A tougher climate

EU merger control has become more challenging

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This article discusses three developments in EU merger control in recent horizontal merger cases: first, an apparent increased reliance by the European Commission (Commission) on the theory of unilateral effects in the absence of single dominance; second, the increased use by the Commission of two structural measures in divestiture remedies – reverse carveouts and upfront buyer approvals; and third, changes in the Commission's review process, specifically in relation to internal documents and market investigations.

Unilateral effects in the absence of single dominance

▌**Mergers in concentrated markets are presumed anticompetitive.** The Commission has raised concerns in a number of recent horizontal merger cases that resulted in a reduction in the number of key suppliers in relatively concentrated markets where no single firm was dominant (eg Case M7559 Pfizer/Hospira, Case M 7555 Staples/Office Depot, Case M 7278 GE/Alstom).

The Commission's starting point appears to be the identification of unilateral effects concerns for all horizontal mergers that decrease the number of key suppliers in relatively concentrated markets, without providing clear-cut thresholds. This is based on the economic theory of oligopolistic competition and difficult, if not impossible, to rebut with empirical evidence.

For example, in Pfizer/Hospira, the Commission raised concerns due to a reduction in the number of suppliers from five to four in three years' time (the merger would have eliminated a pipeline product). In other cases, the Commission found unilateral effects in mergers that would decrease the number of key suppliers from five to four or four to three, etc. As regards the relevant market share thresholds, the Commission indicated in Case M 7421 Orange/Jazztel that there is a presumption of no concerns below a combined market share of 25% (in that case, concerns were found despite the merged entity only obtaining a combined share of 27.45%).

What has become clear is that 3-to-2 mergers are deemed anticompetitive unless exceptional circumstances apply. Previously, where unilateral effects concerns were identified in 3-to-2 mergers, the Commission showed that the merger would eliminate a particularly aggressive or close rival and that the market had high expansion and entry barriers (eg Case M 2861 Siemens/Drägerwerk/JV). By contrast, the Commission's reasoning in Staples/Office Depot demonstrates that anticompetitive concerns in 3-to-2 mergers are difficult to rebut, even if the market in question is characterised by insignificant expansion and entry barriers.

The only possible defence against such concerns appears to be to demonstrate that the merging parties are distant competitors that have to a large degree a complementary offering. Indeed, in 2015, the Commission unconditionally cleared Case M 7429 Siemens/Dresser-Rand (a 3-to-2 merger) having found the parties not to be close competitors as they focused on different market segments. Such a defence is less likely to succeed in relatively homogeneous markets where there is less scope to differentiate. As such, all else being equal, the risk of a finding of unilateral effects seems higher in such markets.

▌**"Closest", "particularly close" or just "close"?** The Commission's approach regarding the requisite degree of closeness of substitution between the merging parties' offerings for concerns to arise has clearly become stricter. In the early 2000s, concerns were only found at clear levels of single dominance. Pre-2004, only the removal of the closest competitor could cause concerns. Post-2004, the Commission started intervening against mergers that eliminated a particularly important or close constraint. And now it suffices that a merger removes merely a close or important constraint. Obviously, in a relatively concentrated market, virtually all players can be considered important constraints and concerns therefore can be easily found: eg Case M 6992 Hutchison 3G UK/Telefonica Ireland (2014).

▌**Ability versus incentive.** The Commission's starting position now appears to be that, in concentrated markets, competitors may have the ability to increase output to defeat a small but significant increase in price but will not have the incentive to do so as it may be more profitable for them to follow a post-merger price rise (see eg Case M 6905 Ineos/Solvay). As such, the argument that there is spare capacity is no longer sufficient to dispel concerns and it is very difficult to prove that competitors have the incentive to increase output.

▌**Conclusion.** The Commission has lowered its threshold for identifying concerns based on unilateral effects, resulting in it intervening against mergers which previously would have been expected to be cleared unconditionally, due to the parties not being particularly close rivals, credible alternative suppliers, low expansion and entry barriers, buyer power, etc. As a result, companies should expect unilateral effects concerns in mergers in relatively concentrated markets and, if they cannot explain why they are distant competitors, be ready to put remedies on the table.

From both a legal and economic perspective, the Commission's approach towards unilateral effects is questionable. But it is unlikely to be tested in court as companies are understandably unwilling to put their merger plans on the line to make such challenge.

Commission officials may argue that this assessment overstates the extent of change in its approach, citing merger statistics showing numbers of unconditional clearances, conditional clearances and prohibitions. These do not, however, properly reflect the Commission's lower thresholds for intervention because, first, parties alert to risks in EU merger control may now shelve merger plans likely to fall foul of the lower thresholds and, second, normally they do not reflect filings pulled, at least in part, because of the lower threshold of intervention (eg Case M 7566 Mondi/Walki Assets).

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New standards in remedies structures

At the outset, it is important to note that it may be difficult to detect any change in the Commission's approach towards remedies in the published versions of Commission decisions, as the discussion on remedies is often heavily redacted for confidentiality reasons.

▌**Reverse carveouts.** The remedies notice is clear that the Commission's preference in divestiture remedies is for an existing viable standalone business to be divested. However, the Commission is taking a stricter procedural approach by insisting increasingly that divestiture remedies comprising only part of a business are effected by reverse carveout – ie an "entire" business is sold and the parts of the divestiture business that are not problematic are sold back to the notifying party. This is intended to ensure that the divestiture business is truly a standalone business. However, it obviously creates uncertainty for the notifying party as to its scope and probably also decreases the attractiveness of the divestiture business for potential buyers who may not be interested in contractually assuming the entire business and then transferring back bits and pieces. Reverse carveouts are especially problematic when the business to be carved out in reverse is relatively substantial.

▌**Upfront buyer approval.** Under the "standard" remedy process, the main transaction may be closed upon receipt of the conditional clearance decision and the notifying party typically has six months to negotiate an agreement with a suitable buyer. With an upfront buyer approval, the main transaction cannot close until agreement with a suitable buyer has been reached and approved by the Commission, pushing back closing by a number of months. This has a profound impact on the timing of the deal – for example, determination of the long-stop date.

The remedies notice provides that an upfront buyer requirement may be necessary where there are considerable obstacles or risks associated with the divestiture. However, recently, upfront buyers appear to be the general rule and not the exception, especially for Phase II horizontal merger cases. In 2015, the Commission required an upfront buyer in most Phase II merger cases cleared subject to divestiture remedies.

Moreover, it is arguably inconsistent for the Commission to require both a reverse carveout (or more substantial remedies) and an upfront buyer, as it often does. If the Commission has to approve the divestiture buyer before the merging parties can close, the buyer can negotiate what it needs beyond the scope of the competition concerns, as opposed to the Commission overburdening the business "just in case".

▌**Conclusion.** When proceeding with a deal that is likely to raise concerns, it is now even more important than before to consider the commercial downside (both the costs as well as the likely delay) that would result from remedies, and to prepare remedies as early as feasible, including the identification of suitable buyers.

Process

▌**Increased reliance on internal documents.** Section 5.4 of the Form CO requires the parties to provide internal board documents, as well as relevant analyses, reports, studies, surveys and comparable documents from the past two years. However, in recent complex cases, the Commission has requested all relevant internal documents, including emails (eg Cases M 7477 Baker Hughes/Halliburton, Siemens/Dresser-Rand, Mondi/Walki Assets, Staples/Office Depot). Such requests are usually made in Phase II but can occur in Phase I or even prenotification (eg Staples/Office Depot).

Parties need to be alert to this risk as, even with negotiated search terms and custodians, these requests easily yield hundreds of thousands of documents. It is therefore often not possible to review all documents prior to submission, particularly given the tight deadlines under EU merger control. Perhaps even more worryingly, the Commission has in a number of cases also requested detailed internal documents from third parties, especially competitors (eg Orange/Jazztel).

▌**Market feedback is more crucial than before.** The Commission has always placed heavy reliance on feedback from customers and competitors received during its market investigation. It appears, however, from recent cases that market feedback from respondents (who are often not required to support their statements or concerns) is now more influential than the substance of the Form CO and other reasoned submissions of the merging parties. It also seems that only a "significant minority" of customers need to provide negative feedback to support a finding of concerns. Moreover, under the Commission's approach towards unilateral effects, it is more likely that the feedback supports a finding of concerns from unilateral effects, as it only requires a finding of reduced competition rather than dominance.

▌**Longer review process.** The European Commission's review process has become markedly longer in horizontal merger cases in concentrated markets. In particular, prenotification can now easily last six months in cases giving rise to substantive questions (eg GE/Alstom, Staples/Office Depot, Halliburton/Baker Hughes).

This is mainly due to more extensive information requests and "informal" market testing without there being necessarily a greater likelihood of avoiding second phase, as is evidenced by these cases which all went to second phase. This development, in combination with increased application of an upfront buyer approval, indicates that companies should exercise increased caution when predicting the likely time needed to obtain approval from the Commission to close their transaction.

▌**Conclusion.** In short, companies now have far less influence over the review process due to the increased value the Commission places on the parties' internal documents as well as market feedback. This makes it even more important than before to review properly relevant internal documents before any submissions are made and to appreciate that the outcome of EU merger control depends foremost on the feedback the Commission receives from third parties. While companies have limited options to influence third parties' feedback (eg GE/Alstom and Ineos/Solvay, where the European Commission was particularly strict) they should exercise caution where they can, namely in the preparation of internal documents, especially in the run-up to a merger.

Final thoughts

EU merger control has become more challenging and cumbersome in complex horizontal cases, and parties need to be prepared to adjust their merger plans and timescales accordingly. This trend looks set to continue. At the time of writing, the Commission had just opened a Phase II investigation in Case M 7932 Dow/DuPont, highlighting innovation concerns post-merger in concentrated markets.