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Premerger Divestiture

Janet McDavid • Andrew J. Graziani

If antitrust counsel forsee competitive problems, the merging companies can propose to divest a package of assets.

Janet L. McDavid, a partner at Washington's Hogan & Hartson, is a past chair of the ABA's Section of Antitrust Law. Andrew J. Graziani is an associate at the firm.

THE FEDERAL TRADE Commission (FTC) or the Department of Justice's Antitrust Division can review, and can either clear or attempt to block, most large mergers. When the merger raises competitive concerns, the agencies may require a remedy, such as divestiture of assets by the parties, before approving the merger.

These divestiture requirements generally impose a time limit on the parties to negotiate the sale of the identified assets. The agencies also maintain jurisdiction to review the proposed divestiture to make sure it is successful. Often, the merger cannot close until all divestiture requirements are met.

The divestiture approval process creates another regulatory step and can lead to delay in closing the merger. In order to make that process more efficient, the FTC's Bureau of Competition recently released a Statement on Negotiating Merger Remedies. See www.ftc.gov/bc/bestpractices/bestpractices030401.htm. The statement can be used by experienced antitrust counsel to help merging companies negotiate an appropriate remedy and close the merger with a minimum of delays.

When antitrust agencies require a merger remedy, the goal is to maintain or restore the competition that may be reduced by the merger. As a result, the agencies focus on ensuring that all appropriate assets are divested; evaluating the ability of the buyer to manage the assets effectively and compete in the relevant market; and assessing whether the divestiture agreement meets the requirements of the divestiture order. Only when all of those hurdles are met will the agencies approve a remedy.

In August 1999, the FTC completed a study reviewing the success or failure of all of the FTC-ordered divestitures between 1990 and 1994. This study identified a number of factors that correlated with successful divestitures; i.e., divestitures that maintain the level of competition existing before the merger. Many of the study's results form the foundation for the FTC's recent remedies statement. See Janet L. McDavid and Corey Roush, "What's the FTC Up To?," NLJ, April 10, 2000, at B6.

The importance of divesting the right assets

When antitrust counsel foresee a competitive problem, the merging companies can propose to divest a package of assets. When the agency identifies competitive problems and initiates a discussion about remedies, the parties have an opportunity to negotiate the scope of the remedy. In either case, the merger partners should focus on several recommendations in the remedies statement:

- Divesting an autonomous business unit, rather than a collection of separate assets, is preferred. If the assets have been successfully run as a unit by one of the merging parties, the FTC is more likely to be satisfied that a buyer can be an effective competitor with those assets.

- If the assets do not comprise a coherent business unit, e.g., a package of intellectual property, the parties should be prepared to explain how those assets will allow a prospective buyer to compete successfully. This may require that the parties identify an upfront buyer so they can demonstrate how the divested assets would be integrated with the buyer's existing assets.

- When combining assets not previously operated together, the parties must take the extra step of demonstrating how these assets will allow the buyer to provide adequate competition.

No matter how complete the package of divested assets, the agencies will not approve a divestiture if they have concerns whether the prospective buyer can operate the assets effectively and restore lost competition. The FTC remedies statement indicates that the companies should consider the following:

- The FTC wants to ensure that the buyer has the financial resources to acquire the assets and the ability and incentives to be competitive over the long term. The FTC will therefore be concerned with the financial strength of the buyer and any prior experience it has in the line of business. The FTC will also inquire into the buyer's rationale for acquiring the assets and likely long-term profitability.

- Buyers that are active in related product markets or adjacent geographic markets, or those who are involved in upstream or downstream markets, are often good candidates.

- Large incumbent competitors will rarely be considered acceptable buyers because their purchase of the assets will raise independent competitive problems.

- Presenting an up-front buyer - one who has already agreed to purchase the assets the merging parties propose to divest - can often help streamline the

process. When the assets being divested are not an autonomous business unit, the FTC may require an up-front buyer.

- If the buyer needs to obtain financing to purchase the assets, the FTC must be assured that those arrangements can be made. Seller financing is generally discouraged since it promotes continuing ties between the seller and buyer.

- In evaluating the buyer, the agency will conduct its own research, which will likely include interviewing the buyer, customers, suppliers, competitors and other possible buyers. The agency will also ask for a business plan and other financial data that indicate the buyer's ability and incentive to purchase the assets and to manage them competitively.

Agency staff will closely review the divestiture agreement and, in some cases, the agency may recommend revisions to the agreement. Counsel may be surprised by the detailed nature of the review and the questioning of exhaustively negotiated provisions. To minimize the concerns the FTC may have with the divestiture agreement, the parties should consider the following:

- The divestiture agreement must transfer all assets subject to the divestiture order.

- Nonsolicitation and noncompete clauses will be closely reviewed and may raise concerns, particularly when they continue for a long time.

- Although the agency will turn to the buyer for help in evaluating the terms of the divestiture agreement, the FTC's review will not stop there. Since the FTC believes the buyer's incentives may differ from its own, the FTC may contact customers, suppliers, and other competitors. These inquiries will supplement interviews with the buyer's counsel and executives and a review of financial and operational information the buyer provides.

- Any third-party consents and regulatory approvals generally must be obtained before the FTC will approve the divestiture. When the FTC orders the merging parties to divest certain assets, it may require more than just a divestiture. In some cases, the FTC will require that the seller provide certain transition services, technical assistance with intellectual property, temporary supply agreements or incentives to encourage the transfer of key employees to give the buyer a quick start.

If the assistance will create an on-going relationship between the buyer and seller, the FTC may appoint an independent third-party monitor to ensure compliance with the divestiture order. The monitor reports to the FTC, but is compensated by the parties. When the merger is likely to close before completion of the divestiture, the FTC may also insist on an "order to hold separate." To preserve competition,

these orders require the divesting party to maintain an independent entity to operate all of the assets to be divested. The FTC's main concern here is a weakening of the assets to be divested and any resulting harm to competition. These orders also usually appoint an independent third party both to monitor compliance with the order and to oversee the operation of the held-separate business.

What should be included in a divestiture application

When the FTC conditions merger approval on the divestiture of certain assets, the acquiring party in the merger must submit a divestiture application. In reviewing the application, the FTC will evaluate both the proposed buyer and the divestiture agreement. While there is no specific format for the application, there are several important things that the divestiture application must include:

- The application should represent that all of the assets that must be divested are part of the divestiture agreement. A copy of the final divestiture agreement and all exhibits should be included.

- The application should include a description of the buyer's business and copies of its recent annual reports, 10K forms and financial statements.

- The buyer should also be prepared to submit a detailed business and financial plan for operating the assets as part of the divestiture application.

After receipt of the divestiture application, FTC staff will conduct due diligence on the proposed divestiture and the buyer, including interviews with the buyer. Given the length of time it often takes for the FTC to review proposed divestitures, merging companies and their counsel can take a number of steps to make the process run more smoothly and help ensure timely clearance.

- Engage antitrust counsel early to help identify any potential competitive concerns. If a divestiture is likely to be necessary, an up-front proposal can be prepared, which can expedite the process. In some cases, the problematic assets can be sold prior to announcement of the deal or the filing of a premerger notification, thereby bypassing the divestiture review process entirely.

- The parties should not be surprised by the intensity of the divestiture review. Even when the seller and buyer are large, sophisticated entities, the FTC will closely review the terms of the agreement and may require amendments. The FTC is willing to substitute its judgment for that of business people.

- When selecting potential divestiture buyers, the seller should conduct due diligence on how well the buyer will meet the FTC's requirements.

- Buyers should be prepared to show a long-term commitment and ability to provide competition in the given market.
- Counsel should note that the FTC's guidelines are limited to that agency.

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