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March 2, 2015

In a rare appellate opinion addressing the merits of a merger challenge, the Ninth Circuit last month sided with the Federal Trade Commission, finding that a 2012 merger of two health care providers in Idaho was likely to substantially lessen competition in violation of the antitrust laws.

Even though it ultimately found for the government, the court broke with long-standing precedent and held that merger efficiencies may create a more efficient combined entity and thereby enhance competition. The decision thus stands as important—and valuable—precedent for firms considering mergers and acquisitions with competitors.

Appellate review of merger challenges

The FTC and Department of Justice review hundreds of proposed mergers under the Hart-Scott-Rodino Act and enter consent agreements with parties to some transactions to resolve competitive concerns every year. But the agencies typically litigate only a handful of merger challenges each year, and appellate decisions are rarer still. The Supreme Court has not issued a substantive merger decision since the mid-1970s.

St. Alphonsus v. St. Luke's thus provides valuable appellate level insight into the state of merger review in the federal courts. As a result, it should guide investigations by the antitrust agencies, as well as district courts in future cases. While of particular interest to tech companies based on the west coast whose deals may be challenged in district courts in the Ninth Circuit, given the relative paucity of appellate level merger challenges, the decision will be relevant to merger challenges in any jurisdiction, where the companies want to argue efficiencies justify the transaction.

Market definition and market share analysis remain paramount

In federal court merger challenges typically follow a "burden shifting framework," under which the government bears the initial burden of establishing a *prima facie* case of likely anticompetitive effect—typically based on high market shares in some "market"—at which point the burden shifts to the defendant to rebut this evidence. If successful, the burden shifts back to the government, which at all times bears the "ultimate burden of persuasion."

The starting point of this analysis is traditionally to define the relevant product and geographic markets. Indeed, the *St. Alphonsus* Court deemed this step—quoting 1970's Supreme Court case law—a "necessary predicate to deciding whether a merger contravenes the Clayton Act."

To define the product market, the court endorsed the DOJ/FTC 2010 *Horizontal Merger Guidelines*' reliance on the "SSNIP" test—which examines whether a hypothetical monopolist in a candidate product market could impose a "small but significant and nontransitory increase in price," considering the anticipated behavior of buyers and sellers. If so, the proposed market constitutes a relevant antitrust market.

Once the relevant antitrust market is established the government bears the burden of showing the likelihood of anticompetitive effects within that market. In *St. Alphonsus* that was fairly straightforward, given the merger was between two of the three adult primary care physician providers in the Nampa, Idaho market—a so-called "three-to-two" merger.

One "metric" commonly used to to predict the competitive effects of such a merger is the Herfindahl-Hirschman Index (HHI), or the sum of the squares of each firm's market share. In this case, the level and change in HHI "blew through" the thresholds established in the *Merger Guidelines*, at which a merger may be "presumed to be likely to enhance market power." Reasoning that a "*prima facie* case can be established simply by showing high market share," the court found the government's initial burden satisfied.

The FTC's *prima facie* case—and the court's analysis of this showing—thus followed the traditional merger framework, relying on market shares in the relevant market. As explained in previous Cooley Alerts, however, the antitrust agencies have in recent years shifted away from a structural antitrust analysis, centered on market definition and concentration, in favor of a "more flexible" framework, which considers factors such as post-merger price increases and historical events (or "natural experiments"), which the agencies consider to be direct evidence of competitive effects.

This "more flexible" framework, reflected in the government's 2010 *Merger Guidelines*, may be used by the agencies. But in federal court, as the Ninth Circuit decision provides, it remains the case that the "determination of the relevant product and geographic markets is a necessary predicate." Indeed, the *St. Alphonsus* Court's analysis of the FTC's *prima facie* case was nothing if not orthodox, beginning with the relevant market definition, and effectively ending with the high market share.

In so reasoning, the Ninth Circuit followed the district courts that have decided merger cases since the 2010 revisions to the *Merger Guidelines*, in continuing to insist on structural merger review, such as *United States v. Bazaarvoice*, discussed in an earlier Alert. These cases effectively require the government to cast its *prima facie* using a structural framework, evincing the enduring significance of market definition and market share.

St. Alphonsus Opens Door For Future Efficiencies-Based Arguments

The decision in *St. Alphonsus*, which requires a divestiture to unwind a consummated acquisition, is most notable because it effectively reversed decades-old law and accepted, in principle, a role for efficiencies in analyzing mergers. While the court ultimately found the parties' "efficiencies defense" insufficient to overcome the government's *prima facie* showing, the court directly addressed the parties' contention that the transaction was both genuinely intended and likely to improve patient care, and hence procompetitive.

Treatment of efficiencies in merger review before the federal courts has long been equivocal, at best. The *St. Alphonsus* Court was quick to cite 1960s Supreme Court cases suggesting that "possible economies cannot be used as a defense to illegality," reasoning that "Congress was aware that some mergers which lessen competition may also result in economies but it struck the balance in favor of protecting competition." The court also noted that no reported appellate decision has ever found that a merger defendant had successfully rebutted the *prima facie* case with an efficiencies defense.

Yet even while expressing some lingering "skeptic[ism]" about the efficiencies defense "in general and about its scope in particular," the court nonetheless indulged the parties' efficiencies-based arguments. This is a big step for the Ninth Circuit, where long-standing precedent had rejected efficiencies as a merger defense.

Citing to the underlying text of the Clayton Act itself, which condemns only those mergers whose effect "may be substantially to lessen competition," the court expressly recognized that a defendant may rebut a *prima facie* case with evidence that the merger will "create a more efficient combined entity and thus increase competition."

The *St. Alphonsus* Court offered one example of such an efficiency: a merger of two small firms that may be able to lower production costs to compete with a large competitor. The *Merger Guidelines* recognize efficiencies may enhance competition in other ways: for instance, incremental cost reductions may reduce or reverse any increases in the merged firm's incentive to elevate price, and may make coordination less likely or effective by enhancing the incentive of a maverick to lower price, or by creating a new maverick firm. Efficiencies may also lead to new or improved products, even if they do not immediately and directly affect price.

In accepting that efficiencies may be relevant to the analysis, the court was careful to emphasize that the "linchpin" of the Clayton Act analysis remains whether the merger is likely to increase—rather than harm—competition. This position is consistent with the *Merger Guidelines*' directive not to challenge mergers in which "efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market."

And this, ultimately, is where the parties' efficiencies arguments foundered. The parties had contended that the merged entity would be able to move towards integrated patient care and risk-based reimbursement, a procompetitive, patient-friendly outcome. The court agreed with this factual predicate—but squarely rejected that it was sufficient to overcome the FTC's *prima facie* showing.

As the court concluded, "the Clayton Act does not excuse mergers that lessen competition . . . simply because the merged entity can improve its operations." Absent an efficiencies argument sufficient to show a "positive effect on competition," the defendant had not overcome the *prima facie* case, dooming the merger.

The FTC has lauded the decision for closely adhering to the "language and intention of the Clayton Act." But arguably, the decision may actually depart from the statute, in a critical way, by effectively requiring that the *defendant* prove that the "merger is not, despite the existence of a prima facie case, anticompetitive." This arguably reverses the Clayton Act's burden of proof, under which the ultimate burden to prove a likely anticompetitive effect rests with the plaintiff.

Future merger defendants will no doubt emphasize that while the three-part merger review framework certainly shifts to the defendant the burden of demonstrating efficiencies, that burden ought not require that the defendant prove the merger is ultimately procompetitive.

The efficiencies defense going forward

Notwithstanding old Supreme Court case law that remains on the books, it is becoming increasingly clear that evidence of merger efficiencies may be introduced to counter a *prima facie* case based on market shares, both before the agencies and in federal court. The *St. Alphonsus* decision provides useful additional support for why efficiencies should at least see the light of day—but at the same time underscores the skepticism to which such arguments will likely be subject.

Prudent companies exploring a potential merger with a competitor should evaluate, analyze, and document proposed efficiencies early in the process of considering a transaction, and should pay attention to how the efficiencies may enhance competition, consulting with counsel and economic experts. To be sure, future merger litigants will face an uphill battle justifying a "two-to-one" or "three-to-two" merger with evidence of efficiencies, but well-founded documentation of procompetitive benefits should ease the burden when proposing a "five-to-four" or "four-to-three" merger, and may at times justify a "three-to-two" merger.

** A version of this Client Alert recently appeared in the* Daily Journal.

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