

FOREIGN AND INTERNATIONAL COMPETITION LAW AND POLICY DEVELOPMENTS

AUSTRALIAN NEWSLETTER

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AUSTRALIAN IMMUNITY PROGRAM FOR COMPETITION LAW ENFORCEMENT

Many of the overseas counterparts of the Australian Competition and Consumer Commission ("ACCC") have recently revised, or are in the process of revising, their leniency or immunity policies. Australia is looking at its program as well.

The increased use of immunity policies is in recognition of the growing importance of cooperation in mounting a successful legal action in respect of violations of competition law. Recent policy reforms are based on a realisation of the increasing difficulty in detecting and proving the existence of anti-competitive conduct, which is further compounded by the fact that such conduct is very often global in its scope and effect.

Immunity programs are particularly important in the field of competition law, where offences are often conducted through a conspiracy among a number of firms or individuals. The covert nature of these offences often means they are difficult to discover or prove without the cooperation of persons who are, or were, themselves implicated in the commission of the offence. This is all the more critical in a small economy such as

Australia where whistle blowers are often easy to identify. Furthermore, Australia has a strong culture against informing, or as it is known in Australia, "dobbing".

The Australian Position

Australian competition law is civil and while that means that the Attorney-General does not get involved, the principles are largely the same as in criminal jurisdictions.

The ACCC has adopted an overtly flexible cooperation policy. Whereas the factors considered by Canada, the European Union and the United States are somewhat prescriptive, the ACCC's guidelines are intended only as an indication of the factors the ACCC will consider relevant when considering a request for leniency. Further, a distinction is made between corporate and individual leniency.

The Policy

The ACCC policy has two levels of amnesty, being:

- (a) immunity from legal action; and
- (b) leniency in the imposition of a civil penalty.

The Australian penalties for competition offences are up to AUS\$10 million per offence for a corporation and up to AUS\$500,000 for an individual.

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Individual Conduct

Leniency, including immunity, may be considered appropriate for directors, managers, officers or employees of a corporation who come to the ACCC as individuals where they:

- (a) have important evidence of a contravention of which the ACCC is either otherwise unaware or has insufficient evidence to initiate proceedings;
- (b) provide the ACCC with full and frank disclosure of the activity and relevant documentary and other evidence available to them;
- (c) undertake to cooperate throughout the ACCC's investigation, and comply with that undertaking;
- (d) agree not to use the same legal representation as the firm by which they are employed; and
- (e) have not compelled or induced any other person/corporation to take part in the conduct and were not a ringleader or originator of the activity.

Corporate Conduct

Leniency is most likely to be considered for a corporation which:

- (a) comes forward with valuable and important evidence of a contravention of which the ACCC is otherwise unaware or has insufficient evidence to initiate proceedings;
- (b) upon its discovery of the breach, takes prompt and effective action to terminate its part in the activity;
- (c) provides the ACCC with full and frank disclosure of the activity and all relevant documentary and other evidence available to

it, and cooperates fully with the ACCC's investigation and any ensuing prosecution;

- (d) has not compelled or induced any other corporation to take part in the anti-competitive agreement and was not a ringleader of the activity;
- (e) is prepared to make restitution where appropriate;
- (f) is prepared to take immediate steps to rectify the situation and ensure that it does not happen again, undertakes to do so and complies with the undertaking; and
- (g) does not have a prior record of contraventions.

Not all of the above criteria must be met in order for leniency to be granted.

The ACCC does not apply separate leniency criteria for the proffer of information at different stages of an investigation, as compared with the Department of Justice in the United States. However, the ACCC will assess very carefully the viability of granting leniency once an investigation has begun, depending on the amount of information currently in its possession.

Experience to Date

One aspect of the Australian situation that is of concern is a reluctance of Australian courts to support regulators or the police where these bodies are alleging that an immunity agreement has been breached.

The ACCC lost a case where it gave immunity on condition of "full and frank disclosure" and when this was not forthcoming joined the person in the substantive proceedings. When this was challenged in court, the action was struck out on the basis that there was ambiguity in the immunity document and it was not clear whether or not the "full and frank disclosure" undertaking was breached.

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The practical issue is that once immunity is granted it is almost impossible to revoke. Consequently, the ACCC has to take this into account when granting immunity.

Experience to date with the ACCC immunity policy is that it is mainly used to give immunity to individuals, such as former employees, in investigations already begun by the ACCC. Having said that, immunities are regularly given.

In only one case to date was immunity given where the ACCC was not already aware of the conduct. In that case, full immunity was given to a corporation and its representatives. This fact caused considerable anger among the other parties to the alleged offence and they took legal action against those given immunity seeking to have them joined in the proceedings. This action was eventually dropped but it had the temporary effect of the ACCC's prime witnesses being under attack and becoming reluctant witnesses. The ACCC fully assisted these witnesses and paid for separate legal representation during the period they were under attack.

ACCC's Review of the Immunity Program

The main issue for the ACCC in the review of its immunity program is whether it takes the lead from other jurisdictions and guarantees full immunity to the first to report an offence that the ACCC is not aware of, even if they are the ringleader. This is a contentious issue for the ACCC.

Conclusion

In all jurisdictions, it is of paramount importance that enforcement agencies be seen to be encouraging parties to come forward as soon as they believe they are implicated in an offence. What is also clear is that requests for immunity must be subject to the closest

scrutiny, and must be considered on the basis of established criteria. Further, all jurisdictions must be satisfied that the public interest will be served by having such a policy.

However, there is a somewhat disturbing aspect of some immunity programs, especially in an era of global cartels and regulatory cooperation. The disturbing aspect is that immunity agreements will often include a clause not to disclose any information about those granted immunity and the conduct to which the immunity relates to overseas regulators, despite the existence of cooperation agreements and even treaties. This raises the issue that if immunity programs are to continue and spread, and if global cooperation is to be encouraged through positive initiatives such as the Global Competition Initiative, this potential conflict and positive impediment must be addressed.

EC COMPETITION LAW DEVELOPMENTS

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A number of important developments in European Community ("EC") competition law have taken place since June 1, 2000. These developments concern both substantive and procedural aspects of the law, and are summarized below.

Vertical Restraints

New rules on the treatment under Article 81 of the EC Treaty of vertical restraints entered into force on June 1, 2000. The new rules are set out in two documents:

a new Block Exemption Regulation (Commission Regulation 2790/1999); and

a set of detailed Guidelines commenting on and explaining the Block Exemption, and describing the

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EC Commission's analytical methodology and enforcement policy with respect to the principal types of vertical restraints (the "VR Guidelines").

The principal objective of the new regime is to introduce greater emphasis on economic analysis in the substantive assessment of vertical restraints. In this regard, the new rules aim to remedy a major criticism levied frequently at the previous regime, namely that its heavy reliance on formalism often led to the availability of a block exemption "safe harbour" not being dependent on the market power of the parties, but on the form of their vertical agreement. The old regime was also criticised for imposing a "strait jacket" effect which encouraged companies to sculpt their agreements so as to fit into the formalistic models that previously enjoyed block exemption, even at the expense of commercial optimization.

The approach to substantive assessment reflected in the new rules is reinforced by an amendment to one of the key procedural rules (Article 4(2) of Council Regulation (EEC) No. 17/62). As a result of this amendment, the EC Commission will henceforth be allowed to grant retrospective individual exemptions in respect of vertical restraints.¹ The practical consequence of this amendment is to remove any need or incentive for precautionary notification of vertical agreements. Moreover, the Commission has adopted a clear policy (signalled in paragraph 65 of the VR Guidelines) of discouraging precautionary notifications. In the absence of a pending complaint or litigation, the Commission will not attach priority to notifications of vertical agreements.

Under the new rules, vertical restraints will benefit from the Block Exemption (which amounts to a fairly robust safe harbour) if they satisfy three sets of conditions:

- (i) no hardcore restrictions in the agreement (these comprise fixed or minimum resale price

maintenance, certain types of territorial restrictions, certain types of restrictions arising in the context of selective distribution and certain types of restrictions on the supply of component parts);

- (ii) the supplier's market share must not exceed 30% (or, in the case of agreements under which a party agrees to supply goods/services only to a given purchaser, the purchaser's market share must not exceed 30%); and
- (iii) any obligation requiring the purchaser to not deal in competing goods or services must be of a fixed term not exceeding five years.

The Block Exemption does not generally apply to vertical restraints between competitors, although this rule is to some extent relaxed in the context of dual distribution systems. Moreover, the EC Commission and (by way of innovation), the European Union Member States, have powers to withdraw the applicability of the Block Exemption in certain circumstances.

Agreements that do not fall within the Block Exemption are not presumptively unlawful (other than to the extent that they contain hardcore restrictions). Their compatibility with Article 81 depends on a rule of reason type of analysis, the methodology of which is described in detail in the VR Guidelines.

The VR Guidelines seek (in Section II(2)) to codify the rules on the treatment of agency agreements under Article 81. This is long overdue (the previous Notice on Agency Agreements dating back to 1962) and reflects the Commission's desire for the concept of a "true" agency relationship (which escapes Article 81 altogether) to be based on economic reality rather than legal form. The rules reflected in Section II(2) may well require review and modification of existing agency agreements that had hitherto been presumed by their

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parties to be compliant with Article 81 by reason of falling into the “true” agent category.

Horizontal Agreements

On November 29, 2000, the Commission adopted two new Block Exemption Regulations: one regarding Research and Development Co-operation Agreements and the other regarding Specialization Agreements. The Commission also adopted a set of Guidelines dealing generally with horizontal agreements (the “HA Guidelines”).

The new Block Exemptions replace two previous Block Exemptions relating, respectively, to Research and Development Agreements and Specialization Agreements. In general, the new Block Exemptions are more liberal than their predecessors. Consequently, more agreements are likely to fall within the safe harbour established by the two Block Exemptions than previously was the case.

The HA Guidelines set out a comprehensive statement of the Commission’s policy in enforcing Article 81 with respect to horizontal agreements. They have been written with clarity and an eye for user-friendliness. In addition to detailed commentary, they contain a number of examples to illustrate the way in which the Commission will apply Article 81 to six categories of horizontal agreement:

- (i) R&D;
- (ii) Joint Production/Production Specialization;
- (iii) Joint Purchasing;
- (iv) Joint Commercialization;
- (v) Agreements on Standards; and
- (vi) Environmental Agreements.

One criticism that can be levied at the HA Guidelines is that they omit to cover a number of types of

agreement that have already been the subject of analysis by the Commission, Court of First Instance and/or Court of Justice. Thus, there is no treatment of:

- co-operative agreements intended to secure the closure of environmentally unfriendly production/storage facilities;
- so-called “crisis cartels” put into effect to eliminate structural over-capacity in manufacturing; and
- information exchange arrangements (such as cross-industry bench-marking schemes).

Enforcement of Articles 81 and 82

The Commission has published a draft Regulation to replace the principal procedural Regulation governing the enforcement of Articles 81 and 82 (Council Regulation (EEC) No.17/62).

The draft Regulation (which is accompanied by a lengthy explanatory memorandum) reflects a radical reform of the way in which Articles 81 and 82 will, in the future, be enforced. The proposed new regime comprises a number of noteworthy features:

- the notification for exemption/negative clearance process will be abolished;
- competition authorities and courts in the EU Member States will (for the first time) be entitled to carry out the rule of reason type analysis envisaged under the third paragraph of Article 81;
- parties will be required to conduct self assessments rather than being able to seek validation of their agreement through the notification process;
- the Commission’s investigative powers will be enhanced; and
- procedures will be put in place to attempt to ensure consistency of application of Articles 81 and 82 by all competition authorities and courts in the EU.

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The proposals represent a radical departure from the current centralized notification-based system. Although there can be no doubt that reform is overdue, practitioners and industry have expressed strong concerns. They fear that the new regime will lead to an unacceptable reduction of legal certainty through fragmentation and "re-rationalization" of the enforcement of Articles 81 and 82. It is feared that the new regime will allow inconsistent application of Articles 81 and 82 among the EU Member States, a problem that hitherto has been minimized thanks to the Commission's monopoly over the granting of exemptions under Article 81(3).

The new Regulation is expected to be adopted by the Commission at the end of 2001 and will be accompanied by a number of explanatory Notices dealing with matters such as the procedure for dealing with complaints of infringement of Articles 81/82 and the way in which the Commission will manage the integrated network of national competition authorities that it aspires to create in the EU.

Merger Review

Notices

Notice on Simplified Procedure

Since September 1, 2000, the Commission has been applying the new simplified procedure to transactions notified under the EC Merger Regulation (the "ECMR").² This procedure (described in a Notice adopted on July 29, 2000) allows more streamlined approval of transactions that, although having a EC dimension (and therefore being subject to mandatory notification and a suspensory waiting period pending approval), are unlikely to cause competition concerns in the EU. In the case of joint ventures, the simplified treatment applies where the EU turnover of the joint venture is less than EUR 100 million and the value of

the EU assets transferred to the joint venture is less than EUR 100 million.

In the case of mergers/acquisitions, the simplified procedure is available where the extent of overlap between the parties is not such as to give rise to an "affected" market (15% or greater market share in the case of horizontal overlaps and 25% or greater market share in the case of vertical linkages). Given that these tests for an affected market are predicated upon accurate and credible market definition and market share measurement, reliance on the simplified procedure is often likely to require pre-notification discussions with the Commission's Merger Task Force ("MTF"). Such discussions will be necessary to ensure that the MTF shares the parties' view on critical issues such as market definition.

Notice on Remedies

On December 21, 2000, the Commission published its *Notice on Remedies Acceptable Under Council Regulation (EEC) No. 4064/89 and Under Commission Regulation (EC) No. 447/98* (the "Notice").³ The Notice explains the Commission's current policy with respect to the analysis and imposition of remedies offered in the context of merger and acquisition transactions subject to review under the ECMR. Although the Notice is not in the nature of legislation, it nevertheless amounts to the first detailed written statement by the Commission of its policy in this important area of merger control. As such, the Notice will provide useful guidance to parties involved in merger review proceedings under the ECMR, whether as merging parties or as third parties seeking to influence the outcome of the Commission's review of a particular merger.

The Notice provides valuable insight into the Commission's policy on a number of issues pertinent

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to remedies in the context of merger review, in particular:

- the Commission's requirements regarding viability of a divested business;
- factors relevant to identifying a business, or combinations of businesses, that are most appropriate for divestiture;
- the suitability of purchasers and of the terms of purchase of a divested business;
- alternative divestiture packages; and
- the role of hold separate trustees and divestiture trustees.

Cases

The last year has seen an abundance of decisions under the ECMR. Four are noteworthy: Time Warner/EMI and Worldcom/Sprint were prohibited by the Commission; the Microsoft/Liberty Media/Telewest transaction was modified in a manner that allowed it to proceed without the need for approval under the ECMR; and Bosch/Rexroth provided the Commission with the first opportunity to require merging parties to give an "up-front buyer" divestiture undertaking.

Court

In its judgment in Case T-41/96 *Bayer AG v. EC Commission*, the Court of First Instance took the rare step of annulling in its entirety a decision taken by the Commission in the application of Article 81. The case concerned alleged attempts by Bayer to prevent parallel imports between Spain, France and the United Kingdom of its pharmaceutical Adalat. The key issue was whether the Commission had established any "agreement" between Bayer and its French and Spanish wholesalers to block parallel imports. Notwithstanding the broad construction that traditionally has been given in EC competition law to the concept of an

"agreement", the Court found that the Commission had failed to establish any concurrence of will on the part of Bayer and the relevant wholesalers, and hence had failed to show the existence of any agreement contrary to Article 81. The Court found that Bayer has pursued a unilateral policy aimed at preventing parallel imports of Adalat, but that given Bayer's modest share of the relevant market, this policy could not be characterized as an abuse of any dominant position. On this basis, Bayer's conduct escaped censure under the EC competition rules. The Commission has appealed against the Court's judgment.

Notes

¹ This will subsist until such time as the notification system is abolished. See the section below entitled "Enforcement of Articles 81 and 82".

² Council Regulation (EEC) No. 4064/89.

³ The Notice is available on DG Comp's Web site at http://europa.eu.int/comm/competition/mergers/legislation/#notice_on_remedies.

U.S. ANTITRUST LAW DEVELOPMENTS

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The recent visible and notable antitrust developments in the United States are numerous – led most dramatically by the Microsoft litigation. This paper focuses on just two specific "events" that bear watching in the U.S. The first event is the release of a compendium on two days of hearings on Internet-based commerce. The report – issued by Federal Trade Commission ("FTC") staff – provides an overview of competition analysis involving business-to-business electronic marketplaces ("B2Bs") and details potentially substantial efficiency gains from ventures in electronic commerce. This report provides in one place a resource

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guide to antitrust review of B2Bs. A second phase of B2B hearings at the FTC followed on May 7-8, 2001; these focused on mergers, interoperability, operating practices, and key issues in online distribution in the business-to-consumer electronic marketplace ("B2C") context.

The other "event" involves recent litigation and three court decisions in the FTC's challenge of a proposed merger of the baby food divisions of H.J. Heinz Company and Milnot Holding Corporation which owns the Beech-Nut brand. The District Court and Appeals Court decisions provide intriguing reading for those interested in recent cases involving efficiency analysis and defence.

B2Bs – Efficiencies and Competition

The last six months of 2000 were marked by virtually daily announcements of new developments in Internet-based activity affecting domestic U.S. and international commerce; albeit slowing after the turn of the year. Among the major developments was the vast proliferation of B2B electronic marketplaces or ventures in a host of industries. These B2Bs involved both simple proprietary systems linking together a single purchaser with large numbers of suppliers and larger joint ventures of companies within a given industry.

Until recently, those involved in counseling ventures embarking into electronic marketplaces in the U.S. have relied heavily on pre-existing policy statements governing joint ventures or speeches by enforcement officials and antitrust reviews of specific ventures.² The October 2000 report of the FTC staff on "Entering the 21st Century: Competition Policy in the World of Electronic Marketplaces" (the "Report") should provide better guidance concerning the views of the U.S. antitrust authorities. The Report summarizes two full days of hearings by over 60 panelists before the FTC

in June 2000. It provides a fuller and more detailed roadmap to possible review than hitherto available to practitioners in the U.S. or those interested in understanding the issues most likely to raise concerns and the type of information most likely to address particular issues.

This paper summarizes some of the key areas of the Report that provide guidance on the issues raised by B2Bs and areas of possible enforcement activity – or avoidance of enforcement activity. The Report is divided into three parts.

Part 1 of the Report provides a detailed overview of developments in B2Bs up through the time of the hearing and is a useful guide to the more detailed statements provided by many of the industry participants in the hearing.³ For those who may be new to the issues raised by electronic marketplaces, this section is a useful starting point. It provides an overview of the key elements of B2Bs. This section includes a useful taxonomy of the types of B2Bs and their organizational format and structures. It also includes key sections that detail the mechanisms by which revenues are generated through or by B2Bs. Included, for example, are discussions of the types of fees and fee structures for services rendered or for sale of information. Similarly, there is detailed description of the mechanisms by which prices are established for the goods and services sold on a B2B.

The last item includes a succinct discussion of the differences between "exchange" formats that allow buyers and sellers to establish market-clearing prices through bidding and formats that allow potential purchasers to set out requests for proposal and receive back sufficient information and proposals to negotiate contracts. The discussion of revenue mechanisms also lists the possible areas of "price" that may raise monopoly or monopsony concerns.

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Part 1 is also useful for categorizing the specific B2B that is under potential antitrust review into the broad categories outlined in Part 1. Doing so provides a good roadmap for working through the efficiencies and competition issues that are detailed in Parts 2 and 3. Almost hidden in Part 1 is an analysis of possible entry barriers and intellectual property issues that may occur in particular contexts. It is useful to revisit this section after finishing the competition analysis in Part 3.

Part 2 of the Report discusses nine specific areas of efficiencies that could be accomplished by B2Bs and provides an overview section on actual and potential efficiencies. The nine sections on efficiencies provide some detailed examples and a possible checklist of the types of efficiencies that arise in certain B2B contexts. These sections also provide information that may be useful for demonstrating such efficiencies. For those B2Bs that do raise substantive concerns, U.S. antitrust agencies are likely to examine and seek clarification and quantification of possible efficiencies. The slant of the Report is similar to the U.S. *Horizontal Merger Guidelines* in its recognition that most ventures are likely to generate substantial efficiencies while raising few concerns.⁴ The efficiency gains detailed in this part of the Report can be broadly categorized into four groups. The first consists of efficiencies that improve information or reduce costs of acquiring information on products, suppliers, or purchasers. The second includes efficiencies from the reduction of administrative costs or duplicative activity. The third group is efficiencies from improved management of purchase and supply patterns or information. The last includes gains from joint purchasing. The Report also notes that many B2Bs have yet to realize efficiencies since they are still in the planning stages.

Part 3 of the Report is the most useful for antitrust practitioners. It provides detailed analysis of two broad categories of possible antitrust concern – market power

problems in markets for the goods and services sold on the B2B and market power problems in the electronic marketplace itself. The former concern focuses on issues such as collusion, monopoly or monopsony power, and exclusionary behavior. The latter concerns more complex issues about the likelihood of entry of additional B2Bs into a marketplace and whether electronic marketplaces and traditional marketplaces are in the same relevant market.

The Report references relevant cases and literature on many of the key areas. Not surprisingly, areas of competitive concern in B2B arrangements include those that have traditionally arisen in joint venture purchasing or supply arrangements – including concern about the aggregation of purchasing power among B2B participants. Areas of enhanced interest in the B2B context are the exchange of information and transparency of information that the Internet and B2B ventures provide. In this context, the Report details the circumstances under which collusion and the exchange of pricing information may be issues. This section provides a counterpoint, however, by citing information from the hearings indicating that many B2B participants may seek firewalls to deter competitors' access to sensitive information, which in turn may limit competitive issues.

The second half of Part 3 addresses areas that may prove newer to some – the competition faced by B2Bs as networks. This part of the Report draws heavily on cases and advisory opinions involving joint ventures in network industries, and it will likely prove very useful as inevitable consolidation occurs in the B2B industry.⁵ The section poses a number of questions. For example, what if the B2B is a market? Are there other competitors in the market? Do these include other B2Bs or brick-and-mortar facilities as well? Is there room for more than a few competitors and how does one assess the prospects for entry? What do the

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competitive dynamics look like, particularly in this latter context? Will a venture be provided antitrust clearance if it faces few competitors?

One statement in the Report provides insight into the kinds of analyses that may prove most important in this last context: “[It] appears likely that potential [antitrust] concerns could be eliminated through well-crafted B2B operating rules.” (Report at page 2.) (This insight is also relevant in situations where the joint venture participants are found to represent a large proportion of purchasers or suppliers in relevant markets.) This statement suggests, at least, that ventures with apparent “structural” problems may nonetheless pass muster if proponents can demonstrate that the operating rules provide clear mechanisms to protect competition and consumers. The hearings on May 7, 2001, with their focus on mergers and operating practices, provided some additional insights into the specific types of operating practices of B2Bs that could limit such concerns. In addition, the May 8, 2001 session, by extending more broadly into online marketing and distribution practices, expanded the scope of analysis well beyond the Report. Transcripts of these hearings and possible additional staff publications of their findings should prove useful reading for all.

Federal Trade Commission v. H.J. Heinz Company

One of the most interesting cases in 2000-2001 was the FTC’s challenge of the proposed merger of H.J. Heinz Company and Beech-Nut. The case involved a merger to duopoly in the U.S. market for prepared baby food. It generated significant interest because the parties initially defeated a FTC request for a preliminary injunction. In a five-day hearing before a U.S. District Court judge, they presented evidence in support of their claim that while the merging firms competed with the dominant supplier (Gerber), they did not constrain each

other’s prices. They also demonstrated projected efficiencies that they claimed would enhance the post-merger firm’s ability and incentive to compete more vigorously with Gerber. An appeals court overturned the decision, however, raising some interesting issues. First, under what circumstances, if any, would the courts permit a merger to duopoly? Second, how much weight, if any, should be given to efficiency claims?

Procedural Background

In February 2000, H.J. Heinz Company (“Heinz”) and Milnot Holding Corporation (“Milnot”) entered into an agreement under which Heinz would merge its baby food business with Milnot’s Beech-Nut baby food business. The transaction was valued at US\$185 million. The transaction was reviewed by the FTC, which issued a Second Request for Information in April. On July 7, 2000, the FTC Commissioners (on a vote of 3 to 2) authorized their staff to challenge the merger and to seek a preliminary injunction in Federal District Court in Washington to enjoin the acquisition pending completion of the proceedings on the merits.⁶

The District Court conducted a five-day evidentiary hearing in late August and September, and the Court denied the FTC’s request for a preliminary injunction on October 18, 2000.⁷ The FTC appealed to the U.S. Court of Appeals for the District of Columbia Circuit, and in early November a three-judge panel granted the FTC’s request for an emergency injunction pending a full hearing on the matter.⁸ The matter was then argued in February 2001 and the U.S. Court of Appeals on April 27, 2001 reversed the District Court’s decision and remanded the case for the entry of a preliminary injunction.⁹

Factual Background¹⁰

The District Court found that there was substantial agreement between the parties regarding the basic facts

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of the case. The Court found that annual U.S. processed baby food sales are from US\$865 million to US\$1 billion, although sales have declined in recent years despite a positive birth rate. It also found that Gerber, Heinz and Beech-Nut are virtually the only manufacturers serving the U.S. market. Gerber has dominated sales for the past four decades, and its market share has been approximately 65% over the past decade. As its share indicates, Gerber enjoys brand recognition and acceptance unmatched in the U.S. market. Gerber positions its products as high-quality "premium" brands. Gerber is effectively the price leader, and while it sometimes lowers prices to meet competitive threats, its products generally command a premium relative to most other suppliers.

The Court found that Heinz was a distant second to Gerber with 17.4% of U.S. sales, although it also noted that Heinz manufactures and distributes food products worldwide and is the world's largest supplier of baby food. Heinz manufactures baby food at only one plant in the U.S. located in Pittsburgh, Pennsylvania. The plant was recently modernized at a cost of US\$120 million, but it now operates at only 40% of rated capacity. Unlike Gerber, Heinz positions its products as "value" brands that sell at a discount relative to Gerber's products.

The Court found that Beech-Nut is the smallest of the three suppliers with 15.4% of the market and that it also manufactures its products in a single plant located in New York State. Beech-Nut characterizes the plant as being not technologically current, and it claims that it would be prohibitively expensive to modernize. Like Gerber, Beech-Nut positions its products as premium brands, and it has been able to sell at the same price levels as Gerber without losing sales.

Finally, the District Court found that most baby food sales are made in supermarkets, that supermarkets

typically stock only two brands, and that all supermarkets carry Gerber products. In contrast, Heinz products are stocked in approximately 40% of all stores, with geographic concentrations in New England, the Southeast and the Deep South. Beech-Nut is sold in 45% of the stores, with geographic concentrations in the Mid-Atlantic States, California and Florida.

Legal Issues

The FTC and the merging parties agreed on a number of key issues. Both sides agreed that the relevant product market was baby food and that the relevant geographic market was no larger than the U.S.¹¹ They also agreed on market shares and concentration, and the defendants did not contest the FTC's allegation that there were significant barriers that made entry unlikely. As a result, the preliminary injunction hearing focused primarily on two issues relating to likely competitive effect. The first was the likely impact of the merger on competition between Heinz and Beech-Nut for the position of "second brand" in supermarkets. The second was the effect of alleged efficiencies on post-merger pricing and innovation by the combined firms.

The FTC had the burden of showing that, based upon the equities and considering the FTC's likelihood of ultimate success, a preliminary injunction would be justified pending a full administrative hearing on the merits. The FTC sought to satisfy its burden of proof by emphasizing the merger's impact on market structure. They noted that the merger would combine the second and third largest manufacturers, increasing concentration significantly in an already highly concentrated market. Using the Herfindahl-Hirschman Index ("HHI") of concentration, the pre-merger HHI is 4225, and the merger would increase the HHI by 510 points to 5258. Under the standards laid out in the *Horizontal Merger Guidelines*, the FTC typically challenges transactions that increase the HHI by 100 points to a post-merger level exceeding 1800.¹²

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Specifically, the FTC alleged that the merger would totally eliminate "trade spending" competition between Heinz and Beech-Nut to be the "second brand" in retail outlets. Manufacturers currently compete for shelf space through fixed and variable trade spending allowances paid to retailers. The FTC argued that trade spending benefits consumers in the form of lower prices and that the merger would eliminate that benefit. The FTC also alleged that the elimination of Beech-Nut as an independent supplier would make it more likely that Heinz would either passively follow Gerber's lead in pricing or allow the two firms to coordinate pricing. The FTC did not, however, allege that the merger would directly eliminate retail competition between Heinz and Beech-Nut.

The Court determined that the FTC had made a prima facie case by demonstrating high concentration. Nonetheless, it also found that the defendants' rebuttal case had overcome the presumption that showing an impact on concentration alone was sufficient. The defendants argued that the concentration analysis was not sufficient to infer a lessening of competition. They presented evidence showing that the defendants competed with Gerber rather than each other. The judge made special note of an econometric analysis performed by the defendants' economic expert showing that Heinz and Beech-Nut do not constrain one another's retail prices. With respect to competition to be the second brand, the expert demonstrated that fixed trade spending has no effect on shelf price and that there was no evidence that variable trade spending levels had any effect on retail prices, even in markets where all three firms were present. The judge concluded that the evidence the FTC cited to support its assertion of an effect on variable trade spending levels and consumer prices was, at best, "inconclusive."¹³

The judge also appeared to be convinced by the defendants' arguments and evidence concerning merger-related efficiencies. The defendants argued that the merger would make the resulting firm a stronger, more vigorous competitor in the future. While he discounted "aspirational" testimony of executives about their post-merger intentions to compete vigorously, he gave credit to "powerful evidence" in the record about proposed efficiencies and the enhanced prospects of the merged entity to introduce new products. The judge noted that courts have begun to consider the implications of efficiency claims in merger cases and that the antitrust agencies themselves purport to take efficiencies into account under their own *Horizontal Merger Guidelines*. At the hearing, Heinz introduced evidence showing that it would achieve merger-specific savings of between US\$9.4 and US\$12 million. Much of the savings are attributable to reductions in fixed costs such as the consolidation of Beech-Nut's production at Heinz's new, underutilized Pittsburgh facility and various spreading of overhead, although some of the savings appear to arise from reductions in variable manufacturing and distribution costs.

The Court also found convincing the defendants' arguments that the merger would increase innovation. Current Heinz policy disfavors the introduction of new products because it lacks substantial national distribution. As a result of the merger, Heinz would go from having a substantial presence in only 40% of stores nationwide to over 90%. This would be high enough to justify the introduction of Heinz's environmental "Oasis" program that has already been introduced in Europe. While the FTC challenged these arguments, it did not present evidence to the contrary.

In the end, the Court denied the FTC's request for a preliminary injunction. While the FTC established a prima facie case by showing an impact on

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concentration, the judge concluded that the defendants had effectively rebutted that case with convincing evidence that the merger would, in fact, increase competition rather than reduce it. The judge also concluded that the equities weighed against an injunction. On the one hand, denying an injunction might allow the assets to be scrambled, denying the FTC effective relief if it did successfully challenge the merger in an administrative hearing on the merits. On the other hand, the judge determined that granting the injunction would kill the merger.¹⁴

The Appeals Court Rulings

The FTC immediately filed an emergency appeal of the District Court's decision. On November 8, 2000, a three-judge panel of the U.S. Court of Appeals for the D.C. Circuit unanimously overturned the District Court's decision and granted the FTC an emergency injunction pending an appeal of the matter to the D.C. Circuit.¹⁵ After hearing arguments in February 2001, the Appeals Court issued its opinion on April 27. The Court reversed the lower court's decision and remanded the case back for entry of a preliminary injunction. The Appeals Court's opinion is broad in scope, addressing both the elements of a prima facie case as well as the efficiencies defence.

With respect to the FTC's prima facie case, the Appeals Court reiterated that "[s]ufficiently large HHI figures establish the FTC's prima facie case that a merger is anticompetitive."¹⁶ The Court also noted that "the FTC's market concentration statistics are bolstered by the indisputable fact that the merger will eliminate competition between the two merging parties."¹⁷ Further, the justices pointed out that both sides agreed that barriers to entry are high, which would enhance the anticompetitive effect of the merger. "As far as we can determine," they concluded, "no court has ever approved a merger to duopoly under similar circumstances."¹⁸

The Appeals Court reviewed rebuttal arguments including pre-merger competition, post-merger efficiencies, innovation and the existence of "structural barriers" to collusion. With respect to the first, the Court focused on both retail and wholesale competition. It rejected the District Court's findings on the lack of retail competition between the merging parties as inconsistent with the inclusion of both parties in a common product market for jarred baby food and cited the District Court's failure to address record evidence on the point. Moreover, the Appeals Court found that the lower court had failed to address the significance of loss of competition at the wholesale level.¹⁹

With respect to efficiencies, the Appeals Court cited Areeda to the effect that "extraordinary efficiencies would be required where the HHI exceeds 1800" and the revised *Horizontal Merger Guidelines* to the effect that efficiencies almost never justify a merger to monopoly or near-monopoly.²⁰ In this case, the justices concluded that the appellees had failed to provide proof of such extraordinary efficiencies. The Court rejected the merging parties' efficiencies defence based on its own analysis of the claimed efficiencies. Among other things, the Court concluded that some of the efficiencies were not merger-specific, such that Heinz could have accomplished some product improvements on its own. Moreover, the Court critiqued the measurement of estimated variable cost savings from plant consolidation and concluded that they overstated substantially the anticipated reduction in variable costs that would be accomplished by the combined operations. The Court concluded that the District Court failed to make sufficient factual determinations required for the efficiency defence to offset the prima facie case.²¹

The Appeals Court next addressed the merging parties' claims concerning benefits from innovation claims. In the end, the justices rejected as speculative the defence

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that the merger was necessary for, and thus would have the benefit of, enabling Heinz to be a more innovative competitor. The evidence put forth by the parties did not prove that there would be more innovation, and the District Court's consequent finding that the merger was necessary for innovation was thus "unsupported and clearly erroneous."²²

The Appeals Court also rejected the District Court's conclusion that there were "structural barriers to collusion" in this market. The economic expert for the parties had argued that the merger would create incentives for the merged entity to compete vigorously with Gerber rather than collude and pointed to other "cartel problems" that would make collusion more difficult and, therefore, less likely. The Appeals Court cited apparent factual inconsistencies in some of the bases for these conclusions, including evidence of past price leadership. The Court also noted that the District Court did not find that these "cartel problems" were likely to be any more of a problem in this market than any other. The opinion ended by noting that in "a market with only two competitors, supracompetitive pricing at monopolistic levels is a danger."²³

Finally, the Appeals Court reached a different conclusion than the District Court regarding the equities. Whereas the District Court was concerned that granting a preliminary injunction would kill the transaction, the Appeals Court placed more weight on the difficulties the FTC would face in obtaining relief if it subsequently challenged the merger successfully but the assets had been long since scrambled. Unlike the District Court, the Appeals Court found that while the parties might decide to abandon the transaction, none had stated that they definitely would do so. The Appeals Court also cited the merging parties' acknowledgment that there was no other buyer for Beech-Nut. The justices concluded that the evidence did not show that granting the preliminary injunction would endanger any claimed

efficiencies if the merging parties eventually prevailed.²⁴

Notes

¹ Margaret E. Guerin-Calvert and Bruce R. Snapp are Principals at Economists Incorporated in Washington, D.C.; both have been active as economists in the public and private sectors for over 20 years on a variety of merger and other antitrust issues in the U.S. and Canada.

² Two sources used as references for policy guidance in the joint venture area are: *Revised Federal Trade Commission, Justice Department Policy Statements on Health Care Antitrust Enforcement* (August 26, 1996) and *Antitrust Guidelines for Collaborations Among Competitors*, issued by the Federal Trade Commission and the United States Department of Justice, April 2000. One recent example of a B2B review and analysis is the brief press release and letters regarding the Covisint B2B. (Press release of September 11, 2000 and accompanying materials for File No. 001 0127 at ftc.gov/opa/2000/09/covisint.htc). In addition, some guidance is provided by the speeches of a number of senior officials from both the FTC and the Antitrust Division of the United States Department of Justice ("DOJ") who have addressed in more general terms the possible areas of concern, including market structure and business practices. Several of these speeches are available at the Internet sites of the FTC or the Antitrust Division (www.ftc.gov or www.usdoj.gov/atr).

³ The individual statements of the participants and the hearing transcripts are available at the FTC website.

⁴ U.S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992 (revised: April 8, 1997) § 0.1 ("...the Agency seeks to avoid unnecessary interference with the larger universe of mergers that are either competitively beneficial or neutral.").

⁵ The May 7-8, 2001 hearings at the FTC focused expressly on merger analysis, including hypotheticals, and should provide additional insight into issues such as market definition involving B2Bs and the competitive implications of consolidation in the B2B context. For the press release describing the May 7-8 hearings, see <http://www.ftc.gov/opa/2001/03/e-commerce.htm>; additional information on the topics covered at the hearings is found at <http://www.ftc.gov/os/2001/03/e-commfrn.htm>.

⁶ "FTC to Challenge Merger of Beech-Nut Nutrition Corp. and H.J. Heinz Co.," FTC Press Release, July 7, 2000 (<http://www.FTC.gov/opa/2000/07/Heinz.htm>).

⁷ *F.T.C. v. H.J. Heinz Co.*, 116 F. Supp. 2d 190 (D.D.C. 2001), rev'd, 246 F.3d 708 (D.C. Cir. 2001) [hereinafter *Heinz District Court*].

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⁸ *FTC. v. H.J. Heinz Co.*, 2000-2 Trade Cas. (CCH) ¶ 73,090 (D.C. Cir 2000) [hereinafter *Emergency Appeal*].

⁹ *Federal Trade Commission v. H.J. Heinz Co.*, 246 F.3d 708 (C.A.D.C. 2001) [hereinafter *Appeals Court*].

¹⁰ *Heinz District Court*, *supra* note 7 at 192-194.

¹¹ The FTC suggested that there might be separate regional geographic markets even though Heinz and Beech-Nut service the entire country from one plant each. *Post Trial Memorandum in Support of the Federal Trade Commission's Motion for Preliminary Injunction* (September 15, 2000) at 17; and *Heinz District Court*, *ibid.* at 195.

¹² For a discussion of the HHI, its method of calculation, and agency enforcement standards, see *Horizontal Merger Guidelines*, *supra* note 4 § 1.5 ("Concentration and Market Shares").

¹³ *Heinz District Court*, *supra* note 7 at 200.

¹⁴ *Ibid.* at 200-201.

¹⁵ *Emergency Appeal*, *supra* note 8. The Court issued a short opinion when it granted the emergency preliminary injunction. We do not examine it in detail here, however, because the Court reached the same conclusions after hearing oral arguments three months later, and its opinion at that time provided a much more detailed discussion of the Court's rationale.

¹⁶ *Appeals Court*, *supra* note 9 at 716.

¹⁷ *Ibid.* at 717.

¹⁸ *Ibid.*

¹⁹ *Ibid.* at 718-719.

²⁰ P. Areeda et al., *Antitrust Law* (New York: Aspen Law & Business, 1998), ¶ 971ff at 44 and *Horizontal Merger Guidelines*, *supra* note 4 § 4.

²¹ *Appeals Court*, *supra* note 9 at 720-722.

²² *Ibid.* at 722-723.

²³ *Ibid.* at 724.

²⁴ *Ibid.* at 726-727.
