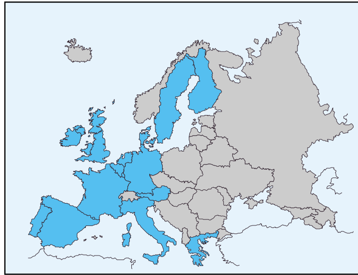
European Union

NAVIGATING THE TREACHEROUS SHOALS OF EC MERGER CLEARANCE



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European Commission (EC) merger clearance became more visible – and perhaps more difficult – last year than ever before. The year saw a record five prohibition decisions, a US/EU clash over GE/Honeywell, fury in France over hundreds of millions of euros lost in prohibited takeovers of French companies (Schneider/Legrand and Tetra Laval/Sidel), and very blunt and public criticism of the EC merger review process and even of competition Commissioner Mario Monti from spurned CEOs who felt that their companies and shareholders were unfairly harmed by the Commission.

The events of 2001 – particularly the GE/Honeywell prohibition – have forced businesses to move EC regulatory clearance to the top of their pre-merger checklists. Press accounts questioned whether the parties in that merger had failed to carefully consider EC competition issues in their early planning or had properly integrated their EC competition counsel with their US antitrust lawyers and the rest of their merger team. Commissioner Monti himself suggested that the parties abandoned the transaction without exploring all avenues to remedy the Commission's competition concerns.

Whether such criticism is valid or not, one thing is clear: Europe has become a more frightening place for companies seeking to merge – even where traditional horizontal overlaps do not appear present. As a result, companies must consider and address potential EC competition concerns very early in their merger planning. What follows are some basic considerations merging companies should keep in mind to ensure that their mergers do not run aground in Europe.

FOUR FACTS THAT MATTER IN EC MERGER CONTROL

Compulsory delay

Certain types of transactions ("concentrations" in EU parlance) must be notified to EC's Merger Task Force (MTF) if the companies involved meet the merger regulation's turnover thresholds. Concentrations are mergers or any other type of transaction whereby one company obtains control over another company or its assets. Save exceptional circumstances, concentrations must be notified if (i) the parties' combined worldwide turnover exceeds €5 billion and at least two parties each have EU turnover of at least €250 million, or (ii) the parties' combined worldwide turnover exceeds €2.5 billion, at least two parties have EU turnover of at least €100 million each, the parties' combined turnover reaches €100 million in three member states, and in the same three member states at least two parties ➨

have turnover of €25 million each. Where these thresholds are satisfied, the concentration must be notified regardless of whether the companies involved are based or have assets in the EU. Parties who fail to notify risk heavy fines and a voided transaction.

The parties are prohibited from closing the transaction before obtaining clearance. The deal is on-hold during this time, even if all necessary board and shareholder approvals have already been won. Integration of the businesses is prohibited and even integration planning must be tightly controlled to avoid the risk of "gun-jumping".

The review process can take more than five months and is burdensome. Dedicated in-house teams of lawyers and business people need to be available to focus almost exclusively on the clearance procedure for an extended period of time. Senior management attention is required in particular for the oral hearing and the remedies discussions.

Aggressive enforcement

Particularly after the shock of GE/Honeywell, companies can ill-afford to treat EC merger control as a mere formality. The stakes are high and can decide the fate of companies and CEOs (Honeywell's CEO Michael Bonsignore resigned after the GE/Honeywell transaction failed). The majority of notified cases still pass muster without extensive scrutiny or divestiture (or other remedy) obligations. However, more and more, prohibition decisions, as well as clearance decisions coupled with remedy obligations, come at a high price for companies. It is estimated that both Schneider and Tetra Laval could lose several hundred million euros each from their prohibited takeovers of Legrand and Sidel.

The Commission will block a transaction (or require remedies) if it expects that the transaction would "create or strengthen a dominant position" on the markets concerned. This test is broad and provides very little guidance on its own; what matters is its application to individual cases. And, without question, the rigor of the Commission's analysis has steadily increased along with its resolve to dole out harsh medicine. Indeed, last year, the Commission prohibited five mergers – over a quarter of all prohibitions in the 12-year history of the EC merger regulation. Twenty decisions were issued after second phase investigation – another record high.

There are a number of possible explanations for the Commission's increased scrutiny. Certainly, European and international market integration, globalization and industry concentration are "objective" external factors that play a role. However, many also point to internal factors at the Commission and within the MTF, including:

- New theories. The MTF today appears more aggressive in developing new theories or expanding the application of old ones than it has been in the past. For example, collective dominance and conglomerate theories, rarely explored in the early days, today have become the basis for prohibition (see, for collective dominance, Airtours/First Choice and EMI/Time Warner; for conglomerate theories GE/Honeywell and Tetra Laval/Sidel).
- Predictive analysis. The MTF seems to be more confident today to base its decisions on predictions about the future. In technology-based industries, the MTF has defined future markets (ie, markets which do not yet exist) and argued that the transaction would create dominance on such future markets (for example the market for online music distribution in AOL/Time Warner). In other cases, the MTF has prohibited mergers resting squarely on predictions of the merging parties' future behavior (even where that behavior would be illegal) and little attempt has been made to show the likelihood of the behavior actually occurring.
- Competitor input. Competitors of merging parties have become increasingly involved in the merger

review process, advancing foreclosure theories or factual assertions to the detriment of the merging parties. As explained further below, their active participation risks skewing the Commission's analysis on the basis of self-interested assertions by parties with interests other than consumer welfare.

- National markets. Despite increasing globalization, the Commission continues to assess many transactions on the basis of national markets. Mergers between companies from smaller member states are increasingly likely to pose problems on that basis (see the Commission's prohibition of the Scandinavian mergers Volvo/Scania and SCA/Metsä Tissue). Larger member states are not necessarily immune either (see the prohibition of the merger of the two French companies Schneider and Legrand).
- Unchecked authority. As a commercial matter, the MTF is a deal's exclusive hope – prosecutor, judge, and jury. Few, if any deals can survive the months or years it has taken for the Court of First Instance to review merger decisions. This may change, however, with the introduction of a new "fast-track" appeal which will be employed for the first time in the merger context in the Tetra Laval/Sidel appeal. Yet court review will not start at the beginning (de novo), but merely overturn for manifest error.

Parties' lack of control

The parties do not drive the merger review process and because of limited transparency may not be able to discern their place in the process. The MTF assesses transactions ex parte. It collects information by sending written information requests to and meeting with the merging parties, customers, competitors, and industry associations. The parties can submit any facts and arguments that they consider relevant and are granted the opportunity to respond to the Commission's concerns both in writing and at an oral hearing. A hearing officer, a Commission official now directly reporting to the competition commissioner, has the task of safeguarding the parties' procedural rights in all respects.

Nevertheless, recent public criticism has argued that in the closed-door process by which the Commission reaches its decision, it does not rigorously assess market data, but instead relies too heavily on questionable information provided by competitors or on predictions about future market development or behaviour without an empirical basis. The merger review process is susceptible to this criticism: the MTF staff has the principal responsibility to gather and analyze the facts and also apply the legal substantive test to the facts. The MTF does not need to provide evidence to any outside authority or court, and outside of the immediate case team, few have the opportunity to see,

let alone test the evidence. Indeed, the parties often do not see all information submitted by third parties. Once the MTF has reached its conclusion, the subsequent formal involvement of the advisory committee (composed of representatives of the national competition authorities) and the college of commissioners in practice has little opportunity to affect the outcome of the case (indeed, the parties have no knowledge about how the case is dealt with in the advisory committee and the college of commissioners, and do not have the opportunity refute anything that is said there).

Absence of negotiating leverage

Discussing remedies is not like negotiating a commercial deal. The remedies process is about persuasion and satisfaction; the only thing that counts is addressing the MTF's concerns.

The timeframe for remedies discussions is very tight. There is little time to engage in a piece-meal strategy increasing the remedies proposal in small increments. The MTF "market tests" the proposed remedies with competitor-complainants – almost invariably yielding a negative response. Often the process leaves the parties to "bargain against themselves" by adding additional remedies, or risk running out of time if they hold back. The parties' ability to negotiate and persuade deteriorates with time. Simply put, faced with an absolute deadline for submission of remedies three months into an in-depth investigation, it is the parties and not the Commission that lose the ability to control the outcome.

In addition, the Commission prefers structural remedies like divestitures to behavioural remedies (such as granting third-party access in network industries – a behavioural remedy that has succeeded). Behavioural remedies are often significantly more cost effective than structural remedies – but achieving acceptance by the Commission can be very difficult. In particular, the Commission's aversion to behavioural undertakings makes remedying behavioural theories ➨

like bundling and tying problematic.

FIVE RULES THAT CAN SAVE THE DEAL

Although there is no road to guaranteed success, merging parties can considerably increase their chances of obtaining clearance by observing some basic rules.

Have EC merger control in mind at all stages of deal preparation

The EC merger review process must be taken into account as early as possible during the internal planning phase of the transaction. At that stage, parties need to assess the likelihood of obtaining clearance and finding other structures.

The transaction agreements should explicitly deal with the merger review process. Deals commonly condition closing upon merger clearance (except where prohibited by law or practice, such as under French takeover rules) and include a "reasonable efforts" clause or even specifying concrete measures of cooperation in the merger review process. In complex cases, it may be advisable to agree ahead of time (for example in a separate joint defense agreement) on the divestitures or other remedies that the parties are willing to offer in order to obtain clearance. If the transaction is an asset or share swap and both parts are notifiable transactions, companies should provide for the situation that only one of the transactions is cleared.

On a more practical level, parties (and their investment bank advisors) should avoid poorly worded language in initial presentations "selling" the proposed deal to the board, as such documents must be submitted to the MTF as part of the notification and can be misinterpreted as evidence of anti-competitive motivation for the deal.

Prepare early for notification

As closing cannot take place before obtaining clearance, parties have an interest in starting the review process early and being fully prepared when it starts.

Preparation for notification involves cumbersome internal information gathering and careful assessment. The notification document (called Form CO) requires masses of detailed information. Parties' internal databases often do not contain the required information, and it has to be assembled specifically for the notification. Yet the most important information is typically not what is required by the Form. Instead, after initial assessment of the potential competition concerns, it is incumbent on the parties to develop the factual base to either confirm or refute the concerns. In addition, given the close cooperative working relationship between the US and EC, it is important to assess the key internal documents that the US agencies will be reviewing in their document-intensive process (and therefore sharing with their European counterparts). Indeed, comparing the market situation in the US and Europe is vital in ensuring that compatible pictures are being painted on both sides of the Atlantic before the regulatory agencies.

Following the initial assessment, the parties must determine their strategy in approaching the MTF: either submit only the information expressly required for a complete notification, or anticipate the MTF's potential concerns and attempt to address them substantively in the notification. The first approach preserves the (often slim) possibility that potential problems may pass unnoticed. The second approach decreases the time pressure, but may raise issues that would not have come up otherwise. In most instances, it is the more prudent approach particularly since last-minute disclosures can undermine the parties' credibility and torpedo the prospect of quick Phase I clearance.

Engage the MTF

Typically, the MTF staff is the critical arbiter of facts in the merger clearance and therefore it is incumbent upon the parties actively to engage the MTF throughout the entire process. Pro-active engagement helps develop credibility and open dialogue which are essential to a successful resolution of most matters. By failing to put forward arguments and fact, parties risk that the MTF will rely more on information submitted by third parties and that the overall relationship with the MTF's case team will deteriorate. In practice, the parties carry the burden of proving the transaction is compatible with the merger regulation.

The entire pre-merger notification process and detailed Form CO have resulted in a process that is "front-loaded" with information and dialogue. Failure to use that dialogue for frank discussion of issues or the failure to continue the open dialogue as the process ages can be critical. For instance, in second phase, the MTF will take about six to eight weeks to investigate the market further. This is a dangerous period, because the parties have little formal involvement at that stage and the MTF will be able to isolate itself from the parties' input submitted during the first phase. This can result in the case team becoming wedded to a particular theory before the parties have a real opportunity to address that theory. In order to optimize the prospect of success in the end phases, the parties must at this juncture identify any remaining concerns with the MTF, begin to formulate possible remedies, and create a constructive path to resolution.

Parties should initiate remedies discussions early during the second phase. It is counter-productive to hold back possible remedy proposals until the later stages of the review process once concerns have been identified and isolated. Indeed, in Schneider/Legrand the Commission's press release criticized the parties for offering last-minute remedies that could not be fully vetted within the time limits on the Commission.

Keep an eye on competitors

Merging parties should be prepared for their competitors to use the merger review against them, whether out of legitimate concern about anti-competitive effects, or illegitimate efforts to use the process to force divestiture of assets they might find attractive, or simply to inflict delay and cost. Competitors know that the MTF takes their concerns very seriously (despite the obvious presence of ulterior motives), and have ample ways to make themselves heard, for example by responses to information requests, additional submission papers, meetings with the MTF and the oral hearing. In notable cases, like the Worldcom cases and GE/Honeywell, competitors worked with outside lawyers and economists and reportedly developed the theories that the Commission relied upon ultimately to block the mergers.

Historically, regulated industries, such as telecommunications, were the first to develop merger opposition as a business tool. However, it has become patently clear throughout industry as a whole that the EC merger review process presents one of the most fruitful opportunities to affect the outcome of the worldwide merger clearance process. Therefore, it can come as no surprise that some firms have become so bold as to approach the merging parties to seek to resolve their concerns before bringing them to Brussels. Sometimes the link between the purported concern and the sought-after resolution may be quite attenuated at this stage.

Beware the magic bullet

In some quarters, the EC merger review process is viewed, at heart, as being a political process that can be won by political lobbying late in the proceedings. Parties should be very cautious in adopting this thinking and in relying on their political connections to get a deal cleared. The GE/Honeywell and Schneider/Legrand mergers were prohibited despite the public interventions of Presidents Bush and Chirac. This is not to say that political pressure never works at the margin, but it certainly has never worked when it has been in the public eye. Applying political pressure will likely cause the Commission to conclude that the

parties are seeking to undermine its authority – and thereby may poison the essential final stage of the procedure.

Similarly, it is very difficult, if not impossible, to overcome a prohibition recommendation from the MTF by lobbying the commissioners' cabinets or the member states. Such attempts, while generally futile, are however considered appropriate avenues of appeal for the parties.

WILL THE PROPOSED GREEN PAPER CHANGES BRING SMOOTHER SAILING?

At the end of 2001, the Commission published a green paper proposing and inviting discussion on a number of possible changes to the EC merger regulation with a view to reforming the regulation by 2003.

Some of the issues addressed in the green paper are of a technical nature (eg on the repartition of jurisdiction between the EU and the member states, or on the type of transactions potentially subject to EC merger control); while others address the review procedure itself, such as a proposal to allow more time for remedies discussions at the parties' request. The green paper also invites debate on substantive issues, such as how to take efficiencies created by a merger into account and whether the current "creation or strengthening of dominance" substantive test should be changed to the "substantial lessening of competition" test used in the US.

The green paper will certainly improve some shortcomings of EC merger review, but many in the antitrust community believe it does not go far enough. Perhaps most importantly, the green paper does not address the internal system of checks and balances and the present mechanisms for judicial review. This means that whatever else changes, the Commission will remain, as some critics say, prosecutor, judge, jury and, sometimes, executioner.