

Client Alert

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ECJ Reverses the *BMG/Sony* Judgment: Court Gives the Commission a Win While Holding It to a High Standard

On 10 July 2008, the European Court of Justice (ECJ) wrote the latest chapter in the *BMG/Sony* merger saga by finding, contrary to the views of the Court of First Instance (CFI), that the European Commission had properly approved the combination as consistent with the EC Merger Regulation.¹ Though a major victory for the Commission and the parties, the ECJ's judgment also highlights the stringent standards of proof and other obligations that the Commission must satisfy when reviewing proposed concentrations.

Background of the Case

The case began in 2004, when Sony and BMG notified the Commission they proposed to combine their global recorded music businesses and create the world's second largest such company. The Commission initiated a Phase II investigation and issued a Statement of Objections (SO) expressing concerns that the merger would facilitate coordinated interaction among the four remaining "majors," who controlled about 80 percent of all music sales in the EEA, thus allowing them to increase wholesale prices above competitive levels. The Commission's SO found the presence of each of the market conditions necessary to allow the majors to reach, monitor and enforce a tacit arrangement after the merger.

The parties responded to the SO with facts and evidence showing that the market's conditions were not actually conducive to coordinated interaction, particularly since competitors often engaged in "campaign discounting," which made any coordination scheme difficult to monitor. The Commission's final decision accepted these arguments, retreated from the SO and approved the merger.

An appeal to the CFI followed from a trade association of independent music companies called the Independent Music Publishers and Labels Association (Impala). In a July 2006 judgement, the CFI annulled the Commission's decision.² While noting the "wide discretion" enjoyed by the Commission when carrying out the "delicate prognosis" of a merger's potential competitive effects, the CFI found the Commission's decision to be unsupported by facts that were sufficiently "accurate, reliable and consistent." Of particular concern was the Commission's so-called "fundamental U-turn" from the SO, a circumstance the CFI found "surprising" in view of "the late stage at which it was made." While acknowledging that an SO is "purely provisional," the CFI nevertheless objected that the Commission adopted an opposite view "only" because of the parties' arguments at the oral hearing but "without carrying out any fresh market investigations."

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With concurrent proceedings pending at the Commission and CFI levels, the case was appealed to the ECJ, which reversed the CFI's judgment and found that the Commission's earlier approval was correct. Although the ECJ sided with the Commission, it took the opportunity to continue its course of developing the obligations and standards of proof that the Commission must follow when reviewing proposed mergers. According to the ECJ:

- The Commission's burden of proof, and its obligation to explain its reasoning, are the same regardless of whether it is approving or prohibiting a merger.
- The Commission is required to consider arguments and evidence submitted by the parties in response to an SO, and to abandon the SO when those arguments so warrant.
- In cases where the Commission seeks to prohibit a merger as facilitating tacit coordination, the Commission not only must show that the market is conducive to such coordination but also must present a plausible theory of how the coordination would function in the particular circumstances.

Each of these conclusions has important implications for parties seeking to defend or challenge proposed transactions going forward.

The Commission's Burden of Proof When Approving a Merger

Like the CFI, the ECJ rejected the merging parties' argument that the Commission should be held to a lower standard of proof when approving a merger than when prohibiting one. The parties contended that proposed concentrations should benefit from a presumption of legality because prohibition orders impose a "serious limitation of the commercial freedom of the notifying parties." In response, the ECJ principally looked to Article 2 of the EC Merger Regulation, which requires

the Commission to approve a proposed concentration only upon concluding that it "would not significantly impede effective competition." The Court observed that nothing in the language of the EC Merger Regulation imposes different standards of proof depending on whether the Commission is approving or prohibiting a merger. By the same token, the Commission's decision itself must disclose "in a clear and unequivocal fashion" the factual and legal basis for its conclusions, regardless of whether it is prohibiting or approving a proposed merger.

The Court's conclusion in this regard is hardly surprising, but it does point to a significant difference between the EU and US merger control systems. US regulatory agencies are not responsible for approving mergers, but instead seek a court order to prohibit those mergers they believe to be unlawful. The European Commission, in contrast, is responsible both for approving and prohibiting mergers falling under its jurisdiction, and either way must write a supporting decision that withstands judicial review. The consequence is that the European Commission often needs substantially more factual information than do US agencies for even competitively benign transactions. And while US authorities can consider their "litigation risk" when deciding whether to challenge borderline mergers, the European Commission cannot. Even for difficult cases where a merger's competitive implications are unclear, the Commission nevertheless must take a position and shoulder the burden of proving its case.

The ECJ did not say precisely how the Commission should go about proving this negative, but the analyses for approving and prohibiting mergers will be the same. In both cases, the Commission is required to consider all of the facts and circumstances relevant to a prospective assessment of whether the concentration is likely to facilitate unilateral or coordinated anticompetitive opportunism. It must consider evidence

of the market's concentration, the market's characteristics relevant to the particular theory of coordination (more on that later in the *Alert*), potential response strategies of customers, entry and expansion barriers and all the other pertinent factors. When these facts do not point towards an ability to increase price or decrease output, the Commission can approve transactions with as much of a basis as when prohibiting them.

The Commission's Obligation to Consider Post-SO Information

In view of its burden of proof, it would be odd if the Commission could not consider persuasive information provided by the parties in response to an SO. The ECJ confirmed that the Commission is not only permitted, but is required to do exactly that, even if it took a contrary position in its SO. The Commission must abandon an SO whenever the available information, including that submitted solely by the parties themselves, indicate that the initial conclusions were unfounded.

As the Court explained, the Commission "must take into account the factors emerging from the whole of the administrative procedure" even if the result is a final decision "radically different" from the SO. Contrary to the CFI's view, moreover, the Commission may accept as true information provided by the parties without conducting a new market investigation—so long as it finds the information to be reliable (as generally will be the case given the penalties for providing false information and the Commission's ability to withdraw its approval).

The issue arose because the CFI had faulted the Commission for relying in particular on the impact of "campaign discounts" on the market's transparency when the SO never mentioned them. Reaffirming that an SO is merely "provisional" and "preparatory," the ECJ rejected the CFI's effort to

distinguish between "assessments" (which could be modified) and "findings of fact" (which could not). Any other rule, the ECJ reasoned, would be contrary to the parties' fundamental rights of defense, making meaningless their access to the file, written responses to the SO and participation in the oral hearing.

The preliminary and provisional nature of an SO means the Commission is not even required to explain why facts in its final decision differ from those in the SO. However, the ECJ made equally clear that a reviewing court is entitled to use the SO when examining the "correctness, completeness and reliability of the facts on which a decision is based." Although the Commission is not required to explain how new facts absent from the SO changed its conclusion (such as why campaign discounts were not mentioned), we can expect the Commission, at least as a practical matter, to explain any direct contradictions in specific factual findings to justify their final decision.

On the other hand, these same rights of defense preclude the Commission from relying on objections that were not contained in the SO when prohibiting a merger. Notwithstanding its provisional nature, the SO must give the parties adequate notice of the Commission's objections and an opportunity to respond.

The Commission's Obligation to Present a Theory of Coordination

Finally, the ECJ ruled that the CFI improperly found that the merger would facilitate tacit coordination without presenting a theory of how that coordination would work in the circumstances of the case. Although the ECJ imposed this obligation on the CFI, there is no reason to believe that the Commission would be held to a lesser standard.

The CFI had concluded, based largely on the SO, that the market was adequately transparent to permit competitors to monitor each other's wholesale prices, a prerequisite to the tacit coordination strategy. But the CFI never identified the monitoring mechanism actually available to them (particularly in light of campaign discounts). The ECJ admonished that it is not enough to consider the relevant market conditions in the abstract, taking a "mechanical approach involving the separate verification of each of those criteria taken in isolation." The CFI, and the Commission, are required to apply those factors in the context of a coherent and plausible theory of coordination specific to the case.

In a collective dominance case, therefore, the Commission is required to explain how the parties will coordinate (whether on price or output, by allocating customers or geographies, etc.) and how they will succeed in the particular circumstances. It is not enough simply to list the relevant *Airtours* factors, find that the market must therefore be sufficiently susceptible to tacit coordination and conclude that the parties somehow will find a way to coordinate. Before prohibiting a merger, the Commission is required to explain what the parties would do and how they would do it. The merging parties must be given an opportunity to examine this theory and explain why it is not plausible. Conversely, the apparent absence of such a strategy should allow the Commission to satisfy its burden of proof when approving a merger.

Conclusion

The ECJ's judgment provides important lessons for merging parties and their counsel:

1. Because the Commission is required to support even clearance decisions with adequate evidence, merging parties must be proactive and provide the data needed to show that the proposed transaction is not likely to be anticompetitive. They cannot simply cast doubt on the Commission's case but must present an affirmative case showing that post-merger market conditions will be no less competitive than pre-merger conditions. Even for apparently benign transactions, the parties will need to work towards giving the Commission everything it needs to write a persuasive and substantiated approval decision.
2. Although the ECJ confirmed that an SO is merely a provisional document, merging parties should still do everything possible to avoid them. Legalities aside, changing the Commission's mind is inherently more difficult and costly than helping them get it right the first time.
3. When faced with an SO, it will not be sufficient for the merging parties merely to point out its flaws. To secure a favorable outcome notwithstanding an SO, the merging parties will be required to present affirmative evidence showing why coordinated or unilateral opportunism is unlikely to result from the merger. Not only must the parties point out the fallacies in the SO but will need to come forward with enough affirmative evidence and detail to permit the Commission to write a favorable decision that can withstand judicial review. And at this stage, they must do so quickly.
4. When the Commission's concerns rest on a potential for post-merger coordination, the parties should demand a detailed explanation of how competitors would achieve it, thus allowing them to counter the concerns to the extent possible with real-world arguments and evidence showing that the coordination would not work in the particular factual circumstances.

While the Commission's high standard of proof places similarly high burdens on merging parties, it also creates greater opportunities to prevent unfounded prohibition decisions. The result promises to be a more accurate application of the EC Merger Regulation to proposed transactions.

Endnotes

¹ Case C-413/06 P, *Bertelsmann and Sony Corporation of America v. Impala*, 10 July 2008.

² Case T464/04, *Independent Music Publishers and Labels Association v. Commission*, 13 July 2006.

If you have any questions about this *Client Alert*, please contact one of the authors listed below:

Howard Rosenblatt
Brussels

Pieter van Osch
Brussels

Or any of the attorneys listed to the right.

Office locations:

Barcelona
Brussels
Chicago
Dubai
Frankfurt
Hamburg
Hong Kong
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New Jersey
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Barcelona

José Luis Blanco
Javier Ruiz Calzado
+34.93.545.5000

Brussels

Bruno Lebrun
Jean Paul Poitras
Howard T. Rosenblatt
Andreas Weitbrecht
Susanne Zühlke
+32.2.788.6000

Chicago

Janet Malloy Link
Kenneth G. Schuler
+1.312.876.7700

Dubai

Rindala Beydoun
+971.4.704.6300

Frankfurt

Bernd-Wilhelm Schmitz
+49.69.6062.6000

Hamburg

Marco Núñez Müller
+49.40.41.40.30

Hongkong

Joseph A. Bevash
+852.2522.7886

London

John Colahan
Marc Hansen
John Kallaugher
+44.20.7710.1000

Los Angeles

Charles H. Samel
Belinda S. Lee
+1.213.485.1234

Madrid

José Luis Blanco
Javier Ruiz Calzado
+34.91.791.5000

Milan

Matteo F. Bay
+39.02.3046.2000

Moscow

Mark M. Banovich
+7.495.785.1234

Munich

Gaby Eickstädt
+49.89.20.80.3.8000

New York/

New Jersey

Bruce J. Prager
Manfred Gabriel
+1.973.639.1234 (NJ)
+1.212.906.1200 (NY)

Northern Virginia

Eric L. Bernthal
+1.703.456.1000

Orange County

Jon D. Anderson
+1.714.540.1235

Paris

Christophe Clarenc
Alain Georges
Hugues Vallette Viillard
+33.1.40.62.20.00

Rome

Fabio Coppola
+39.02.3046.2000

San Diego

Michael J. Weaver
+1.619.236.1234

San Francisco

Daniel M. Wall
Karen E. Silverman
Peter K. Huston
Hanno F. Kaiser
Joshua N. Holian
+1.415.391.0600

Shanghai

Rowland Cheng
+86.21.6101.6000

Silicon Valley

Patrick E. Gibbs
+1.650.328.4600

Singapore

Mark A. Nelson
+65.6536.1161

Tokyo

Bernard E. Nelson
+81.3.6212.7800

Washington, D.C.

Margaret M. Zwisler
Abbott (Tad) B. Lipsky, Jr.
Michael G. Egge
E. Marcellus Williamson
+1.202.637.2200