurate and complete information . . . [and] must be given sufficient time to acquaint themselves with the divested assets, its potential and gather all relevant data during due diligence." (*Id.* at 69) Although the EU Study claims giving sufficient information is "current practice" that is required by paragraph 11 of the Model Divestiture Commitments, it subsequently includes a complaint by:

> "the purchaser [who] was given only two days to carry out the due diligence and the parties restricted access to significant information, including on key employees. The purchaser was thus unable to identify the employees it needed for the divested business." (*Ibid.*)

Moreover the Study indicates:

> "the scope for opportunistic behavior of *purchasers* [has been minimized] by keeping confidential certain additional aspects of the commitments , such as for

> example, the timetable for divestiture or the nature of an alternative remedy. . . . to prevent strategic bargaining by candidate purchasers. . . . This is also current practice. (*Id.* at 71)

This conclusion about the bargaining power of purchasers is directly contrary to the experience of the FTC staff. The FTC Study confirmed that purchasers are at an inherent disadvantage to the seller as to the character of the divested assets. Moreover, so long as there are multiple possible buyers, the requirement to sell at no minimum price is totally irrelevant. The price will reflect the buyers' estimates of the value of the assets.

The Role of Buyers in Formulating FTC Divestiture Remedies

Purchasers are viewed differently in the two Studies. The FTC Study started with an assumption that potential buyers have played and should play an indispensable role in formulating effective divestiture remedies. The FTC staff believed that buyers are more likely than the FTC staff to have the knowledge and incentive to evaluate, or even formulate, a viable and competitive set of divestiture assets. In contrast, the EU Study reiterates its concern that giving prospective buyers too much information could grant buyers too much leverage in negotiating the terms and price of the divested assets. Consequently, the EU Study focuses more on the success or failure of types of divestiture packages; whereas the FTC looked more at the reasons that particular kinds of buyers made correct or incorrect decisions and what the effects of those decisions were.

This different role of the buyer in formulating the divestiture provides the basis for some differences in the divestiture process. For example, the EU Study reports that sometimes small buyers are quite successful. At the FTC, we were sufficiently impressed by the success of smaller acquirers to note that a higher percentage of small buyers had been successful than large buyers. By themselves, these numbers suggest the agencies should not automatically eliminate small companies as potentially viable buyers. The FTC's use of buyers in formulating remedies also provided a basis for looking at our interviews for clues that might explain what seemed like a counterintuitive result.

In fact, this inquiry helped us to gain some wider understanding of the process by which defects in FTC orders arise. In both FTC and EU practice, the acquiring firm has, or merging parties have, the responsibility in the first instance of formulating the divestiture and finding an appropriate buyer. At the FTC, our practice had relied heavily on the buyer or potential buyers of the divested assets to evaluate the adequacy of the remedy proposal of the acquiring firm. The conventional wisdom was that a company was not going to plunk down a large chunk of money unless it had reason to believe that the divestiture would become a viable business. Even our pilot study cast doubt on that proposition. The full study showed a range of misjudgments by buyers that was astonishing. The candor of buyers of divested assets as to their mistakes gave us great confidence in their presentation of the facts of the divestitures and made us less concerned about verifying details with other parties. The truth is that the number and extent of the errors made by buyers was so large that I was shocked.

It became apparent that no one really knows how a complex business operates until he has run that business and even then there may many important matters that the management never knows. But we found different levels of ignorance among buyers of different sizes and different consequences for mistakes. A gross generalization would be that large multidivisional conglomerate firms tend to be worse buyers because they are most prone to make mistakes by focusing on larger strategic concepts and ignoring operational details. Their acquisitions are generally made by acquisition divisions or senior managers who are responsible for multiple products. These managers frequently do not fully appreciate the operational problems of their own business much less those of a business they have never run. In my view, the worst example we encountered was a company that bought a product that was in development. It successfully developed the product with materials supplied by the seller and then discovered its manufacturing personnel did not know how to produce the materials, and could not have done so without a financially prohibitive investment for this single product. No one thought to ask the production people at the time of the purchase.

Small buyers are unlikely to make this kind of mistake, especially if they are investing a substantial part of their net worth in the acquisition. They are more likely to want to know the exact details of the business before committing their money. Chances are good that if they make mistakes their acquisition will fail because they lack the resource to try other methods. Even so, small businesses may be more prone to make more mistakes of other kinds if they lack business experience.

The propensity of large companies to make mistakes of great magnitude was common. One large company told us they paid twice what the assets were worth, but they were a large company and could absorb the initial loss and it was an innovative company that quickly grew the product lines. Why did firms pay so much more than the assets were worth? Why didn't these firms do better due diligence? From repeated conversations with different buyers, we developed some consistent answers. Buyers assumed they were getting a bargain because the FTC orders required a sale at no minimum price. They were concerned that if they asked too many questions, the respondent would turn to a less troublesome buyer and they would lose the opportunity to snap up a bargain.

Another large company argued against the divestiture of the unlawfully acquired firm because, although it was a stand-alone company, it was still in development. Instead the prospective buyer claimed, if supplied by the respondent with certain critical supplies, it could more quickly establish effective competition. With some reluctance, staff recommended the firm's resolution to the Commission because the firm seeking to buy the assets was both a potential competitor and a well established firm in a related market. Unfortunately, this well established firm had no production experience in making this product and was required to replace within a year all of the new equipment they had acquired. Why did the firm start up a new venture rather than take over an almost operating business? Like the firm that had acquired a product it could not make, the managers simply assumed that production would not be a problem. Their resources allowed the firm to continue with a second attempt, but competition was not quickly restored.

As a result of these interviews it became clear that buyers and potential buyers were not as knowledgeable as we had assumed. Also, as the EU Study also confirms, the interests of the buyer are not always the same as the interests of the competition agency. Buyers were sometimes willing to settle for a niche that did not require competition with the firm that was ordered to divest.

The FTC study recommended means to compensate for the fact that it cannot rely so heavily on potential buyers and buyers by requiring of the buyers much more detailed plans for the divested assets. Neither competition agency has the training or expertise to know how to run the businesses that are ordered to be divested. At the FTC, the staff believes that it must consult with managers of the divesting company and with potential buyers to determine if the divested assets will produce a viable business. Managers generally have a higher degree of credibility if they believe they are going with the assets to the new buyer. The test for the credibility of buyer's views is more complex given that their highest priority is to obtain the assets at what they believe is a bargain price. The business plan often becomes the template for staff analysis of assertions by buyers. Does the plan make sense? Has the buyer the freedom to use improved technology or is it boxed in by patents? Can the buyer obtain necessary inputs, distribution, etc? I found it surprising when potential buyers had not considered one or more of these issues. Forcing the buyer to consider such issues frequently changed the scope of the remedy to include, among other things, more technology, access to the respondent's plants to see the process in operation, and to require the transfer of key personnel. So the FTC Study concluded that agency staff has no choice other than to trust the potential buyer and the respondent, but it also needed to verify what the buyer and respondent tell the staff.

The EU Process for Designing Divestiture Remedies

Neither the EU Study nor the many useful internet guides issued by the EU staff give much guidance on how EU orders and undertakings are designed. The Study shows that the EU divestiture process operates differently but it has experienced as many problems as the FTC in drafting appropriate orders, and its rate of success is no less than that of the FTC. Two procedural differences may account for some of the overall success of the EU divestitures. The first is that the premerger notification form used by the EU is much more comprehensive than that used by the FTC. The EU form is more like an FTC Second Request, but in many respects is more demanding in requiring a description of the current state of competition in the firm's industries, its relations with suppliers and distributors, and a description of likely future developments in the industries. Second, the EU emphasizes the desirability of the merging firms meeting with the EU staff prior to filing premerger notifications so as to make the filings more useful to the EU staff. The prefiling meetings and later required state-of-play meetings between staff and the parties may provide the staff with equivalent information to that developed by the FTC, and where it does not, the EU staff can and has in some cases decided that the acquiring parties must present a fix-it-first buyer. That proposed buyer could provide the same kind of information that the FTC normally seeks concerning the salability and viability of the to-be-divested business.

The Role of Trustees in Securing Compliance with Divestiture Remedies

Both agencies have relied on trustees to keep track of and help implement ordered divestitures. I am not clear on the roles that the EU has approved for trustees. Their general function is similar to that of FTC trustees. They are paid by the parties and report to the competition agency on implementation of the remedial order. The EU study reports two phenomena that are unusual in the FTC experience. On the one hand, it appears that EU trustees frequently have authority to order the parties to take certain actions related to defining the assets to be divested. On the other hand, the Study suggests trustees have not always had access to facilities to monitor whether divestiture obligations are occurring. The apparent inconsistency may reflect differences between (unfortunate) past practices and the current recommended EU Best Practices. See the Best Practice model forms and recommendations published by the EU at <europa.eu.int/comm/competition/mergers/divestitures_commitments> What is current practice is another matter.

Both limiting the access of trustees and delegating decisional authority to the trustee may create troublesome issues. In an earlier AAI Commentary, *The FTC Monitor Trustee*, I suggested that the success of FTC trustees rested in part on the fact that they did not have the authority to impose decisions on the respondent or the buyer of the divested assets. What they have is access. Such access is granted by the FTC Order that authorizes the appointment of the trustee and delineates the powers of the trustee. The most important of these is the right of access to the books, records, personnel, and facilities of the respondent. FTC trustees normally reiterate access and other rights in their contract with the respondent, and sometimes obtain parallel commitments from the buyers of the assets.

This access has proven critical to the success of the FTC trustees for at least two reasons. First, without such access the trustee cannot effectively monitor whether the obligations of the Order are being followed. One of the clearest findings of the FTC Study was that buyers of divested assets do not generally complain to the FTC staff that they are not receiving what they are entitled to obtain under the Order. Indeed, it was this general failure to complain that misled staff to underestimate the prevalence of defects in Orders and divestiture contracts and the extent to which respondents failed to fulfill their obligations. We identified two reasons why complaints were infrequent. Buyers of divested assets were often unsure of what their rights were and whether the Compliance Division would be able to help them. In addition, to the extent they were obtaining any supplies and/or technical assistance from the respondent, they seemed to assume that a complaint would most likely result in worse, not better, treatment as a result of creating problems for the respondent with the FTC. A monitor trustee was an effective solution to this problem. Trustees are not vulnerable to retaliation by the respondent. They can and do keep FTC staff abreast of developments concerning the divestiture.

The second critical role that FTC trustees have played is one that was not fully anticipated until its widespread effect became manifest. In contrast to the EU which appears to favor the use of accountants and investment bankers as trustees, the FTC has favored business executives, scientists or consultants. The rationale for the FTC preference has been clear, especially since the divestiture study. The FTC Compliance Division employs almost exclusively lawyers. Few of these otherwise distinguished lawyers know much about such industry-specific matters as machinery, chemical processes, computer source code, or FDA regulatory rules. Our idea was that the monitor trustee should provide that knowledge that we did not have so that we could track whether the divestiture was being effectively implemented. Questions about quality, suitability, timeliness of assistance or supply obligations of the buyer depend on an understanding of the industrial context. Our trustees have generally been chosen for a combination of specialized and general business knowledge to supplement the capabilities that the Compliance Division did not have.

One side effect of having a knowledgeable trustee is that when he or she looks at a divestiture plan, the trustee should have an informed view about whether it is likely to be effective or what would be needed to make it effective. And trustees have been free in expressing their views to the respondent and the buyer of the divested assets in a discreet manner. Over the course of an extended divestiture, the parties have often found that the trustee has more experience than they in the transfer of the business and they have learned to trust the judgment of the trustees.

In some cases, the trustees have explained necessary procedures with which the parties had no previous experience and in others they have been able to resolve differences between the parties because they have access to the operations of both the respondent and the buyer. Their credibility is enhanced in part because they have no power to impose solutions. Had they power to impose solutions one or the other of the parties might have an incentive to take an adversarial stance and try to limit the access of the trustee. Without any power, the trustee can only persuade the parties that there is a better way that will save the respondent money or speed the delivery to the buyer. The decisions remain with the parties.

Conclusions and a Suggestion

The summary and conclusions of the two studies are again sufficiently parallel that they do not need much discussion. The principal guidance is to divest a viable business as soon as possible to a suitable buyer with a good monitor who has full access. Delay, lack of due diligence, continuing entanglements such as supply contracts and technical assistance or access remedies may to some extent be inevitable or necessary but they increase the risks of a loss of competition.

Like the advice of the successful stockbroker to buy low and sell high, the advice is easy to state once the studies have revealed the pitfalls that decrease the chances of maintaining competition. The trick is how to accomplish these divestiture policies. Merging parties are not always willing to agree to the best possible remedy. The anticompetitive overlap may be tiny in comparison to a large arguably procompetitive or efficient merger. The proof of competitive harm may be difficult to obtain and overly resource intensive. The best remedy may be politically unacceptable. Second or third best remedies may therefore be ordered. Our understanding of the divestiture process has given us tools to make these less risky, and perhaps more likely to succeed. Certainly, I have seen a few orders or actions at the Commission since the FTC Study that probably would not have been tried before the study. These include a 20 year supply contract, a division of trademarks between respondent and the buyer of the divested assets and other novel nondivestiture remedies.

I wonder how we (the FTC and the EU) are doing now that we know more about what we are doing. I think it is time for new divestiture studies. The Monitor and Hold Separate Trustees were introduced as a result of the Studies. We ought to take a look at how these different kinds of trustees have functioned. Did they help, as I suggest, or were they more trouble than they were worth? What powers helped implement the orders? Is there a way to bring in experts like the trustee before an order is final to advise on the formation of the divested entity? Have there been notable changes for the better as a result of the Studies and adoption of new more explicit procedures to implement merger remedies? Some of these studies ought to look at the questions that were too hard for a large study, like a re-analysis of some markets to see if the remedies really maintained competition in price, quality and innovation.

The art and science of remedy-building is something that for many years played a back-seat role in antitrust enforcement. Today, the remedy is properly seen as an integral part of competition policy. It needs an ever-sturdier basis in empirical observation. The FTC and EU studies on divestiture are actually landmark events on the path to better enforcement. It is time, however, for second-generation studies to be undertaken.