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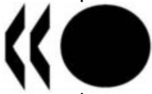

Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development **09-Oct-2006**

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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

DAF/COMP/WP3/WD(2006)67
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Working Party No. 3 on Co-operation and Enforcement

ROUNDTABLE DISCUSSION ON EVIDENTIARY ISSUES IN MERGER REVIEW:

-- United States of America --

17 October 2006

This note is submitted by the United States of America to WP3 FOR DISCUSSION at its forthcoming meeting to be held on 17 October 2006.

JT03215344

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EVIDENTIARY ISSUES IN MERGER REVIEW:

UNITED STATES OF AMERICA

1. Federal antitrust laws in the United States (primarily section 7 of the Clayton Act and section 1 of the Sherman Act) allow the United States enforcement agencies, the Antitrust Division of the Department of Justice and the Federal Trade Commission, to petition an independent court to prevent the consummation of a transaction that may substantially lessen competition. Courts in the United States use an adversarial system to evaluate evidence. As a result, the United States agencies have significant expertise in gathering and using evidence in merger cases.

1. Obtaining Evidence

2. The U.S. enforcement agencies obtain evidence for the dual purposes of (i) determining whether the merger will substantially lessen competition and (ii) preparing for any adversarial adjudicative proceeding, or "hearing", regarding the merger. The agencies gather information from parties and third parties. This information can include business records and data, a broad range of party and third party sworn written statements, interviews, affidavits, and oral testimony. The agencies obtain evidence from multiple sources in order to develop a broad, representative, and reliable view of often complex markets. The agencies seek to determine whether the overall weight of the evidence supports a theory of competitive effects.

3. In most merger investigations in the United States, the initial evidence obtained by the agencies is from Hart-Scott-Rodino ("HSR")[1] notifications filed by the merging parties. The filing forms request several categories of information, including the products and/or services in which the companies compete and the companies' sales information for these products. The initial filing also must include certain transaction documents, including "4(c) documents"[2] created by or for senior executives. These documents provide the agencies with information regarding the companies' reasons for entering into the proposed deal, the valuation of the deal, the areas of potential overlap, and a high-level view of how the companies perceive the market. For more than 80% of mergers, the HSR filings alone provide information sufficient to allow the agencies to determine that the transaction in question does not raise competitive concerns.

1 . The Hart-Scott-Rodino Antitrust Improvements Act of 1975 (HSR Act) establishes premerger notification and waiting periods for transactions that meet certain threshholds. (Information relating to premerger notification, including forms, statutes and guides, can be found at http://www.ftc.gov/bc/hsr/hsr.htm). Even if a transaction does not meet the reporting thresholds, the U.S. agencies have the power to investigate the transaction and, if appropriate, take enforcement action.

2 . Item 4(c) of the form that parties file with the antitrust authorities pursuant to the HSR Act requires the production of "studies, surveys, analyses and reports that were prepared by or for any officer(s) or director(s) (or in the case of unincorporated entities, individuals exercising similar functions) for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, competitors, markets, and potential for sales growth or expansion into product or geographic markets."

4. When the agencies open an investigation into a transaction, the first step is usually to request that the parties voluntarily submit further information and documents. Such information may include the identity of major customers in the markets at issue, the identity of other suppliers of overlap products, and available market share information. The agencies also often request additional documents, such as long-term strategic plans for the overlap products, annual business/marketing plans, and other documents that may describe the products, pricing, and market structure. During this period, the agencies may also interview market participants, particularly major customers and competitors.

5. For the few transactions (approximately 3% of reported transactions) that merit a substantial or full phase investigation, the agencies commit significant resources to gather detailed information to analyze the proposed merger. A request for additional information, also known as a Second Request, requires the merging parties to provide the agencies with relevant information, data sets, and documents from key employees. The documents that must be produced cover all aspects of merger analysis, and include documents relating to pricing, bidding, competition, marketing, research and development, manufacturing, intellectual property, prior acquisitions, and efficiencies. In addition, the Second Request requires the submission of data (usually in electronic form) relating to, among other things, unit and revenue sales, pricing, costs, and production. Data for use in empirical economic analysis of a merger is increasingly an important source of evidence to be considered along with more traditional forms of evidence.

6. Compulsory process is used to obtain documents, data, and other information from third parties, although many fewer demands are made on third parties. Third-party interviews, written statements and testimony provide the agencies with information that is critical to their merger review and analysis. During a substantial investigation, the agencies frequently interview dozens of customers, competitors, and other market participants to collect facts needed to establish or disprove the legal and factual theories of the investigation. For example, in an investigation focused on coordinated effects staff will use interviews to determine what sensitive transaction/bid information (price, output, capacity) is available to competitors and when it is available, the size and frequency of sales transactions, and the importance of non-price competition. To ensure that this evidence is representative of the broader market, the agencies seek to interview a broad spectrum of customers to account for issues such as customer size, geographic location, frequency of purchases, and downstream competition.

7. In many cases, the views of customers and other market participants are memorialized in sworn statements or through sworn oral testimony. These statements are often useful to the agency's decision-makers' determination of how a case would be presented to a court, and often may be used in a court proceeding to support the agency's position.

8. When mergers are challenged by the agencies, whether in federal district court or Federal Trade Commission administrative hearings, the agencies often are able to obtain additional evidence through discovery.

2. The Admissibility and Persuasiveness of Evidence

9. U.S. courts evaluate evidence in two stages. In the first instance, courts apply the rules of evidence, which determine whether evidence may be admitted in a trial. Second, the court must determine, as the finder of fact, how much weight to give to the evidence.

10. One of the goals of the rules of evidence is to separate out evidence that has a serious weakness affecting its reliability. For example, the rules of evidence restrict the use of hearsay evidence (out-of-court statements used to prove the truth of the matters asserted). As another example, witnesses generally are required to have a foundation of personal knowledge supporting their testimony. The rules of evidence incorporate courts' practical experience across many kinds of cases and in many different substantive areas

of law.

11. Economic analysis in the form of expert testimony can be very important in a merger investigation. The rules of evidence address the admissibility of this kind of evidence, and generally require that it be both based on a reliable foundation and relevant to the task at hand.[3] Similarly, procedural rules have evolved in response to the increasing complexity of expert testimony and now require greater advance disclosure to opposing parties regarding the details of an expert's opinions and reasoning.[4] This disclosure is crucial for allowing a more thorough evaluation of the increasingly sophisticated economic analysis in merger cases.

12. Testimony from executives provides one illustration of the value of evidentiary rules, as well as some of the complexity of applying those rules to antitrust cases. Typically, executives testify as fact witnesses and therefore must testify based on personal knowledge;[5] they may not simply convey inadmissible hearsay[6] nor provide the type of technical opinions that only experts can provide.[7]

13. The requirement of personal knowledge and the restrictions on hearsay are important to avoid the inevitable distortion of information as it is passed along and, equally important, to permit the cross-examiner to test the limitations in the witness's observations. When a witness relies on the statements of another person, it is difficult to test for the dangers that hearsay often poses, for example that the speaker may have misperceived the situation, may have been biased or insincere, or may have stated the information ambiguously.

14. In contrast, when someone is directly involved in an aspect of a business and has a duty to pass along accurate information to others in the business, then there is more reason to trust what is conveyed. Internal documents generated before a company was contemplating a merger often provide reliable insight into the dynamics of competition and a contemporaneous evaluation of competitors, potential entrants, substitute products, and constraints on pricing. This insight explains why business records are generally admissible under an exception to the hearsay rule if the record is made by a person with knowledge of the matters described in the record, at or near the time of the events recorded, and in the course of a regularly conducted business activity.[8] Similarly, it explains why courts often give an executive greater latitude to testify about matters internal to the executive's own business, even when the executive does not have first-hand knowledge about every aspect of the business.[9] As long as the executive has some personal knowledge about the relevant part of the business and relies on the information conveyed in the ordinary course of business, the executive generally may testify about that subject, even though the testimony relies in part on reports from others.[10] For example, executives may testify about profits and losses, even though that information obviously compiles data from many sources.[11] But at the same time, an executive who has no role in evaluating profits and losses should not be deemed a proper witness to testify on the subject,

3 . *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993). *See* Fed. R. Evid. 702 and 703

4 . *See* Fed. R. Civ. P. 26(a)(2).

5 . *See* Fed. R. Evid. 602.

6 . *See, e.g., Kaczmarek v. Allied Chemical Corp.*, 836 F.2d 1055, 1060-61 (7th Cir. 1987).

7 . *See* Fed. R. Evid. 701(c).

8 . *See* Fed. R. Evid. 803(6).

9 . *See, e.g.,* 2000 Advisory Committee Notes to Fed. R. Evid. 701.

10 . *Agfa-Gevaert, A.G. v. A.B. Dick Co.*, 879 F.2d 1518, 1523 (7th Cir. 1989).

11 . *See, e.g., Mississippi Chemical Corp. v. Dresser-Rand Co.*, 287 F.3d 359 (5th Cir. 2002).

regardless of whether the information deals with the executive's own business.[12]

15. Another important criterion for evaluating evidence from market participants is whether the evidence was generated in anticipation of litigation. Business records, for example, are generally not admissible when they are made in anticipation of litigation. To take a famous example from the law of evidence, a railroad that routinely prepared reports after accidents could not offer those reports as business records at a trial about liability for the accident.[13] The original sources for the information in the reports would have to be used. Likewise, enforcement agencies and courts should be cautious about testimony from a competitor of the merging parties who would face a more effective rival post-merger or where there are other reasons that a competitor's or customer's testimony might be unreliable.[14] More generally, the Federal Rules of Evidence permit a judge to exclude a business record when "the source of information or the method or circumstances of preparation indicate a lack of trustworthiness."[15]

16. An issue that recurs in antitrust cases is whether an executive may testify about the preferences of the company's customers. Again, the basis of the executive's knowledge and the scope of the executive's testimony are critical to both admissibility and persuasiveness. An executive's testimony about customers' reactions to past price increases might well be admissible as evidence of buyers' preferences. Or an executive's testimony about the important terms in negotiations with buyers might provide further evidence of buyers' preferences. The less speculation and more first-hand knowledge involved, the stronger the testimony.

3. Using the Right Evidence in Merger Hearings

17. A second critical issue in merger hearings is whether, as a matter of sound economics and policy, the available evidence is sufficient to determine whether a merger is anticompetitive.

18. The DOJ/FTC Merger Guidelines ("Merger Guidelines") explain that when an enforcement agency is trying to define a market and to evaluate the reaction that buyers would have to a price increase, the agency may consider evidence that addresses the following questions: (1) Have buyers shifted their purchases in the past from one product to another in the face of a price increase? (2) Is there evidence that sellers have based their business decisions on the prospect that buyers will switch to another product in response to a price increase? (3) What evidence is there on the timing and costs to buyers of switching products?[16] These types of evidence can help an enforcement agency prove the appropriate market definition.

19. Similarly, in trying to evaluate the competitive effects of mergers, the evidence presented by the agency must correspond to the agency's theory of harm. In cases based on coordinated effects, for example, economists, judges, and commentators have identified a series of conditions in a market that affect the likelihood of successful collusion. Some of the most obvious factors are the number of competitors, concentration, and the ease of entry. Others include whether the product is differentiated, whether it is durable, whether competitors have similar cost structures, and whether pricing is transparent.[17] Just as important, the Merger Guidelines ask whether the merger will affect the market's

12 . *See, e.g., Walton v. Nalco Chemical Co.*, 272 F.3d 13, 25 (1st Cir. 2001).

13 . *Palmer v. Hoffman*, 318 U.S. 109 (1943).

14 . *See, e.g.,* Ken Heyer, Predicting the Competitive Effects of Mergers by Listening to Customers (forthcoming, Antitrust Law Journal, 2006).

15 . Fed. R. Evid. 803(6).

16 . DOJ/FTC Horizontal Merger Guidelines (1997) at § 1.11.

17 . *See, e.g.,* Richard A. Posner, Antitrust Law, 69-79 (2d ed. 2001).

structure by eliminating a maverick firm, making detection and punishment of cheating easier, or increasing the incentives to coordinate. Similarly, cases grounded in unilateral effects in differentiated product markets often include evidence as to whether the merging firms are close competitors and whether and how consumers divert purchases between the merging firms as relative prices change.

20. ·Evidence on one issue may helpfully corroborate (or undermine) another.[18] For example, internal documents from a company showing evidence of past coordination among certain firms can help confirm other evidence that those firms' products form an antitrust market.

4. Four Recent Cases in the United States

21. Four recent cases illustrate evidentiary issues that the agencies face in merger hearings. Two unsuccessful challenges, *Arch Coal*[19] and *Sungard*[20], raised issues relating to customer testimony. Two successful challenges in *UPM*[21] and *Staples*[22] highlight the importance that an agency offers evidence specifically addressing the agency's theory of competitive harm.

22. ***FTC v. Arch Coal-Triton*** **(2004)**. The government challenged Arch Coal's acquisition of Triton Coal's North Rochelle mine in the Southern Powder River Basin ("SPRB") of Wyoming. Before the acquisition, three large companies – Arch, Kennecott, and Peabody – owned a large majority of the SPRB mining capacity. The remaining capacity was controlled by fringe companies with smaller market shares. The Commission argued that the acquisition would increase the likelihood that the three largest SPRB coal producers would coordinate to reduce output. The Commission relied on evidence from the parties' documents that the mine operators had announced their future intentions with regard to production; publicly encouraged other coal producers to have production discipline; and kept detailed information regarding the production and capacity at rivals' mines. The Commission also presented a number of customers as witnesses who testified about the benefits of having multiple suppliers of SPRB coal.

23. The court was unpersuaded by the Commission's evidence and denied the preliminary injunction request. The court discounted the customers' proffered statements of concern about the transaction. Although the court said it did not doubt the customers' sincerity, the court concluded that "the substance of the concern articulated by the customers is little more than a truism of economics: a decrease in the number of suppliers *may* lead to a decrease in the level of competition. Customers do not, of course, have the expertise to state what *will* happen in the SPRB market, and none have attempted to do so."[23]

24. ***United States v. Sungard Data Systems, Inc.*** The merging parties sold disaster-recovery services for businesses' computer systems, and the Antitrust Division argued that the relevant product market was shared hotsite services for customers with mainframe and midrange computer systems.[24] Excluded from the Division's product market were a number of other types of disaster-recovery services: internal hotsites, quick-ship services, coldsites, work-area recovery, mobile hotsites, and high-availability services. The narrower market definition dramatically affected market concentration. Under the Division's proposed market definition, the acquisition would create a duopoly, with the post-merger firm holding a 71% market

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18 . *See, e.g., Commentary on the Horizontal Merger Guidelines* at 14-15.

19 . *FTC v. Arch Coal, Inc.*, 329 F. Supp.2d 109 (D.D.C. 2004).

20 . *United States v. Sungard Data Systems, Inc.*, 172 F. Supp.2d 172 (D.D.C. 2001).

21 . *United States v. UPM-Kymmene Oyj*, 2003 WL 21781902 (N.D. Ill. July 23, 2003) (unpublished).

22 . *FTC v. Staples*, 970 F. Supp. 1066 (D.D.C. 1997).

23 . *Arch Coal, Inc.*, 329 F. Supp.2d at 146.

24 . *Sungard Data Systems, Inc.*, 329 F. Supp. 2d at 181.

share.[25] In contrast, the defendants alleged that including external and internal hotsites for mainframe and midrange computers in the market definition would yield a post-merger share of only 35%.[26]

25. In rejecting the government's proposed product market, the court explained that the defendants' approximately 7,500 customers were "extremely" varied in both their needs and the computer equipment they used and that the Division relied on too limited a sample of customers from the proposed product market in gauging the effects of a price increase.[27] The court noted that the Division had submitted statements from 50 customers saying that they would not switch products in the face of a price increase, but that the defendants had submitted 90 statements from customers saying that they would switch products if faced with a price increase.[28] Noting the significant differences among customers in their needs and computer equipment, the court concluded that the Division had failed to show what customers in its proposed product market would do in the face of a price increase and consequently had failed to show how a hypothetical monopolist in that market would behave. The court concluded that it could not determine whether the government's 50 declarations were "representative of the shared hotsite client base."[29]

26. ***United States v. UPM-Kymmene Oyj.*** The government successfully challenged this merger between two companies in the paper industry that make adhesive labels. At trial, the Antitrust Division relied on coordinated effects as the theory of competitive harm. In blocking the transaction, the district court accepted the government's claim that there were two relevant product markets, bulk VIP prime labels and bulk prime labels, both of which were types of paper-faced adhesive labels. A key issue posed by the case was whether coordination was likely between the post-merger firm and the leading firm, which collectively would have held about a 70% share. A closely related issue was whether the remaining fringe firms would defeat any attempted price increases post-merger.

27. At trial, the Division presented internal documents and other evidence showing which firms had followed past price increases, as well as evidence showing the ability of the leading firm and the post-merger firm to punish firms that did not go along with price increases. Similarly, there was evidence that one of the parties to the merger, which had previously been an aggressive competitor, would have a reduced incentive to compete once it acquired additional share and capacity through the merger. The leading firm and one of the merging parties also had previously discussed their mutual concerns about intense price competition; the post-merger firm's role as a supplier to the leading firm provided another means to enhance cooperation, rather than competition, between the firms. Finally, the Court relied on evidence that fringe producers had insufficient capacity to discipline a coordinated price increase by the two incumbent firms.

28. ***FTC v. Staples***. Staples, Inc., a chain of office-supply superstores, proposed to acquire Office Depot, Inc., another chain of office-supply superstores. The proposed transaction would have combined two of the three national office-supply chains. In challenging the transaction, the Commission argued that the relevant product market was limited to supplies sold at office-supply superstores and did not include sales from other places where customers could buy office supplies.

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25 . *Id.* at 181.

26 . *Id.* at 187.

27 . *Id.* at 182-83, 189.

28 . *Id.* at 191.

29. *Id.* at 193. The agencies continue to believe that the views of customers are important to the substantive analysis of the competitive effects of mergers and that sophisticated customers can provide relevant testimony in litigation challenges to transactions. Based on their experience in reviewing thousands of mergers, the agencies have found that customers' business needs and responsibilities often require that they become highly knowledgeable about certain aspects of competition in their suppliers' markets.

29. In persuading the court to block the transaction, the Commission demonstrated that, in metropolitan areas where a superstore faced no rival office-supply superstore, it charged higher prices than in areas where it faced superstore competition. Other evidence demonstrated that each superstore regularly dropped prices in areas where another superstore entered, but did not do so in response to entry by other sellers of office supplies. The evidence relating to the impact of competition on pricing consisted of the parties' own business documents and through comprehensive econometric analysis. In addition, newspaper advertising and other promotional materials reflected greater price competition in areas where the superstores faced local rivalry from another superstore.