ALERTS

The Proposed 2023 Draft Merger Guidelines: A Primer for Private Equity

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What happened?

On July 19, 2023, the Antitrust Division of the Department of Justice ("DOJ") and the Federal Trade Commission ("FTC") jointly released for public comment the 2023 Draft Merger Guidelines ("Draft Guidelines"), which would replace the current merger guidelines for both horizontal and vertical mergers. The Draft Guidelines shift away from the longstanding consumer welfare-focused approach to merger enforcement and substantially expand the circumstances under which the agencies may challenge a transaction.

The proposal is part of President Joe Biden's economic-reform agenda and is in response to the executive order he signed in 2021 to improve competition across the economy. That order directed the DOJ and the FTC to rewrite their guidance for companies on how the agencies seek to enforce antitrust laws for mergers.

The comment period will close on Sept. 18, 2023, after which the agencies will review the comments received and finalize the new Merger Guidelines.

Although the Draft Guidelines are touted by the agencies as "business-model agnostic," they could be of particular concern to the private equity industry.

What are merger guidelines?

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Merger guidelines describe and guide the agencies' review of mergers and acquisitions to determine compliance with federal antitrust laws. They are issued by the antitrust agencies to explain how they approach merger enforcement.

The first merger guidelines were released in 1968 and have been revised multiple times over the course of different administrations. The agencies last updated the Horizontal Merger Guidelines for mergers between direct competitors in 2010. The Vertical Merger Guidelines for deals between companies in the same supply chain were last revised in 2020 (although the FTC withdrew its approval of those Trump-era changes in 2021).

Are merger guidelines enforceable?

The agencies' merger guidelines are not binding on courts, but they can influence how judges evaluate challenges to mergers and acquisitions and often are cited in decisions.

The Draft Guidelines are unique in that they include citations to cases, providing courts with a blueprint to understand and bolster the agencies' now more progressive views on antitrust enforcement. Both Assistant Attorney General ("AAG") Jonathan Kanter and Chair Lina Khan, the top officials at the DOJ and the FTC, respectively, emphasized the agencies' efforts to ensure the Draft Guidelines are "legally rigorous" and not "an ideological document."

What do the Draft Guidelines say?

The Draft Guidelines give an overview of thirteen guidelines that the agencies may use when determining whether a merger is unlawfully anticompetitive under the antitrust laws and would apply to both horizontal and vertical deals. The Draft Guidelines also describe the frameworks and tools that may be used when analyzing a merger with respect to each guideline.

The 13 guidelines:

1. Mergers should not significantly increase concentration in highly concentrated markets.

2. Mergers should not eliminate substantial competition between firms.

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3. Mergers should not increase the risk of coordination.
4. Mergers should not eliminate a potential entrant in a concentrated market.
5. Mergers should not substantially lessen competition by creating a firm that controls products or services that its rivals may use to compete.
6. Vertical mergers should not create market structures that foreclose competition.
7. Mergers should not entrench or extend a dominant position.
8. Mergers should not further a trend toward concentration.
9. When a merger is part of a series of multiple acquisitions, the agencies may examine the whole series.
10. When a merger involves a multi-sided platform, the agencies examine competition between platforms, on a platform or to displace a platform.
11. When a merger involves competing buyers, the agencies examine whether it may substantially lessen competition for workers or other sellers.
12. When an acquisition involves partial ownership or minority interests, the agencies examine its impact on competition.
13. Mergers should not otherwise substantially lessen competition or tend to create a monopoly.

Major revisions include a shift away from the consumer welfare standard (focusing on how mergers and conduct impact prices and output) in favor of more protection for workers and suppliers of the merger firms, and a lowering of the threshold for a firm's post-merger market share that would lead to enforcers potentially challenging a deal.

The Draft Guidelines also, for the first time, explicitly reference issues that can arise from deals involving private equity firms.

How has the perspective on private equity transactions changed?

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Under previous administrations, private equity transactions were considered unlikely to raise significant antitrust concerns. This has changed under the Biden administration. Both the DOJ and the FTC have been vocal about the need to scrutinize private equity firms' transactions and board appointments, particularly in the healthcare sector.

Key areas of concern that the FTC and the DOJ repeatedly have raised include:

Roll-up strategies. Antitrust enforcers frequently have spoken of a need to scrutinize and combat roll-up strategies, particularly by private equity firms, where a large portion of a market is acquired one relatively small transaction at a time. AAG Kanter vowed early in his tenure to take a tough stance on buyout groups aiming to "hollow out or roll up an industry and essentially cash out," stating that such firms would face consequences for pursuing a strategy that is "very much at odds" with competition. Chair Khan has noted that there are "instances when a firm will undertake a series of acquisitions, no single one of which may raise legal concerns, but in the aggregate there can be significant consolidation of a market." She recently warned that the FTC was "putting folks on notice that those types of instances can warrant legal scrutiny and legal concern."

Chilling competition. Regulators are focused on "whether certain private equity investments may chill fierce competition on the merits." They are concerned that private equity firms are more interested in consolidating competitors than promoting competition. Specifically, the DOJ has noted its concern that certain private equity investments may "blunt the incentive of the target company to function as a maverick or a disruptor in health markets" or "cause the target company to focus solely on short-term financial gains and not on advancing innovation or quality." The enforcers' concerns are fueled by the "buy, strip and flip" practice employed by some firms, where undervalued companies are acquired, restructured and sold off shortly thereafter, as well as the perceived negative effects of private equity in the healthcare space. For example, Chair Khan highlighted an FTC study showing a jump in mortality after nursing homes were acquired by buyout groups.

Divestiture buying. Both the DOJ and the FTC have sounded the alarm on buyout groups acquiring assets that companies have been ordered to divest to complete another merger. AAG Kanter has stated that private equity's involvement often exacerbates antitrust issues, which is an

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abrupt turnabout from the Trump administration's DOJ that asserted private equity divestiture buyers "may be preferred" over strategic buyers. While expressing concern that "divestitures may not fully preserve competition across all its dimensions in dynamic markets," AAG Kanter specifically noted that "too often partial divestitures ship assets to buyers like private equity firms who are incapable or uninterested in using them to their full potential." In a different interview, he stated that settlement divestitures often involve private equity firms that often are "motivated by either reducing costs at a company, which will make it less competitive, or squeezing out value by concentrating [the] industry in a roll-up." Given the current administration's skepticism of divestitures as merger remedies in general, as well as for private equity specifically, private equity firms can expect increased scrutiny as proposed divestiture buyers.

Interlocking directorates. Subject to certain safe harbors, Section 8 of the Clayton Act prohibits the same person (or the same firm through its representatives) from serving as an officer or director of two or more competing companies. The DOJ has stepped up its enforcement against such interlocking directorates. This past March, AAG Kanter noted that more than a dozen board members have stepped down (three of the last four interlocks unwound by the DOJ involved private equity firms), and that the DOJ has "nearly 20 open investigations" into possible illegal interlocks. He further stated that there are "many additional opportunities" to "deconcentrate the economy" through Section 8 enforcement. (Note that private equity firms should periodically evaluate their portfolio companies for potential interlocks as their businesses evolve. Companies that do not initially compete may become competitors as product and service lines change.)

HSR filing deficiencies. The DOJ previously stated its concern regarding "filing deficiencies in the private equity space" and that private equity firms "may not be taking seriously enough their obligations under the HSR Act." Although the DOJ did not elaborate on what these filing deficiencies were, the recently proposed revamp of the notification form required by the Hart-Scott-Rodino ("HSR") Act likely addresses its concerns with the significantly expanded disclosure requirements for investment funds. The proposed HSR changes also would provide the agencies with information regarding interlocking directorates and previous non-reportable acquisitions of companies within the same industry. (Note that the proposed HSR changes could require weeks, or

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possibly months, to prepare if a private equity deal involves complex fund and transaction structures and significant overlaps between the parties.)

What portions of the draft guidelines are most relevant to private equity?

Roll-up acquisitions. Reflecting the agencies' concern regarding roll-up strategies, the Draft Guidelines allow the agencies to consider the cumulative competitive effect of an entire series of acquisitions, rather than just an individual deal. According to the proposal, "[a] firm that engages in an anti-competitive pattern or strategy of multiple small acquisitions" in the same business line may violate antitrust laws, even if no single deal would harm competition or tend to create a monopoly. The agencies also may examine a pattern or strategy of growth by assessing the acquirer's "history and current or future strategic incentives," including by examining the parties' consummated and unconsummated acquisitions, as well as their current or future plans as described in ordinary course business documents.

Partial control or common ownership. The Draft Guidelines allow the agencies to consider the competitive effect of the acquisition of non-controlling "partial control or common ownership" (e.g., when investors hold minority shareholdings in a number of companies that compete with each other). The Draft Guidelines identify three ways a partial acquisition may affect competition. First, a partial acquisition may give the partial owner the ability to influence the competitive conduct of the target (e.g., through governance or board appointment rights). Second, a partial acquisition may reduce the incentive of the acquiring firm to compete (e.g., a partial owner may not develop a new product feature to win market share from a firm in which it has acquired an interest). Third, a partial acquisition may give the acquiring firm access to competitively sensitive information from the target that can result in lessened competition (e.g., by enhancing the ability of the target and partial owner to coordinate their behavior).

Lowering of market share and concentration thresholds. The Draft Guidelines substantially lower the market share and concentration thresholds for when a transaction is presumed to substantially lessen competition. Under the Draft Guidelines, a merger would be presumptively unlawful if it has a post-merger market concentration — measured by the Herfindahl-Hirschmann Index ("HHI") — of 1,800 HHI and an increase in

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100 HHI from pre-merger levels. Under the 2010 Horizontal Merger Guidelines, the concentration level for presumptive harm is an increase in 200 HHI to a post-merger concentration of 2,500 HHI.

To illustrate, assume a hypothetical market of six competitors, each with a 15 percent share, and a smattering of smaller competitors totaling the remaining 10 percent. A merger of two of the six competitors would increase the HHI by 450 to a post-merger HHI of 1810. Under the Draft Guidelines, this hypothetical merger would be presumed to substantially lessen competition, whereas the 2010 Horizontal Merger Guidelines would deem this a merger resulting in a "moderately concentrated" market that may warrant scrutiny. Indeed, a merger could be presumed anticompetitive under the Draft Guidelines even where one of the parties has a small share. For example, in a market where seven players have shares of 30 percent, 25 percent, 20 percent, 10 percent, 5 percent, 5 percent and 5 percent, a merger between the 10-percent player and a 5-percent player would be presumed problematic.

The Draft Guidelines also add a presumption of unlawfulness for any horizontal merger resulting in an increase of 100 HHI and a market share over 30 percent, as well as a presumption of vertical foreclosure concerns if the merged firm would have a market share above 50 percent for an input that a rival might want to access (a departure from the longstanding rule that antitrust law protects "competition, not competitors"). The current merger guidelines do not state any market share presumptions. Notably, the 2010 guidelines recognize that market shares and concentration are tools to be used in assessing the competitive effect of a proposed merger, whereas the Draft Guidelines are clear that transactions tripping the thresholds are presumptively problematic.

Potential competition. Noting that "[t]he antitrust laws reflect a preference for internal growth over acquisition," the Draft Guidelines expand on the circumstances in which a merger may be illegal due to potential competition. Under the proposal, a merger may be illegal where it eliminates an "actual" potential competitor (e.g., where the possibility of entry or expansion by one or both parties to the merger would have resulted in new or increased competition in the market in the future) or a "perceived" potential competitor (e.g., where there is "current competitive pressure exerted on other market participants by the mere perception that one of the firms might enter"). Even when assessing the threat to "actual" potential competition, the Draft Guidelines require the agencies

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to show only that one of the merging firms had a "reasonable probability" of entering the relevant market absent the merger.

Competition for workers. Rather than just focusing on customers, the Draft Guidelines, for the first time, would allow the agencies to examine how deals will affect workers (e.g., a combined firm's power over a labor market may lead to "lower wages or slow wage growth, worsen benefits or working conditions, or result in other degradations of workplace quality"). Both the DOJ and the FTC emphasized that enforcement against anticompetitive conduct in labor markets remains a high priority. Many deal proponents point to "efficiencies" or "synergies" that often in large part consist of the elimination of worker redundancy in the merged firm. These arguments about the benefits of lowering costs likely will carry little weight when they conflict with a policy of protecting workers.

Higher bar for efficiencies arguments. Reflecting the current administration's skepticism of efficiencies as a procompetitive benefit (note that the FTC withdrew its approval of the 2020 Vertical Merger Guidelines largely because those guidelines "improperly contravened the Clayton Act's language with its approach to efficiencies, which are not recognized by the statute as a defense to an unlawful merger"), the Draft Guidelines significantly raise the evidentiary burden for merging parties to demonstrate cognizable efficiencies. For example, noting that "[p]rocompetitive efficiencies often are speculative and difficult to verify and quantify, and efficiencies projected by merging firms often are not realized," the proposal would require that the "benefits are verifiable, and have been verified, using reliable methodology and evidence not dependent on the subjective predictions of the merging parties or their agents." This is perhaps an insurmountable bar to meet given that any procompetitive efficiencies offered by the parties necessarily would be based on projections.

Will the agencies continue to litigate even though they are not succeeding in court?

The threat of litigation has caused a number of deals to be called off across a range of industries, but the current administration's enforcers largely have come up short in litigated cases where judges have rejected nearly every merger challenge, including every challenge to a vertical deal. The DOJ has won one merger case that went to trial, convincing a D.C. district judge that Penguin Random House's proposed acquisition of

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Simon & Schuster risked giving the combined entity too much bargaining leverage over authors of anticipated bestsellers when negotiating publishing rights.

Some have speculated that the agencies are making gains even while losing in court by developing case law that will strengthen their cases down the line. For example, even though the DOJ has yet to secure a guilty verdict involving no-poach or wage-fixing agreements, courts in at least four circuits now have ruled that such agreements can be prosecuted criminally under Section 1 of the Sherman Act. And, even though the FTC failed to block Meta's acquisition of Within Unlimited, a developer of virtual reality fitness apps, the FTC succeeded in obtaining a ruling that, in an actual potential competition case, it is enough for the government to show that an acquirer had the ability and incentive to enter a target's market even if there is no evidence that the acquirer had made actual plans or intended to do so before agreeing to buy the target.

The Draft Guidelines indicate that the regulators are not changing their aggressive approach despite their litigation track record.

What happens now?

It remains to be seen what form the final Guidelines will take once the agencies have considered public comments. Although the Draft Guidelines cite to case law, the agencies would have to persuade courts to agree with their interpretation of precedent (and reject over four decades of jurisprudence based on the consumer welfare standard to do so). Convincing lower court judges to back novel legal theories will only be made more difficult given the conservative majority on the Supreme Court.

Regardless of the final form that the Draft Guidelines will take, private equity firms should expect increased scrutiny of their transactions (even if not HSR-reportable), portfolios and board appointments as part of the broad enforcement push by the antitrust agencies. When considering a potential transaction (whether a merger or acquisition of control or a partial acquisition), firms should engage antitrust counsel early in the process to assess antitrust risk, including analyzing competition and potential competition in horizontal, vertical and related markets, as well as evaluating potential labor market impacts. Antitrust counsel can help educate deal teams on document creation and the risks arising from, for example, overstating market share or improperly describing markets. In

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addition, given the expanded HSR disclosure requirements recently proposed by the FTC, antitrust counsel can begin compiling the required information earlier in the process to minimize any HSR-related delays.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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