LATHAM&WATKINS

Client Alert Commentary

Latham & Watkins Antitrust & Competition Practice

September 20, 2022 | Number 3009

US Federal Judge: Efficiencies Analysis Inadmissible in Antitrust Merger Trial

A recent US federal district court ruling finding a defendant's evidence of cost savings inadmissible could change how efficiencies evidence is presented in merger cases.

A US federal district court ruling last month has prevented Penguin Random House LLC from using certain economic data to justify its $2.18 billion acquisition of Simon & Schuster Inc. after the judge issued a midtrial order excluding Penguin Random House's evidence of predicted cost savings — cost savings the publisher argued would be passed on to authors in the form of higher book advances.[1]

On August 17, 2022, US District Judge Florence Y. Pan issued an order from the bench granting a pre-trial motion filed by the Department of Justice (DOJ) that sought to exclude expert testimony evidence of the merging parties' so-called efficiencies, or a reduction in costs associated with the consolidation of the two companies. While courts traditionally have been skeptical of efficiencies defenses to mergers and have established high legal bars to crediting such evidence, Judge Pan's decision ruling the evidence inadmissible represents a departure from prior cases that allowed the evidence to be presented at trial. Whether the defendants will appeal the ruling is unclear.

In remarks delivered at Georgetown Law's Annual Global Antitrust Enforcement Symposium on September 13, 2022, Jonathan Kanter, DOJ's Assistant Attorney General for Antitrust, stated that the DOJ's and the Federal Trade Commission's (FTC's) forthcoming revised Merger Guidelines will reconsider efficiencies arguments for mergers.[2] He also specifically referenced the Penguin Random House trial and opined that a disconnect among merger law, merger policy, and market realities has arisen in recent years.[3] His remarks highlight the prospect that we may see ramifications stemming from Judge Pan's decision.

This Client Alert analyzes the Penguin Random House ruling and how it deviates from prior efficiencies case law, and advises defendants on strategic considerations when presenting efficiencies evidence in Section 7 merger challenges.

Efficiencies in Defense of Mergers

Section 7 of the Clayton Antitrust Act of 1914 bars mergers whose effect "may be substantially to lessen competition, or to tend to create a monopoly."[4] Federal courts assess Section 7 claims under a three-part, burden-shifting framework.[5] First, the plaintiff (here, the government) must establish a prima facie case that the merger is anticompetitive. If the plaintiff establishes such a case, the burden then shifts to the

defendants (here, the merging parties) to rebut it. If the defendants succeed on rebuttal, the burden of producing evidence of anticompetitive effects shifts back to the plaintiff and merges with the ultimate burden of persuasion, which is incumbent on the plaintiff at all times.[6]

As part of the analysis, defendants can rebut the plaintiff's case by showing "either that the combination would not have anticompetitive effects or that the anticompetitive effects of the merger will be offset by extraordinary efficiencies resulting from the merger."[7] The "linchpin of any efficiencies defense" lies in the language of the Clayton Act, which "speaks in terms of 'competition.'"[8] The defense "requires proof that a merger is not, despite the existence of a prima facie case, anticompetitive" because "the prima facie case portrays inaccurately the merger's probable effects on competition."[9] The efficiencies defense recognizes that efficiencies created by a merger can "enhance the merged firm's ability to compete, which may result in lower prices, improved quality, enhanced service, or new products."[10]

While the Supreme Court has not formally adopted the efficiencies defense, many circuit and district courts have at least been tentatively willing to recognize the defense, though none have yet accepted the defense as a stand-alone reason why a merger that creates anticompetitive effects does not violate Section 7 of the Clayton Act.[11]

Prior Case Law

For years, both the DOJ and the FTC have urged courts not to consider parties' claimed efficiencies in Section 7 cases, arguing that efficiencies are not specifically recognized under the law as a proper defense to an otherwise unlawful transaction, and that such projections, even when considered, are inherently speculative.[12] While courts have not, to date, accepted those DOJ and FTC invitations to reject the defense entirely, they have established a high threshold for crediting such evidence. Specifically, courts that have recently evaluated whether an efficiencies defense is "cognizable" under the Clayton Act have noted that defendants bear the burden of producing "clear evidence showing that the merger will result in efficiencies that will offset the anticompetitive effects and ultimately benefit consumers."[13] In order for efficiencies to be cognizable, the claimed efficiencies must (1) offset the anticompetitive concerns in highly concentrated markets, (2) be "merger specific" (i.e., the efficiencies are not capable of being achieved by either party alone), (3) be reasonably verifiable and not speculative, and (4) not arise from anticompetitive reductions in output or service.[14]

In *FTC v. Hackensack Meridian Health*, the FTC brought an action against a healthcare system and a hospital, alleging their agreed-to-merger violated the Clayton Act on the basis that it was likely to substantially lessen competition.[15] The district court entered a preliminary injunction to prevent the merger, and the defendants appealed. In analyzing the district court's decision to issue the preliminary injunction, the Third Circuit discussed the availability of an efficiencies defense at length.[16] The Third Circuit clarified that efficiencies are to be understood on a sliding scale: "The magnitude of the efficiencies needed to overcome a prima facie case depends on the strength of the likely adverse competitive effects of a merger."[17] The court went on to explain that a showing of extraordinary efficiencies is only required if there is also evidence of outsized anticompetitive effects. In other words, courts must take their cues from the specific direct evidence presented in each case. Although the Third Circuit agreed with the district court's ultimate conclusion and affirmed the preliminary injunction, the court noted that "to the extent the District Court required a showing of extraordinary procompetitive effects, it would have been incorrect."[18]

In *United States v. Anthem, Inc.*, the D.C. Circuit likewise "assume[d] the availability of an efficiencies defense" in analyzing whether the district court erred in rejecting the defendant's efficiencies and granting a preliminary injunction to enjoin the merger between two national health insurance carriers.[19] Although the D.C. Circuit ultimately sided with the lower court, the D.C. Circuit explained that the trend among

lower courts and secondary authorities is that the Supreme Court "can be understood only to have rejected 'possible' efficiencies, while efficiencies that are verifiable can be credited."[20]

In *ProMedica Health System, Inc. v. FTC*, the merging parties appealed a final FTC order requiring divestment of a community hospital following a prior merger.[21] There, the Sixth Circuit clearly recognized the viability of an efficiencies defense, quoting not only from the DOJ's and FTC's jointly issued 2010 Horizontal Merger Guidelines but also a prominent economist's analysis published in an antitrust trade journal. The court specifically noted that "[e]fficiencies generate *downward* pricing pressure that may outweigh the upward pricing pressure," and thus merging parties often seek to overcome a presumption of illegality by arguing the presence of efficiencies that enhance consumer welfare.[22]

Even though all of the rulings mentioned above ultimately discredited the merging parties' efficiencies defenses, the lower courts heard and considered the entirety of the defendants' evidence of pro-competitive cost savings, including testimony from the defendants' economic experts.

The Penguin Random House Ruling

In July 2022, the DOJ filed a pre-trial motion seeking to preclude Penguin Random House from presenting testimony evidence from its hired expert regarding the defendants' alleged efficiencies.[23] The Penguin Random House expert's opinion relied on a synergies model produced by a business executive at Penguin Random House. The DOJ argued that the expert's review of the parties' model was not a proper methodology to verify cognizable efficiencies.[24] In particular, the DOJ argued that the expert did not himself verify the synergy amounts or test the reasonableness of the model's assumptions, which were otherwise unsubstantiated.[25] Moreover, according to the DOJ, the expert did not analyze whether the efficiencies were of the type that could offset harm.[26]

In addition to attacking the DOJ's claims on the merits of the Penguin Random House expert's methodology, the defendants in their opposition motion emphasized that efficiencies are an important issue for the court to decide at trial, not by motion before presentation of the evidence.[27] The defendants further argued that the DOJ's attacks on the parties' efficiencies model and the expert's opinions at best should influence the weight given to the evidence, not its admissibility in the first instance.[28]

In a lengthy opinion read from the bench during trial, the court rejected the defendants' arguments and ruled in favor of the DOJ, preventing the defendants' expert from testifying regarding claimed efficiencies.[29] In reaching its decision, the court reasoned that many of the efficiencies projections forming the basis of the Penguin Random House expert's opinion were not verifiable. More importantly, none of the projections had been independently verified by anyone, and therefore they were not cognizable under the Horizontal Merger Guidelines.[30] For that and other reasons, the court held that the expert's testimony on merger-related efficiencies was unreliable.

The court relied on five prior rulings of the D.C. District Court in support of Judge Pan's decision.[31] Judge Pan noted that "[w]here efficiencies are not independently verifiable and verified, no court in this jurisdiction has ever given any weight to such efficiencies evidence."[32] In each of those cases (as well as the ones discussed above), however, the court allowed the full presentation of the evidence at trial before determining it was not credible. Three of those five cases, like in Penguin Random House, involved testimony from a defense expert regarding the parties' claimed efficiencies.

Put another way, the courts in the cases that Judge Pan relied on found it necessary to hear the expert's testimony and weigh the credibility of that evidence in the context of the overall competitive effects of the transaction. By contrast, Judge Pan's ruling prohibited presentation of the expert testimony.

Key Learnings

The Penguin Random House ruling does not reject the viability of an efficiencies defense to a merger. However, it does call into question whether evidence related to cost savings or procompetitive effects will have any place in Section 7 litigations unless it meets the rigorous standards established for efficiencies to be accepted. Prior case law has made clear that "even where evidence of efficiencies in the relevant market will not support an outright defense to an anticompetitive merger, such evidence is relevant to the competitive effects analysis of the market required to determine whether the proposed transaction will substantially lessen competition."[33] This suggests that a court should weigh the totality of the evidence in making its decision, including by hearing an expert's testimony on efficiencies, even if the court later decides to discount such evidence, in whole or in part. However, now it is an open question whether moving forward such evidence can factor into any merger analysis at all if courts adopt Judge Pan's approach and require that efficiencies be verified before they can be admitted into evidence.

Defendants are incentivized to complete rigorous independent verification of efficiencies analyses

While the DOJ and the FTC have sought to convince courts not to consider efficiencies as part of a Section 7 analysis, their efforts in Penguin Random House may have the opposite effect. In other merger cases, defendants have not made efficiencies a significant part of their presentations. Indeed, recognizing the reality that courts rarely accept such arguments, defendants have in many cases done precisely what the defendants in Penguin Random House did, i.e., eschew devoting significant resources to develop efficiencies arguments and instead present limited evidence of cost savings as part of the overall competitive effects analysis. But if the possibility exists that future courts adopt Judge Pan's approach and begin to analyze the admissibility of efficiencies evidence pre-trial rather than considering the weight and credibility of that evidence after its presentation, defendants may feel compelled to present more robust efficiencies analyses in order to mitigate the risk that the evidence will be thrown out before trial. If that occurs, the government may have a harder time excluding such evidence in future cases, and we could actually see more courts analyzing such claims.

Efficiencies defenses may become more critical to rebutting a presumption of anticompetitive harm

In today's era of antitrust merger enforcement, US agencies appear to be attempting to block more and more proposed mergers. As part of those efforts, the DOJ and the FTC may be willing to bring merger challenges in which the alleged harm is less "significant" than that in prior challenges. For example, in Penguin Random House, a merger valued at $2.18 billion, the DOJ's own expert alleged only $29 million in harm per year based on the expert's model (which the defendants argued did not reflect the real world), or barely over 1% of the transaction value on an annual basis.[34] By contrast, the merging parties argued that cost savings due to the merger could translate into over $100 million in additional author compensation by 2025 — an amount far more than enough to offset the DOJ's alleged harm, should the parties' efficiencies have been credited by the court. If low levels of harm are alleged, even a small amount of efficiencies can easily demonstrate that there will be no overall anticompetitive effect as a result of a transaction. The potential for efficiencies to offset low levels of harm makes the determination of cognizable efficiencies a potentially vital component of a merger defense. In other words, at the same time that the DOJ and the FTC are incentivizing defendants to conduct more thorough efficiencies analyses, they may be bringing cases in which such analyses take on added importance. Accordingly, if a challenged merger is likely to result in cost savings that are meaningful compared with the alleged harm, companies should ensure that proper independent consultants and experts are retained to verify the cognizability of such savings, to increase the likelihood that the evidence will be credited by the court.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Lawrence Buterman
lawrence.buterman@lw.com
+1.212.906.1264
New York

Katherine A. Rocco
katherine.rocco@lw.com
+1.212.906.1215
New York

Joy M. Dineo
joy.dineo@lw.com
+1.415.395.8197
Bay Area

Endnotes

1 The case is *United States v. Bertelsmann SE & Co. KGaA.*, No. 1:21-cv-02886-FYP (D.D.C. filed Nov. 2, 2021) [hereinafter *United States v. Bertelsmann*].

2 *See* Leah Nylen, *DOJ Antitrust Chief Says Merger Efficiency Defense Is Under Review*, Bloomberg News (Sept. 13, 2022), *at* https://www.bloomberg.com/news/articles/2022-09-13/doj-s-kanter-says-efficiency-defense-for-mergers-is-under-review?leadSource=uverify%20wall.

3 *See* Jonathan Kanter, *Respecting the Antitrust Laws and Reflecting Market Realities*, Georgetown Antitrust Law Symposium (Sept. 13, 2022), *at* https://www.justice.gov/opa/speech/assistant-attorney-general-jonathan-kanter-delivers-keynote-speech-georgetown-antitrust#_ftn2.

4 15 U.S.C. § 18.

5 *FTC v. Penn State Hershey Med. Ctr.*, 838 F.3d 327, 337 (3d Cir. 2016).

6 *Id.* (citing *St. Alphonsus Med. Ctr.-Nampa Inc. v. St. Luke's Health Sys., Ltd.*, 778 F.3d 775, 783 (9th Cir. 2015)).

7 *Id.* at 347.

8 *Id.* at 349 (quoting *St. Alphonsus*, 778 F.3d at 790).

9 *Id.* (quoting *St. Alphonsus*, 778 F.3d at 790).

10 DOJ & FTC, *Horizontal Merger Guidelines* § 10 (2010) [hereinafter Horizontal Merger Guidelines].

11 *See ProMedica Health Sys., Inc. v. FTC*, 749 F.3d 559, 571 (6th Cir. 2014); *St. Alphonsus,* 778 F.3d at 788–92; *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 720 (D.C. Cir. 2001); *FTC v. Univ. Health, Inc.*, 938 F.2d 1206, 1222 (11th Cir. 1991).

[12] *See, e.g.*, Proposed Conclusions of Law of the United States at 44-51, *United States v. AT&T*, No. 1:17-cv-02511-RLJ (D.D.C. May 8, 2018), ECF No. 127; Plaintiffs' Joint Pre-Trial Memorandum at 19-22, *St. Alphonsus Med. Ctr.-Nampa, Inc. v. St. Luke's Health Sys., Ltd.*, No. 1:12-cv-00560-BLW (D. Colo. Sept. 13, 2013), ECF No. 203.

[13] *In re Otto Bock HealthCare N. Am., Inc.*, No. 9378, 2019 WL 2118886, at *50 (FTC May 6, 2019); *see also FTC v. Hackensack Meridian Health, Inc.*, 30 F.4th 160, 166 (3d Cir. 2022).

[14] *See Hershey*, 838 F.3d at 348-49; *Horizontal Merger Guidelines* § 10.

[15] *See FTC v. Hackensack Meridian Health, Inc.*, 30 F.4th 160 (3d Cir. 2022).

[16] *See id.* at 175-79.

[17] *Id.* at 176-77.

[18] *Id.* at 177.

[19] *United States v. Anthem, Inc.*, 855 F.3d 345, 355 (D.C. Cir. 2017).

[20] *Id.* at 355.

[21] *ProMedica Health Sys., Inc. v. FTC*, 749 F.3d 559 (6th Cir. 2014).

[22] *Id.* at 571.

[23] *See generally* United States' Motion *In Limine* to Exclude Testimony of Dr. Edward Snyder Regarding Efficiencies, *United States v. Bertelsmann* (July 7, 2022), ECF No. 135-1.

[24] *Id.* at 7-14.

[25] *Id.* at 7-9.

[26] *Id.* at 14.

[27] *See* Defendants' Memorandum of Points and Authorities In Opposition to United States' Motion *In Limine* to Exclude Testimony of Professor Edward Snyder Regarding Efficiencies at 3-6, *United States v. Bertelsmann* (July 22, 2022), ECF No. 130.

[28] *Id.* at 13-20.

[29] *See* Transcript of Bench Trial, Morning Session at 2749-72, *United States v. Bertelsmann* (Aug. 17, 2022).

[30] *Id.* at 2763-64.

[31] *See id.* at 2767-70 (citing *United States v. H&R Block, Inc.*, 833 F. Supp. 2d 36 (D.D.C. 2011); *United States v. Aetna*, 240 F. Supp. 3d 1 (D.D.C. 2017); *FTC v. Sysco Corp.*, 113 F. Supp. 3d 1 (D.D.C. 2015); *FTC v. Wilh. Wilhelmsen Holding, ASA*, 341 F. Supp. 3d 27 (D.D.C. 2018); *FTC v. Staples*, 970 F. Supp. 1066 (D.D.C. 1997)).

[32] *Id.* at 2755.

[33] *FTC. v. Arch Coal, Inc.*, 329 F. Supp. 2d 109, 150-51 (D.D.C. 2004). *See also FTC. v. Tenet Health Care Corp.*, 186 F.3d 1045, 1054-55 (8th Cir. 1999) (finding that district erred by not considering evidence of efficiencies even where defendant's efficiencies defense "may have been properly rejected by the district court"); *Aetna*, 240 F. Supp. 3d at 94-98 (analyzing defendant's claimed efficiencies even where court ultimately determined efficiencies were insufficient to rebut the government's prima facie case); *Staples*, 970 F. Supp. at 1088-90 (same).

[34] Defendants' Memorandum of Points and Authorities In Opposition to United States' Motion *In Limine* to Exclude Testimony of Professor Edward Snyder Regarding Efficiencies, *supra,* note 27 at 1.