2020 FORUM ON

M&A AND GOVERNANCE

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CLE Materials: Regulatory Deal Risk

FORUM ON M&A AND GOVERNANCE 2020 U.C. BERKELEY

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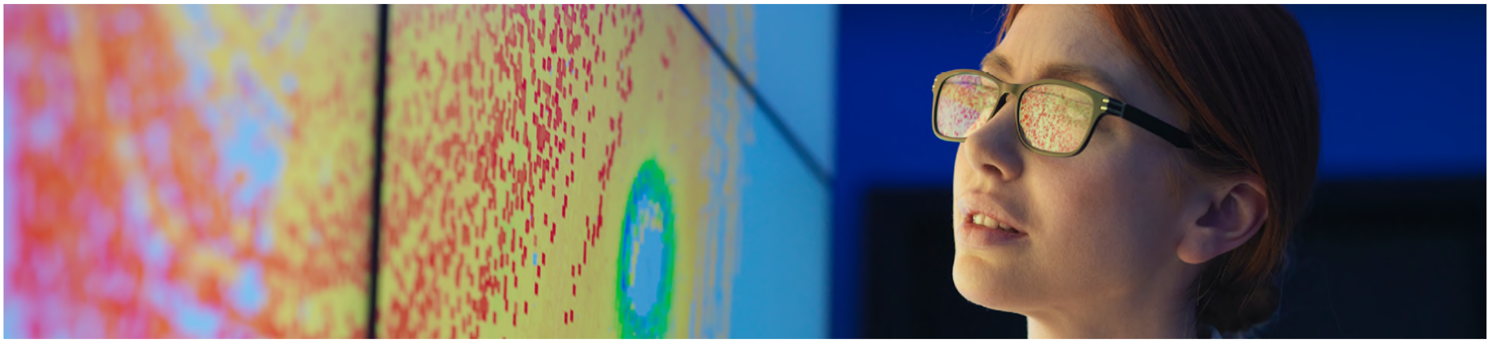

10 key themes

Strategic acquisitions

Assessing risk in an era of heightened intervention in deals

Which deals are likely to face greater scrutiny in 2020?

Transactions in innovative industries, such as pharmaceuticals and tech, remain high on the agenda of merger control authorities globally amid concerns about potential under-enforcement in recent years.

As competition authorities seek to predict the impact of proposed transactions on potential future competition in complex and rapidly evolving markets, companies planning strategic acquisitions need to prepare for a rigorous review.

Transactions involving digital markets remain an area of specific focus for merger review in view of their importance to the global economy and the difficulty of evaluating their impact on potential future competition. Authorities around the globe have held hearings, established task forces and commissioned studies considering the effectiveness of current merger control tools in digital markets, both whether the correct transactions are subject to the review process and whether reviewed transactions are being cleared when they should have been subject to remedies or prohibited altogether (see theme 1).

Many start-ups ultimately aim to be bought out by a larger company to give them access to better resources and a wider customer base. Whilst the impact of such acquisitions will in many cases be pro-competitive, authorities remain concerned that some of these transactions have the specific intention of slowing innovation and removing potential future competition: so-called 'killer acquisitions'.

In view of the small size of such targets, which may not yet be revenue generating, these transactions are not necessarily subject to merger review in many jurisdictions. The US has always had a transaction value threshold for mandatory merger review (and revised it specifically after the internet boom to capture the acquisition of certain high-value, low-revenue targets), and the German and Austrian authorities introduced this in 2018 to catch transactions (particularly in digital markets) where turnover is low but valuation is high.

The European Commission canvassed opinion about introducing a transaction value threshold in 2017 but has not taken this forward so far, although Executive Vice-President Vestager has indicated her continuing interest in this area.

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Whilst a transaction value threshold is not currently anticipated at EU level, following the introduction of transaction value thresholds in Germany and Austria we can expect more acquisitions of successful smaller companies to come to the authorities' attention, raising the potential of referral up to the European Commission, which the parties should provide for in transaction planning.

Martin Klusmann
Antitrust Partner,
Düsseldorf

In their substantive review, authorities continue to grapple with how to analyse the specific features of digital markets, in particular access to data and network effects. Across all industries, the authorities' focus on innovation theories of harm continues and companies should expect detailed review of this issue in future transactions. Particularly in focus is what merging parties' plans would have been absent the transaction at hand and the impact of those alternative plans on market structure and competitiveness.

Anticipating higher levels of intervention

As antitrust authorities become more interventionist generally, borderline cases that might have been cleared five to ten years ago now face closer scrutiny and risk. Recent examples in the US include the Federal Trade Commission's ongoing challenges to the *Tronox/Cristal* and *Evonik/PeroxyChem* mergers.

The EU General Court's judgment in *CK Hutchison's* challenge of the European Commission's decision to prohibit its proposed acquisition of UK mobile operator *O2* is also anticipated in the first half of 2020. This judgment is expected to be the first to review the 'significant impediment to effective competition' test that was introduced for EU merger review in 2004, and the Commission's increasingly expansive interpretation of this standard over the last 10 years. The judgment will also be the first ruling by the EU Courts on what has been seen as a restrictive approach by the Commission to in-country consolidation in telecoms markets.

This follows the 2019 *UPS* judgment where the Court of Justice criticised the Commission for failure to disclose relevant evidence. That failure is now the basis for a €1.7bn damages claim by *UPS* against the Commission.

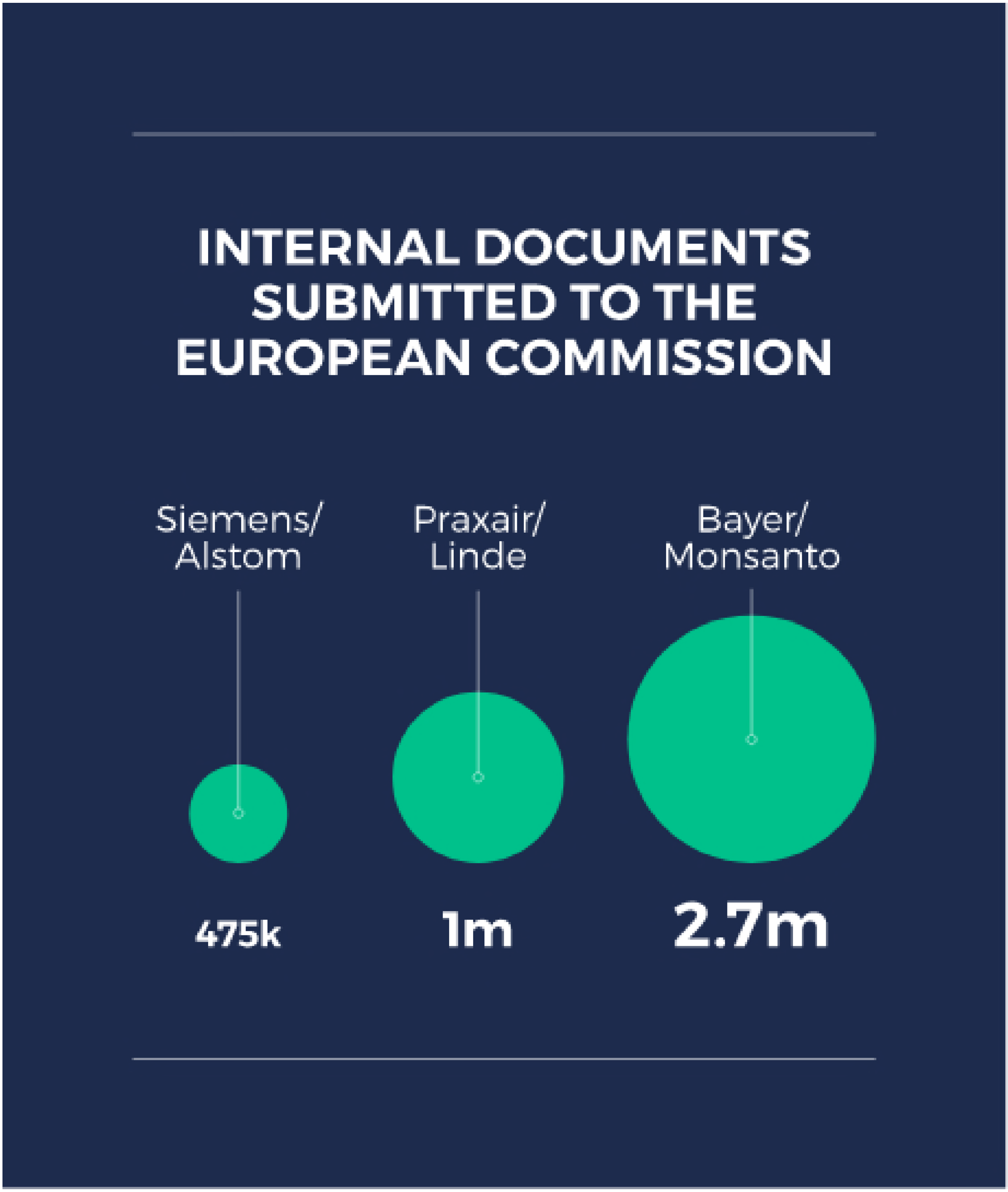
The role of evidence – internal and third party

As authorities seek to determine these increasingly complex issues within the confines of the merger review timetable, the parties' internal documents are an important focus. Companies should anticipate significant internal document production as part of the review.

Whilst customer feedback has always been taken very seriously by merger control authorities, issues raised by competitors are increasingly playing into authorities' theories of harm, and the parties will want to think carefully about likely third-party reactions in planning their merger review strategy.

Buyers should take particular care in evaluating potential synergies and how and where these might arise when assessing the business case for the transaction – careless wording can raise concerns about the buyer's intentions that can be hard to dismiss.

Deirdre Trapp
Antitrust Partner,
London



Impact on deal timing and certainty

With increasingly rigorous merger reviews around the globe, parties are seeking to provide for this in transaction documents through lengthening the period between signing and closing. Sellers wishing to achieve certainty of execution are requiring that buyers commit to making significant efforts to secure necessary merger control approvals, including seeking unconditional obligations to take all necessary steps to do so ('hell or high water' clauses). Both parties need to front load their antitrust analysis to be able to negotiate their position in relation to such requirements.

> No buyer covenant to achieve closing (even a hell or high water commitment) is necessarily risk free. Where the outcome of regulatory review is uncertain, merger parties ought to be prepared to negotiate reverse termination fees that come due if the buyer fails to receive the requisite regulatory clearances. The nuances of the triggers of these fees, whether they constitute liquidated damages, whether they are payable in the form of cash or strategic assets, and the exceptions to the triggers are among the issues that can make a difference for a well-advised party.

Ethan Klingsberg
Global Transactions Partner,
New York

The potentially lengthy period between signing and closing is a period of uncertainty for the target business, and buyers will want to limit the potential for value loss and the defection of key staff during that period. Continued vigilance around potential gun-jumping can be expected from authorities around the globe, and care must be taken in providing for buyer oversight of and decisions regarding the conduct of the target business pre-closing. Authorities may raise questions on deal protocols during the merger review, so it is critical that this does not go further than necessary to protect the value of the investment.

Remedy strategy

Antitrust agencies have demonstrated their continued preference for structural (or quasi-structural) over behavioural remedies in recent cases. Remedies in innovation cases are almost always likely to be structural: the parties should think in terms of a stand-alone R&D unit unless it is possible to show that specific assets can be carved out without undermining their innovation potential. On the other hand, fair, reasonable and non-discriminatory (FRAND) type obligations would seem more likely to address concerns regarding big data. A 10-year series of FRAND commitments was recently accepted by the European Commission to address concerns regarding access to TV channels, streaming services and advertising space in relation to a proposed broadcasting acquisition.

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If an authority has concerns regarding what it views as a “killer acquisition”, limited or targeted divestitures may not work (or be applicable) and the parties may need to convince the authority on the substance to avoid a prohibition or litigation.

Jenn Mellott
Antitrust Counsel,
Brussels and Washington DC

The remedy process has become significantly more complex over the last 10 years – merger control authorities are taking more time to review and test the parties’ proposals and demanding larger commitments to address their concerns. The remedy process is dynamic and open to manipulation by interested third parties. Merging parties need to ensure there is enough time to address any concerns within the merger review timetable.

Concerns about the practicality of implementation and viability may lead to remedies that are greater in product and/or geographic scope than strictly necessary to remove the overlap between the parties. Fix-it-first or upfront buyer requirements are an increasingly material possibility to address viability concerns, and parties need to factor this into transaction planning. The parties may be prepared to accept a longer pre-notification period (including pre-notification market testing) to seek to reduce the authority's concerns before the formal filing timeline starts, but need to ensure sufficient time remains at the back end of the transaction timetable to provide for remedies negotiation and implementation.

Antitrust authorities are market-testing remedies much more extensively than they did 10 years ago. The statutory deadlines for submitting remedy proposals do not always reflect this and may not provide enough time to negotiate a solution. It is therefore crucial to start the remedy process sufficiently early in the merger review.

Thomas Wessely
Antitrust Partner,
Brussels

U.S. DEPARTMENT OF JUSTICE AND THE FEDERAL TRADE COMMISSION

DRAFT VERTICAL MERGER GUIDELINES

RELEASED FOR PUBLIC COMMENT ON JANUARY 10, 2020

1. OVERVIEW

These Guidelines outline the principal analytical techniques, practices and enforcement policy of the Department of Justice and the Federal Trade Commission (the "Agencies") with respect to vertical mergers and acquisitions ("vertical mergers") under the federal antitrust laws.[1] The relevant statutory provisions include Section 7 of the Clayton Act, 15 U.S.C. § 18, Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§ 1–2, and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. Most particularly, Section 7 of the Clayton Act prohibits mergers if "in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." This provision applies to vertical mergers[2], as Congress made plain in the 1950 amendments to the Clayton Act.

These Guidelines should be read in conjunction with the Horizontal Merger Guidelines.[3] The principles and analytical frameworks used to assess horizontal mergers apply to vertical mergers. For example, Section 1 of the Horizontal Merger Guidelines—describing in general terms the purpose and limitations of the Horizontal Merger Guidelines and the goals of merger enforcement—is also relevant to the consideration of vertical mergers. Other topics addressed in the Horizontal Merger Guidelines, but not addressed herein, such as the analytic framework for evaluating entry considerations, the treatment of the acquisition of a failing firm or its assets, and the acquisition of a partial ownership interest, are relevant to the evaluation of the competitive

[1] These Guidelines supersede the extant portions of the Department of Justice's 1984 Merger Guidelines, which are now withdrawn and superseded in their entirety. They reflect the ongoing accumulation of experience at the Agencies. These Guidelines may be revised from time to time as necessary to reflect significant changes in enforcement policy, to clarify existing policy, or to reflect new learning. These Guidelines do not cover horizontal or other types of non-vertical acquisitions.

[2] Vertical mergers combine firms or assets that operate at different stages of the same supply chain. Examples of vertical mergers include: a manufacturer acquiring one of the firms that supplies it with parts; or a retail chain buying the manufacturer of one of the consumer products that it sells. In describing a vertical relationship, the stage closer to final consumers (such as a distributor, retailer, or finished goods manufacturer) is termed "downstream," and the stage farther from final consumers (such as a supplier, wholesaler, or input manufacturer) is termed "upstream."

[3] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (2010).

effects of vertical mergers as well. Vertical mergers, however, also raise distinct considerations, which these Guidelines address.

These Guidelines are intended to assist the business community and antitrust practitioners by increasing the transparency of the analytical process underlying the Agencies' enforcement decisions. They may also assist the courts in developing an appropriate framework for interpreting and applying the antitrust laws in the vertical merger context.[4]

2. MARKET DEFINITION AND RELATED PRODUCTS

In any merger enforcement action involving a vertical merger, the Agencies will normally identify one or more relevant markets in which the merger may substantially lessen competition. Many of the general purposes and limitations of market definition described in Section 4 of the Horizontal Merger Guidelines are also relevant when the Agencies define markets for vertical mergers, and the Agencies use the methodology set forth in Sections 4.1 and 4.2 of the Horizontal Merger Guidelines to define relevant markets for vertical mergers.

When the Agencies identify a potential competitive concern in a relevant market, they will also specify one or more related products. A related product is a product or service that is supplied by the merged firm, is vertically related to the products and services in the relevant market, and to which access by the merged firm's rivals affects competition in the relevant market. A related product could be, for example, an input, a means of distribution, or access to a set of customers.

> *Example 1: A retail chain buys a manufacturer of cleaning products. In this example, the Agencies may identify two relevant markets. The first potential relevant market is the supply of cleaning products to retail customers in a given geographic area. For this relevant market, the related product is the supply of the cleaning products by the manufacturer to retailers in the geographic area. The second potential relevant market is the supply of cleaning products to retailers in a given geographic area. For this relevant market, the related product is the purchase or distribution of that manufacturer's cleaning products to sell to retail customers in the geographic area.*

[4] These Guidelines are not intended to describe how the Agencies will conduct the litigation of cases they decide to bring. Although relevant in that context, these Guidelines neither dictate nor exhaust the range of evidence the Agencies may introduce in litigation.

3. MARKET PARTICIPANTS, MARKET SHARES, AND MARKET CONCENTRATION

The Agencies may consider measures of market shares and market concentration in a relevant market as part of their evaluation of competitive effects. The Agencies evaluate market shares and concentration in conjunction with other reasonably available and reliable evidence for the ultimate purpose of determining whether a merger may substantially lessen competition.

The Agencies use the methodology set out in Sections 5.1, 5.2 and 5.3 of the Horizontal Merger Guidelines to measure shares and concentration in a relevant market, but do not rely on changes in concentration as a screen for or indicator of competitive effects from vertical theories of harm.

The Agencies may also consider measures of the competitive significance of the related products as part of their evaluation of competitive effects in a relevant market. One such measure may be the share of the output in a relevant market that uses the related products. If the related products are used in a smaller share of sales in the relevant market the merged firm's control of the related products may be less likely to have substantial effects on competition in the relevant market.

> *Example 2: Company A is a wholesale supplier of orange juice. It seeks to acquire Company B, an owner of orange orchards. The Agencies may consider whether the merger would lessen competition in the wholesale supply of orange juice in region X (the relevant market). The Agencies may identify Company B's supply of oranges as the related product. Company B's oranges are used in fifteen percent of the sales in the relevant market for wholesale supply of orange juice. The Agencies may consider the share of fifteen percent as one indicator of the competitive significance of the related product to participants in the relevant market.*

The Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market.

In some circumstances, mergers with shares below the thresholds can give rise to competitive concerns. For example, the share of the relevant market that uses the related product may understate the scope for material effects if the related product is relatively new, and its share of use in the relevant market is rapidly growing. Moreover, a share of 20 percent or more in the relevant market or a related products' share of use in the relevant market of 20 percent or more, or both, does not, on its own, support an inference that the vertical merger is likely to substantially lessen competition. The purpose of these thresholds is not to provide a rigid screen to separate competitively benign mergers from anticompetitive ones. Rather, they provide one way to identify some mergers unlikely to raise competitive concerns and some others for which it is particularly important to examine other competitive factors to arrive at a determination of likely competitive effects.

4. Evidence of Adverse Competitive Effects

The Agencies consider any reasonably available and reliable evidence to address the central question of whether a vertical merger may substantially lessen competition. The types of evidence described in Section 2.1 of the HMG can also be informative about the effects of vertical mergers, including: actual effects observed in consummated mergers, direct comparisons based on experience, and evidence about the disruptive role of a merging party. Pre-existing contractual relationships may affect a range of relevant market characteristics. The Agencies also consider market shares and concentration in relevant markets and related products (see Section 3), and may rely on evidence about head to head competition between one merging firm, and rivals that trade with the other merging firm, when evaluating unilateral effects (see Section 5). The sources of evidence the Agencies rely on are the same as those set forth in Section 2.2 of the Horizontal Merger Guidelines and include documents and statements of the merging parties, their customers, and other industry participants and observers.

5. Unilateral Effects

A vertical merger may diminish competition between one merging firm and rivals that trade with, or could trade with, the other merging firm. Whether the elimination of double marginalization resulting from the merger, or cognizable efficiencies, are likely to reduce or reverse the adverse unilateral effects, is addressed in Sections 6 and 8.

This section discusses common types of unilateral effects arising from vertical mergers. Section (a) discusses foreclosure and raising rivals' costs. Section (b) discusses competitively sensitive information. These effects do not exhaust the types of possible unilateral effects.

a. Foreclosure and Raising Rivals' Costs

A vertical merger may diminish competition by allowing the merged firm to profitably weaken or remove the competitive constraint from one or more of its actual or potential rivals in the relevant market by changing the terms of those rivals' access to one or more related products. For example, the merged firm may be able to raise its rivals' costs by charging a higher price for the related products or by lowering service or product quality. The merged firm could also refuse to supply rivals with the related products altogether ("foreclosure").

Where sufficient data are available, the Agencies may construct economic models designed to quantify the likely unilateral price effects resulting from the merger. These models often include independent price responses by non-merging firms. They also can incorporate the elimination of double marginalization (see Section 6) to give a likely net effect from changes to pricing incentives, as well as incorporate cognizable efficiencies (see Section 8). These merger simulation methods need not rely on market definition. The Agencies do not treat merger simulation evidence as conclusive in itself, and they place more weight on whether their merger simulations consistently predict substantial price increases than on the precise prediction of any single simulation.

A vertical merger may diminish competition by making it profitable for the merged firm to foreclose rivals in the relevant market by denying them access to a related product. Alternatively, the merger may increase the incentive or ability of the merged firm to raise its rivals' costs or decrease the quality of their rivals' products or services, thereby reducing the competitive constraints imposed by those rival firms. In identifying whether a vertical merger is likely to result in unilateral harm to competition through foreclosure or raising rivals' costs, the Agencies may consider whether:

> (1) The merged firm's foreclosure of, or raising costs of, one or more rivals would cause those rivals to lose sales (for example, if they are forced out of the market, if they are deterred from innovating, entering or expanding, or cannot finance these activities, or if they have incentives to pass on higher costs through higher prices), or to otherwise compete less aggressively for customers' business;
>
> (2) The merged firm's business in the relevant market would benefit (for example if some portion of those lost sales would be diverted to the merged firm);
>
> (3) Capturing this benefit through merger may make foreclosure, or raising rivals' costs, profitable even though it would not have been profitable prior to the merger; and,
>
> (4) The magnitude of likely foreclosure or raising rivals' costs is not *de minimis* such that it would substantially lessen competition.

Mergers for which each of these conditions are met potentially raise significant competitive concerns and often warrant scrutiny. The next paragraphs provide illustrative examples of the application of this general framework to different settings.

> *Example 3: In Example 2, the merged firm may be able to profitably stop supplying oranges (the related product) to rival orange juice suppliers (in the relevant market). The merged firm will lose the margin on the foregone sales of oranges but may benefit from increased sales of orange juice if foreclosed rivals would lose sales, and some of those sales were diverted to the merged firm. If the benefits outweighed the costs, the merged firm would find it profitable to foreclose. If the likely effect of the foreclosure were to substantially lessen competition in the orange juice market, the merger potentially raises significant competitive concerns and may warrant scrutiny.*

Example 4: Company A supplies a component (the related product) to Companies B and C, which each use to make final products in a downstream market (the relevant market). Companies A and B merge. When the merged firm bargains with Company C over the price of the related product, it may be more willing to hold out for higher prices compared to an unintegrated Company A because losing (or delaying) sales of the related product to Company C may be more costly for standalone Company A than for the merged firm. Higher prices paid by Company C for the related product may lead to higher downstream prices.

Example 5: Company A is the sole supplier of an active ingredient (the related product) for a pharmaceutical drug made by Company B (the relevant market). Company C is considering entering the relevant market. If Company B buys Company A, the merged firm may find it profitable to refuse to supply the ingredient to any rivals or potential rivals if doing so would deter Company C from entering, or prevent it from financing entry, by requiring it to start producing both the active ingredient and the drug at the same time (two stage entry). If refusing to supply entrants was profitable for the merged firm, and if the likely result was that competition in the relevant market would be substantially lessened compared to the level that would have obtained absent the merger, the merger potentially raises significant concerns and may warrant scrutiny.

Example 6: Company A distributes wholesale consumer cleaning products to retailers (the relevant market). It buys Company B, which makes one of the brands that Company A distributes. The merged firm may find it profitable to raise the price of wholesale distribution of rival brands (the related products) after the merger, even if the price rise was not profitable for the unintegrated Company A. As a result of the merger, the merged firm captures the upstream margin on any sales that are diverted from rival brands to Company B's brand. If the merged firm has a sufficiently important position in the relevant market, and the price rise it imposes on the wholesale distribution of rival brands is sufficiently high, competition may be substantially lessened compared to the level that would have obtained absent the merger, the merger potentially raises significant concerns and may warrant scrutiny.

b. Access to Competitively Sensitive Information

In a vertical merger, the combined firm may, through the acquisition, gain access to and control of sensitive business information about its upstream or downstream rivals that was unavailable to it before the merger. For example, a downstream rival to the merged firm may have been a premerger customer of the upstream firm. Post-merger, the downstream component of the merged firm could now have access to its rival's sensitive business information. Access to a rival's competitively sensitive information can, in some circumstances, be used by the merged firm to moderate its competitive response to its rival's competitive actions, for example it may preempt or react quickly to a rival's procompetitive business actions. Under such conditions, rivals may see less competitive value in taking procompetitive actions. Relatedly, rivals may refrain from doing business with the merged firm rather than risk that the merged firm would use their competitively sensitive business information as described above. They may become less effective competitors if they are forced to rely on less preferred trading partners, or if they pay higher prices because they have fewer competing options.

6. Elimination of Double Marginalization

Elimination of double marginalization can occur when two vertically related firms that individually charge a profit-maximizing margin on their products choose to merge. Absent the merger, the downstream merging firm would ignore any benefit to the upstream merging firm from setting a lower downstream price and making higher sales. But if the two merge, the resulting firm will benefit from both margins on any additional sales, and capturing the upstream margin, through merger, may make the price reduction profitable even though it would not have been profitable prior to the merger. Elimination of double marginalization may thus benefit both the merged firm and buyers of the downstream product or service.

The agencies generally rely on the parties to identify and demonstrate whether and how the merger eliminates double marginalization. There will be no elimination of double marginalization if the downstream firm cannot use the inputs from the upstream one, for example, because it uses an incompatible technology. The effects of the elimination of double marginalization may be lower if, prior to the merger, the merging parties already engaged in contracting that aligned their incentives, for example by using a two-part tariff with a fixed fee and low unit prices that incorporate no, or a small, margin. The effects of the elimination of double marginalization in the downstream market may also be offset by a change in pricing incentives working in the opposite direction: if the merged firm raises its price in the downstream market, downstream rivals may increase their sales, which could increase their demand for inputs from the merged firm's upstream business. Capturing this benefit through merger may make the downstream price increase more profitable.

The Agencies will not challenge a merger if the net effect of elimination of double marginalization means that the merger is unlikely to be anticompetitive in any relevant market.[5]

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[5] The Agencies may also consider elimination of double marginalization that is not strictly in the relevant market, using the principles set out in footnote 14 of the Horizontal Merger Guidelines for efficiencies that are inextricably linked.

7. Coordinated Effects

In some cases, a vertical merger may diminish competition by enabling or encouraging post-merger coordinated interaction among firms in the relevant market that harms customers. Section 7 of the Horizontal Merger Guidelines describes how the Agencies evaluate coordinated effects. In particular, Section 7.1 notes that the Agencies are more likely to challenge a merger on the basis of coordinated effects when the relevant market shows signs of vulnerability to coordinated conduct, and the Agencies have a credible basis on which to conclude that the merger may enhance that vulnerability. Section 7.2 sets forth evidence relevant to evaluating whether a market is vulnerable to coordination. The theories of harm discussed in the Horizontal Merger Guidelines, as well as those discussed below, are not exhaustive, but rather are illustrations of the manner in which a merger may lessen competition due to coordinated effects.

A vertical merger may enhance the market's vulnerability to coordination by eliminating or hobbling a maverick firm that otherwise plays or would play an important role in preventing or limiting anticompetitive coordination in the relevant market. For example, the merged firm could use its power over a product or service in a related product to harm the ability of a non-merging maverick in the relevant market to compete, thereby increasing the likelihood of coordinated interaction among the merged firm and rivals participating in that market.

Coordinated effects may also arise in other ways, including when changes in market structure or the merged firm's access to confidential information facilitate (a) reaching a tacit agreement among market participants, (b) detecting cheating on such an agreement, or (c) punishing cheating firms.

> *Example 7: The merger brings together a manufacturer of components and a maker of final products. If the component manufacturer supplies rival makers of final products, it will have information about how much they are making, and will be better able to detect cheating on a tacit agreement to limit supplies. As a result the merger may make the tacit agreement more effective.*

Some effects of a vertical merger may make the market less vulnerable to coordination. For example, a vertical merger's elimination of double marginalization (see Section 6) may increase the merged firm's incentive to cheat on a tacit agreement, thereby reducing the risk of coordinated effects.

8. EFFICIENCIES

Because vertical mergers combine complementary economic functions and eliminate contracting frictions, they have the potential to create cognizable efficiencies that benefit competition and consumers. Vertical mergers bring together assets used at different levels in the supply chain to make a final product. A single firm able to coordinate how these assets are used may be able to streamline production, inventory management, or distribution, or create innovative products in ways that would have been hard to achieve though arm's length contracts.

The Agencies will evaluate efficiency claims by the parties using the approach set forth in Section 10 of the Horizontal Merger Guidelines. The Agencies do not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is unlikely to be anticompetitive in any relevant market.

Assistant Attorney General Makan Delrahim Delivers Remarks at ABA's 2019 Antitrust Fall Forum

Washington, DC ~ Monday, November 18, 2019

Remarks as prepared for delivery

"As Time Goes By" Protecting the Future of Innovation Through Effective Antitrust Enforcement

Good afternoon, it is a pleasure to join you again this year at the ABA Antitrust Fall Forum, my third as Assistant Attorney General. I am particularly thankful to Maureen Ohlhausen and Svetlana Gans for the hard work they put in organizing this event.

I have been proud to call myself a member of the ABA Antitrust Section for years. I am grateful for the opportunities that it has provided me and my colleagues, as well as young and emerging leaders in the antitrust bar. Regardless of background or political affiliation, the Antitrust Section welcomes members, leaders, and future leaders of our profession with open arms.

Unfortunately, actions in the past and more recently by some acting on behalf of the broader American Bar Association have undermined the important work of the Antitrust Section and sections devoted to other practice areas. I am referring to the ABA system for rating judicial nominees and the recent controversy surrounding the ABA's rating of Ninth Circuit nominee and DOJ colleague Lawrence VanDyke. If reports are true that the ABA judicial nominee rating committee broke its own rules, it paints a disturbing picture of abuse that all of us as lawyers should take seriously and work to address. When it comes to advancing the legal profession on fair and nonpartisan terms, it is my hope that ABA leadership could learn something from the Antitrust Section.

I commend the Section for dedicating this Fall Forum to one of the defining antitrust issues of our era: the role of competition law in policing anticompetitive conduct and transactions in technology sectors and digital markets. It was a great honor to hear today from Deputy Attorney General Jeffrey Rosen, whom I have the pleasure of working alongside, regarding the Department's review of leading digital platforms.

At the Antitrust Division, our goal in this review is to ensure that digital markets live up to their promise of unlocking incredible value for consumers, including making it easier for consumers to compare, choose, and use products and services through platforms. We do so by protecting against conduct or transactions that harm competition, including competition that takes place on those platforms.

Over the past several years, we have overcome the mindset that somehow digital markets could not or should not be policed by antitrust law. Many cautioned against antitrust enforcement by arguing that monopoly rents in high-tech markets are fleeting, because the markets move so quickly and because barriers to entry are almost always low.

In recent years, the conversation among antitrust practitioners has evolved, in line with the growing public perception that digital platforms that enjoy durable network effects may be acting anticompetitively.

I would like to focus today on the role of innovation within the antitrust framework, and specifically the role of innovation effects in how we analyze potentially anticompetitive conduct.

Put simply, consumers benefit when companies or individuals innovate—whether by increasing internal business efficiency, by improving previous versions of products and services, or by developing new and exciting products that render old ones obsolete. Where anticompetitive conduct or mergers reduce innovation, consumers will fail to reap these welfare gains as the benefits of innovation are delayed.

When enforcers consider bringing an antitrust lawsuit, they often weigh two dueling concerns: overenforcement or "false positives," and underenforcement or "false negatives." Yet it is easy to overlook the fact that false positives and false negatives are not all created equal. The stakes vary depending on the dimension of competition, or the competitive effect, in question.

Consider price effects. If the government brings suit and enjoins a company practice that is, in fact, procompetitive, then that company may be deterred from competing as vigorously and lowering prices in the future. Conversely, if the government fails to act against a monopolist engaging in anticompetitive conduct, then consumers also may incur higher prices. As economists often note, however, these harmful price effects may be fleeting—especially in high-tech markets—due to monopoly's natural tendency to incentivize greater entry. Absent insurmountable barriers to entry, the thinking goes, consumers will suffer only a short-term deadweight loss due to higher prices, and the market will correct itself.

When it comes to innovation effects, however, the cost of under- and over-enforcement may be much more pronounced. That is because innovation is cumulative; one new innovation can unlock an entire array of new innovations. Thus, if antitrust enforcers get an enforcement decision wrong and stifle or delay innovation, consumers not only will miss out on that particular product improvement, they also could lose the opportunity to enjoy dozens of additional new products or services.

To put it more concretely, suppose in the early 2000s a monopolist gained a stranglehold on mobile devices and took unlawful actions to exclude a competitor who had a disruptive touchscreen innovation ready to roll out to the market. Suppose further that no antitrust enforcer intervened and, as a result, there was less innovation, such that smartphones with touchscreen-apps hit the market five years later—in 2012 rather than 2007. How much economic value, including entire business models, would have been delayed during those five years? The amount likely would run into the hundreds of billions of dollars, if not higher.

The same could be true of overzealous antitrust enforcement against business conduct that is not, in fact, anticompetitive. In particular, the Antitrust Division has cautioned against the application of antitrust law to patent disputes where a patent holder is merely attempting to monetize his or her investment in research and development, consistent with the statutory construct under the patent laws. Devaluing patent rights through the threat of antitrust lawsuits and treble damages against unilateral conduct can reduce incentives for the next generation of innovation, depriving consumers of the benefits the U.S. patent system creates.

In high-tech markets undergoing rapid transformation, the byproduct of robust competition is innovation that can benefit American consumers and fuel the next generation of business opportunities and new products. The stakes of getting it wrong are high.

Similarly, it is important for antitrust enforcers to recognize the risks of misapplying antitrust law in creative fields that experience significant change. I hope you all were in attendance this morning to hear Deputy Attorney General Rosen's remarks on this very subject. He highlighted how the forces of creative destruction have shaped and reshaped industries: sometimes causing opportunities for new competition, and sometimes enabling entrenched players to exclude competition. He focused in particular on the film industry.

As DAG Rosen observed, the film industry has undergone much transformation over the past few decades. As a Los Angeles native and movie fan, I have always viewed film as a form of art to "inform or delight," to share culture and to broaden minds, to lift us up to, and to highlight areas for, correction. To know the hopes and disappointments of the past century of human history requires only a look at our great movies. They tell stories central to our existence: stories of family, love, war and… of course, antitrust enforcement. I'm sure we (and probably only us antitrust lawyers) fondly remember waiting on the edge of our seats for the release of *The Informant* starring Matt Damon, which tells the story of the lysine price-fixing conspiracy.

The movie industry itself features in the Antitrust Division's history of enforcement. As many of you may know, the Division filed an antitrust lawsuit in 1938 alleging several major motion picture companies had engaged in a conspiracy to control the motion picture industry through their ownership of film distribution and exhibition.

After several years of litigation leading to a Supreme Court decision, in 1948, the Justice Department and the defendants agreed to a series of consent decrees, collectively called the "*Paramount* decrees." The five defendants that owned movie theaters were required to divest their distribution operations from their exhibition business. They also were prohibited from both distributing films and owning theaters in the future without court approval. To this day, no major movie distributor owns a significant number of movie theatres.

The *Paramount* decrees also outlawed certain distribution practices. These enduring regulations by decree included: setting minimum prices for movie tickets; bundling multiple films into a single theatre license – known as "block booking"; entering into a single license to cover all theatres in a theatre circuit, known as "circuit dealing"; and granting unreasonable "clearances" – granting exclusive rights to movies for specific geographic areas.

The *Paramount* consent decrees had no termination date and continue to govern how the film industry conducts itself to this day. Since the decrees were entered, however, the movie industry has undergone significant change. Back in the 1930s and 40s, metropolitan areas generally had a single movie theatre with one screen that showed a single movie at a time. Today, not only do our metropolitan areas have many multiplex cinemas showing films from different distributors, but much of our movie-watching is not in theatres at all. Technological advancements, most recently subscription streaming services, have permitted more American consumers to watch movies anywhere they want at any time. Competitive pressures have emerged from unexpected sources. For example, some of you might remember the now-defunct Moviepass, which charged consumers one flat price to see an unlimited number of movies in theaters. This business model was flawed, and this led to effective prices so low that some described it as a "great socialist scheme accidentally implemented by very confused capitalists." Moviepass ultimately exited the market, but nevertheless has affected how some movie theaters are looking at innovation; AMC launched its own monthly flat-free program last year.

These changes illustrate that markets can evolve, and no one can predict with certainty from where and in what form innovation will appear. Once innovation has occurred, however, it would be a mistake for antitrust enforcers to limit the potential for consumer-enhancing innovation. We cannot pretend that the business of film distribution and exhibition remains the same as it was 80 years ago.

Fortunately, to update the *Paramount* consent decrees in light of industry change does not require predicting the future of a dynamic field; antitrust enforcers simply must recognize the changes that have already occurred, as well as business models already deployed in other markets. As Henry Ford once famously remarked, "if I had asked people what they wanted, they would have said faster horses." In this case, antitrust enforcers can see the cars; it thus makes little sense to enforce the law as if we rode horses.

In response to these changes, the Antitrust Division opened a review of the *Paramount* consent decrees last year as part of our broader initiative to review all legacy antitrust decrees. We invited public comment on whether specific prohibitions of the *Paramount* decrees ought to be updated or eliminated – or whether the decrees should be terminated as a whole. Our inquiry has been to determine whether the decrees remain useful to prevent the original horizontal conspiracy or its recurrence.

We have determined that the decrees, as they are, no longer serve the public interest, because the horizontal conspiracy – the original violation animating the decrees – has been stopped. Along with the passage of time, the *Paramount* decrees have already remedied the effects of the violation, ridding the industry of "all taint" of the horizontal conspiracy and undoing what the conspiracy had achieved. Changes over the course of more than half a century also have made it unlikely that the remaining defendants can reinstate their cartel. Evolution in antitrust law has further made blanket prohibitions of certain vertical restraints inappropriate. Accordingly, the Division finds the consent decrees no longer meet consumer interests.

Today, I am announcing that the Antitrust Division will be asking the court to terminate the *Paramount* consent decrees, except for a two-year sunset period on the bans on block booking and circuit dealing. The sunset period will allow the defendants and movie theatres a period of transition to adjust to any licensing proposals that seek to change the theatre-by-theatre and film-by-film licensing structure currently mandated by the decrees.

To be clear, terminating the *Paramount* decrees does not mean that the practices addressed in them are now considered per se lawful under the antitrust laws. They are not insulated from antitrust scrutiny. Rather, consistent with modern antitrust law, the Division will review the vertical practices initially prohibited by the *Paramount* decrees using the rule of reason. If credible evidence shows a practice harms consumer welfare, antitrust enforcers remain ready to act.

This is a more appropriate role for the Antitrust Division. As filmmaker Martin Scorsese says, “Cinema is a matter of what’s in the frame and what’s out.” Antitrust enforcers, however, were not cast to decide in perpetuity what’s in and what’s out with respect to innovation in an industry. Our role is instead to weigh evidence-based arguments to enforce the antitrust laws – not to act as directors in the marketplace.

As the movie industry goes through more changes with technological innovation, with new streaming businesses and new business models, it is our hope that the termination of the *Paramount* decrees clears the way for consumer-friendly innovation.

Thank you.

Speaker:
Makan Delrahim, Assistant Attorney General

Attachment(s):
Download Remarks as Prepared

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Component(s):
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Updated November 25, 2019

Assistant Attorney General Makan Delrahim Delivers Remarks at the 2018 Global Antitrust Enforcement Symposium

Washington, DC ~ Tuesday, September 25, 2018

It Takes Two:
Modernizing the Merger Review Process

Good morning, and thank you for inviting me to speak here today. It is a pleasure to be at Georgetown University for this year's Global Antitrust Enforcement Symposium.

Events like these, which bring competition enforcement officials together to speak with members of the private bar, the business community, and the academic community, serve an important role in the continued development of antitrust law and its enforcement. They facilitate the rule of law by increasing transparency and predictability in enforcement. This, in turn, promotes competition and conserves both public and private resources by allowing the private bar to better counsel their clients so they can avoid anticompetitive behavior. Such events also allow competition agencies yet another opportunity to understand concerns that the business community may have about antitrust enforcement.

Today, I am going to address one of those concerns. My remarks will focus on modernizing the merger review process.

First, I will address the fact that mergers increasingly take longer to review and clear. Many think that is a problem. I do too, and I will explain why.

Second, I will discuss a series of changes that we are making at the Antitrust Division to address this problem and expedite the merger review process.

The Division is committed to achieving this result whenever possible without compromising the quality of merger reviews, but we cannot do it on our own. The merging parties and the Division both exert significant control over the pace and timing of compliance. It is important to recognize that shortening any investigation requires the cooperation of the merging parties. We need you to submit the necessary information promptly and work with us in good faith to resolve open issues expeditiously. It also means that parties shouldn't hide the eight ball!

Why do I believe that the merger review process needs to be modernized?

There is widespread agreement that significant merger reviews are taking longer to complete. According to one source, in calendar year 2017, significant merger reviews conducted by U.S. antitrust enforcers took an average of 10.8 months to resolve. That's up from an average of 7.1 months in 2013, which is a 65% increase, according to this source.

Several factors likely have contributed to this increase, some of which are beyond our control.

First, in this electronic age, merging parties frequently maintain enormous quantities of data and documents. It takes longer for the parties to produce them, and it takes longer for enforcement agencies to analyze them.

Second, more and more transactions are international in scope. Necessary coordination with our foreign counterparts — while beneficial— could add time.

Third, when divestitures are required to protect competition and remedy anticompetitive elements to transactions, we increasingly require upfront buyers that are pre-approved before consent decrees can be filed. That also adds time.

So the question is, what can we do, despite these factors, to increase the efficiency of merger reviews?

Nobody wins with unduly lengthy reviews — other than lawyers and expert economists, perhaps. The Antitrust Division's mission is to protect competition for the benefit of American consumers. That means ensuring that pro-competitive mergers are not unduly delayed by our review process. Indeed, most mergers are pro-competitive, or at least competitively neutral.

As far back as 1982, the Horizontal Merger Guidelines reflected this idea, stating that, "While challenging competitively harmful mergers, the Department [should seek] to avoid unnecessary interference with the larger universe of mergers that are either competitively beneficial or neutral."

Shortly after the guidelines were issued, then-Assistant Attorney General William Baxter elaborated on this idea. He faced criticism that the 1982 Merger Guidelines were too clear and provided too much guidance. This, the argument ran, would "encourage mergers right up to the line" drawn in the Guidelines. Baxter noted that this criticism "exhibit[ed] an inherent hostility to the phenomenon of mergers themselves."

Baxter rejected this hostility, emphasizing that mergers are "an important and extremely valuable capital market phenomenon, that they are to be in general facilitated, and that it is socially desirable that uncertainty and risk be removed wherever possible to do so, subject, of course, to the very important limitation that where a merger threatens significantly to lessen competition, it should be halted."

I agree with Bill Baxter.

Delay is a form of uncertainty and risk, and we should seek to remove it from the merger-review process whenever possible.

Changes made to the HSR Act nearly twenty years ago reflect the same goal. In my time on the staff of the Senate Judiciary Committee, I worked on legislation that raised the HSR Act filing thresholds to reflect inflation since 1976, and, perhaps more importantly, pegged them to inflation going forward. This dramatically reduced the number of reportable transactions, allowing the agencies to focus their resources on identifying transactions that are more likely to raise competitive concerns.

Let me pause here to make an important broader point.

Too often, effective leadership in antitrust enforcement is equated with the number of enforcement actions brought. The more enforcement actions brought, the thinking goes, the better the enforcement regime. In 1940, Justice Robert H. Jackson, then the Attorney General, rejected this thinking. As he said, "Any prosecutor who risks his day-to-day professional name for fair dealing to build up statistics of success has a perverted sense of practical values, as well as defects of character." I stand with Attorney General Jackson.

Our job is not to bring the most enforcement actions. Our job is to get the right result. More than that, our job is to get the right result in an efficient manner, which often means reaching consent agreements with parties to remedy fully the sources of anticompetitive harm. Only when that is not possible, should we litigate.

That brings me to the second reason that unduly long merger reviews are a problem: they can waste public and private resources.

Certainly everyone in the business community who has received a second request, and everyone in the private bar who has worked on one, understands how burdensome compliance can be. We always want to minimize that burden consistent with upholding the antitrust laws.

Some perspective is important. Last year, the Division opened an investigation into only 2.3% of proposed transactions, and issued second requests in less than 1% of proposed transactions. That 1%, however, is expensive. It is also resource intensive.

The government also spends enormous amounts of time and money reviewing mergers that go to a second request. Now, let me be clear, this is time and money well spent when it is necessary to protect competition. Some transactions present knotty problems and it takes a while to untangle them. Once we are in a position to understand the competitive significance of the transaction, however, every additional minute and dollar spent reviewing the merger is deadweight loss. We have limited resources. As a related side note, over the past ten years the Antitrust Division's budget has stayed roughly constant in nominal terms, which means it has declined in real terms, as salaries and other expenses have risen. A significant part of my job, then, is ensuring that we use those limited resources wisely.

So, how can we improve the process?

In a moment, I will announce a series of reforms we are taking to modernize merger review process, but let me lay down an important benchmark to help orient our thinking on this: Provided that the parties expeditiously cooperate and comply throughout the entire process, we will aim to resolve most investigations within six months of filing.

We are not unilaterally disarming, to be sure.

We will never compromise our ability to enforce the law effectively.

With the merging parties' cooperation, we can expedite our review without compromising quality, and provide expeditious certainty to the business community, and the markets.

Of course, every case is different. Not every investigation can be resolved in six months. Indeed, in some cases, the parties may prefer a longer investigation rather than a quick decision by the Division. Or the parties may wish to extend the timing for various reasons. If the goal of the business community is a shorter review, however, we share that goal and are committed to working towards it.

With that said, let me discuss what we are doing going forward, and will continue to do, to modernize the merger review process. Every merger investigation has distinct stages, and I will discuss improvements that we are making at each stage in the merger review process.

1) Meet with the Parties Early. Often the first stage in an investigation is for the parties to meet with staff. One improvement that we are making is that the Antitrust Division Front Office will be open to an initial, introductory meeting. We expect that these meetings will be most productive if the parties include key executives from relevant businesses. We want to understand their deal rationale and any other facts they believe will be important to our analysis.

2) Model Voluntary Request Letter. Another improvement is that we soon will publish a model voluntary request letter on the Antitrust Division's website. As many of you know, the Division often asks for the voluntary production of key information during the initial waiting period. This information is crucial to resolving mergers during the initial waiting period for the simple reason that there are enormous information asymmetries between the parties and the enforcer, especially early in a merger investigation. Parties should be prepared to provide key information within the first few days of their HSR filing, if not before filing, to allow the staff time to confirm critical facts through the parties' document productions and our own independent investigation. One of my deputies, Barry Nigro, gave a speech on this topic last February, and I would encourage you to read it.

Publishing the model voluntary request letter is intended to give the parties a head start in identifying the kind of information they should look for, so that they can be proactive and submit it as early as possible in the process. A tailored version of this letter is sent to the parties in almost every investigation we open. It identifies information we believe will allow us to assess quickly whether there is any potential anticompetitive harm that would require a longer, more in-depth investigation. The sooner we get this information, the sooner we can close investigations that do not raise competitive issues. When a more in-depth investigation is required, we can use that information to narrow the scope of the investigation as much as possible.

3) Pull-and-Refile Accountability. We also have implemented a system to track what happens when parties pull-and-refile their HSRs. The Division cannot, of course, resolve all concerns within the initial 30-day waiting period. The parties, rather than face a second request they believe unnecessary, may choose to pull-and-refile their HSRs. Our new system is designed to ensure that we have an investigative plan in place to maximize our use of the additional time. We will determine whether we can close the investigation without issuing a second request, or, if one is necessary, narrow it as much as possible.

4) Model Timing Agreement. We are also publishing a model timing agreement on our website. As many of you know, timing agreements are a mechanism to encourage an orderly process by which the parties comply with the second request and the Division analyzes the transaction and decides whether to clear it, seek remedies, or seek to block it. Done right, timing agreements are mutually beneficial. The Division gets certainty on timing — which is in the parties' control — and the parties get certainty, among other things, on the number of custodians, the number of depositions, and the availability of meetings with the Front Office.

Too often, though, negotiations over timing agreements are taking on a life of their own. Both the parties and the Division are spending too much time on process, slowing our ability to get to the heart of the matter. To facilitate reaching an agreement, we will be publishing a model timing agreement on our website.

5) Reforming Timing Agreements. We are also cognizant that timing agreements are a deviation from the process that Congress outlined in the HSR Act, which sets a deadline of 30 days for the Division to decide once the parties certify compliance with the second request. Thus, we also intend in the coming months to make changes to the model timing agreement in order to narrow potential areas of disagreement, facilitate more efficient reviews, and bring the process closer in line with the HSR Act. While we are still fine tuning the specifics, here are a few examples.

- A) Fewer Custodians: We will seek documents from fewer custodians than we generally have in the past. While every investigation is different, as a general matter we will assume that 20 custodians per party will be sufficient unless the Deputy AAG in charge of the investigation explicitly authorizes more.
- B) Fewer Depositions: We will also take fewer depositions than in the past. Again, while every investigation is different, we generally will not seek more than 12 depositions unless the deputy in charge of the investigation authorizes a greater number.
- Together with reducing the number of custodians, these changes will tangibly reduce the burden on the parties of complying with a second request.
- C) Shorter Time from Compliance to a Decision: We also will strive to make a decision as quickly as possible from the time the parties' certify compliance. We will make a decision in no longer than 60 days — sooner, if possible —with the proviso that a Deputy AAG can authorize an extension if necessary.

In exchange for these benefits, we also are going to modify what we expect from the parties:

- D) Faster and Earlier Productions of Documents: We will expect to receive documents and other information earlier in the compliance period. If the parties employ traditional document reviewers, this will mean a more robust rolling production, with the parties producing several tranches of documents roughly evenly spaced over the compliance period. For parties employing technology assisted review, it will mean completing the bulk of the production a certain number of days in advance of certifying full compliance.
- E) Earlier Production of Data: Data is increasingly important in many investigations. Data is often the key to getting merger decisions right. Frequently, there is no reason that data cannot be produced substantially earlier than production of the main bulk of documents. We will expect to receive early cooperation on identifying relevant data for our economists to analyze. We will further expect production of useable data substantially before the second request compliance date.
- F) No More Privilege Log Gamesmanship: We also want to eliminate gamesmanship on privilege issues. The Division respects the attorney-client privilege and the work product doctrine, but too often we see parties game the process, withholding large numbers of documents as privileged, only to de-privilege and dump many of these documents on us much later in the process, often on the eve of a particular deposition. While some of the de-privileged documents might be close calls, most never should have been withheld in the first place.
- G) Longer Post-Complaint Discovery Period: Finally, we will require adequate time to conduct post-complaint discovery in the event that it results in contested litigation. Because most merger investigations do not result in contested litigation, and parties therefore can reduce the burdens of the second request review by agreeing to defer some discovery until after a complaint is filed.

6) CID Enforcement. In addition to those improvements to the timing agreement, which you will see on our website when the model timing agreement is posted, we are going to take steps to ensure that third parties comply with our civil investigative demands in a timely manner. A second request is the primary tool by which we get information from the merging parties. While the merging parties are generally the most important source of information about the competitive significance of a transaction, third parties often possess critical documents and data.

As you know, the Antitrust Civil Process Act empowers the Assistant Attorney General of the Antitrust Division to issue CIDs for relevant materials. In significant merger investigations, this can be an essential tool to collect third-party documents, data, and testimony. As you can imagine — in fact, as many of you know firsthand — third parties rarely greet CIDs with enthusiasm. Compliance is often slow and incomplete. This hampers the Division's ability to analyze the transaction at issue expeditiously. Going forward, we are going to hold CID-recipients to the deadlines and specifications in the CIDs we issue. When necessary, we will not hesitate to bring CID enforcement actions in federal court to ensure timely and complete compliance.

7) Demonstrating Leadership in Parallel Investigations. We are also seeking ways to improve coordination with foreign enforcers in parallel investigations. To facilitate the process, when facing parallel investigations, parties should consider aligning time periods with other jurisdictions if possible, and where appropriate ask us to help with that. If there is cooperation on the parties' side, we will gladly help reduce the burdensome red tape wherever possible.

8) Withdrawing the 2011 Remedies Guide. We are also taking a close look at our remedies policy. Negotiating remedies to anticompetitive mergers often adds significant time to the merger review, and our commitment to shortening the duration of merger reviews extends to the remedies phase. While our review is underway, I want to be transparent with the bar about what the Division's practices will be. To that end, today, I announce the withdrawal of the 2011 Policy Guide to Merger Remedies. The 2004 Policy Guide to Merger Remedies will be in effect until we release an updated policy.

9) Release of Merger Review Statistics. I have described a long list of changes we will be making.

How will you know if they have had an impact?

We will increase transparency.

Going forward, we are going to release statistics that show, on average, how long the Division is taking to review mergers. Specifically, we will release the average duration of second request investigations and the average length of time from the opening of a preliminary investigation to the early termination or closing of the investigation, including investigations that did not result in the issuance of second requests. The Division previously released these statistics in connection with the 2006 amendments to the Merger Review Process Initiative. We believe that releasing them periodically going forward will increase our own accountability and give the private bar and the business community greater insight into our process.

To conclude, we are committed to accelerating the pace of merger review consistent with enforcing the law because we believe that doing so is good for American consumers and taxpayers. We have taken action already, and we plan to do more in the coming months. It does takes two, however. To that end, I welcome the private bar and any other interested parties to reach out to discuss any other ideas we should consider as we continue to make our processes more efficient.

Thank you.

Speaker:
Makan Delrahim, Assistant Attorney General

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Updated November 19, 2018

European Commission

Ursula von der Leyen

President-elect of the European Commission

Mission letter

Brussels, 10 September 2019

Margrethe Vestager

Executive Vice-President-designate for a Europe fit for the Digital Age

Dear Margrethe,

Earlier this year, the people of Europe made their voices heard in record numbers at the European elections. They presented us with a mission to be decisive and ambitious on the big issues of our time that are shaping the future of our society, economy and planet.

Changes in climate, digital technologies and geopolitics are already having a profound effect on the lives of Europeans. We are witnessing major shifts all the way from global power structures to local politics. While these transformations may be different in nature, we must show the same ambition and determination in our response. What we do now will determine what kind of world our children live in and will define Europe's place in the world.

Our job as the European Commission will be to lead, to grasp the opportunities and to tackle the challenges that these changes present, working hand in hand with people from across Europe and with the governments, parliaments and institutions that serve them.

This is the guiding principle behind my Political Guidelines for the next European Commission 2019-2024, which I presented to the European Parliament on 16 July 2019. I outlined six headline ambitions on which I want the European Commission's work to focus. These priorities are interlocking and are part of the same picture. In this spirit, I have put together a College in which we will all work, decide and deliver together.

An open and inclusive way of working

This approach reflects the open, inclusive and cooperative way of working that I will instil throughout the Commission, as well as in our relationships with others.

The College: One team

The European Commission functions on the **principle of collegiality**. This means we are one team: we all work together following a whole-of-government approach, we all have our say, we all decide collectively and we all take ownership of what is agreed.

To help us deliver on our ambitions and commitments, **I will empower eight Vice-Presidents** to steer and coordinate thematic Commissioners' Groups on each of the Commission's priorities. They will be supported in this role by the Secretariat-General. All Commissioners will be in one or more Groups. The Commissioner for Budget and Administration will report directly to me.

Of the eight Vice-Presidents, the **three Executive Vice-Presidents** will have a dual function. As Vice-Presidents, they will lead a Commissioners' Group and be supported by the Secretariat-General. In addition, they will also manage a policy area and have a Directorate-General under their authority for this part of their job. One of the three Executives, First Vice-President Timmermans, will chair the College in my absence.

The High Representative/Vice-President will support me in coordinating the external dimension of all Commissioners' work. To ensure our external action becomes more strategic and coherent, it will be systematically discussed and decided on by the College. To support this, all services and Cabinets will prepare the external aspects of College meetings on a weekly basis, mirroring the process already in place for interinstitutional relations. This should also better align the internal and external aspects of our work. This will be a **'Geopolitical Commission'**.

I believe that we need to **speak and listen more to one another**, starting from within the Commission. College meetings will be places of open and honest discussion. As President I will set the agenda, but all College decisions will be taken collectively. In line with our commitment to fully digitalise the Commission and the need to use resources conscientiously, College meetings will be paperless and digital.

Each Commissioner will ensure the delivery of the **United Nations Sustainable Development Goals** within their policy area. The College as a whole will be responsible for the overall implementation of the Goals.

Interinstitutional relations and better policy making

Along with our close relations with the Council, I want to strengthen the Commission's **special partnership with the European Parliament**. This priority must cut through the work of each Member of the College, starting with myself.

I will expect you to ensure the European Parliament is regularly briefed, notably before major events and at key stages of international negotiations. In light of my support for a right of initiative for the Parliament, you should work closely with the relevant Committees, and be active and present during the preparation of resolutions requesting that the Commission legislate.

The more we build a consensus when designing policy, the quicker it can become law and make a difference to people's lives. This is why we need an **open and cooperative approach throughout the legislative process**, from policy design to final agreement. I will expect you to attend all political negotiations, known as trilogue meetings, with the other institutions.

We need to ensure that regulation is targeted, easy to comply with and does not add unnecessary regulatory burdens. The Commission must always have the leeway to act where needed. At the same time, we must send a clear signal to citizens that **our policies and proposals deliver and make life easier** for people and for businesses.

In this spirit, the Commission will develop a new instrument to deliver on a **'One In, One Out' principle**. Every legislative proposal creating new burdens should relieve people and businesses of an equivalent existing burden at EU level in the same policy area. We will also work with Member States to ensure that, when transposing EU legislation, they do not add unnecessary administrative burdens.

Proposals must be evidence based, widely consulted upon, subject to an impact assessment and reviewed by the independent Regulatory Scrutiny Board. You will ensure that they respect the principles of **proportionality and subsidiarity** and show the clear benefit of European action.

Given that any legislation is only as good as its implementation, I want you to **focus on the application and enforcement of EU law** within your field. You should provide support and continuous guidance to Member States on implementation, and be ready to take swift action if EU law is breached.

Bringing Europe closer to home

I want to **strengthen the links between people and the institutions that serve them**, to narrow the gap between expectation and reality and to communicate about what Europe is doing.

We must engage with all Europeans, not just those who live in the capitals or are knowledgeable about the European Union. I will expect you to **visit every Member State within the first half of our mandate** at the latest. You should meet regularly with national parliaments and take part in Citizens' Dialogues across our Union, notably as part of the Conference on the Future of Europe.

A stronger relationship with citizens starts with building trust and confidence. I will insist on the **highest levels of transparency and ethics** for the College as a whole. There can be no room for doubt about our behaviour or our integrity. The Code of Conduct for Commissioners sets out the standards and the rules to follow.

You will ensure budgetary spending represents value for taxpayers and follows the principles of sound financial management.

Making the most of our potential

The gender-balanced College I am presenting today makes good on my pledge to put together a Commission that is more representative and draws on all of our potential. This is a good start, but there is plenty more work to be done.

I expect you to **draw on all of Europe's talents** when it comes to setting up your own Cabinets. That means striking an appropriate balance in terms of gender, experience and geography.

The Commission should also lead by example when it comes to ensuring better representation and a diversity of voices in our public life. With this in mind, all public events organised by the Commission should aim to feature gender-balanced panels and a broad range of perspectives from across Europe.

Your mission

I would like to entrust you with the role of Executive Vice-President for a Europe fit for the Digital Age.

Over the next five years, Europe must focus on maintaining our digital leadership where we have it, catching up where we lag behind and moving first on new-generation technologies. This must cut across all of our work, from industry to innovation. At the same time, we must ensure that the European way is characterised by our human and ethical approach. New technologies can never mean new values.

In striving for digital leadership, we must focus on making markets work better for consumers, business and society, and must support industry to adapt to globalisation and the twin climate and digital transitions. We need companies that compete on equal terms and consumers that can benefit from lower prices, greater choice and better quality.

As Executive Vice-President, you will have a dual function. You will chair the Commissioners' Group on a Europe fit for the Digital Age. In addition, you will be responsible for the competition portfolio. In leading the work on a Europe fit for the Digital Age, you will ensure all policy dimensions are fully taken into account.

A Europe fit for the digital age

The digital transition will have an impact on every aspect of our economy and society. Your task will be to ensure that Europe fully grasps the potential of the digital age and strengthens its industry and innovation capacity. This will be a key part of strengthening our technological leadership and strategic autonomy.

- I want you to co-lead our work on a new **long-term strategy for Europe's industrial future**, working together with the Executive Vice-President for an Economy that Works for People. In implementing the strategy you will work with the Member States and involve businesses of all sizes. You should maximise the contribution of investment in research and innovation in supporting our policy objectives.

- You will ensure cross-fertilisation between civil, defence and space industries.

- You will co-lead the work on a **new SME strategy**, working together with the Executive Vice-President for an Economy that Works for People. This should focus on supporting small businesses, entrepreneurs and start-ups, notably by reducing the regulatory burden and enabling them to make the most of digitisation.

- In the **first 100 days** of our mandate, you will coordinate the work on a European approach on **artificial intelligence**, including its human and ethical implications. This should also look at how we can use and share non-personalised big data to develop new technologies and business models that create wealth for our societies and our businesses.

- I want you to coordinate the work on upgrading our liability and safety rules for digital platforms, services and products as part of a new **Digital Services Act**. In this context, you should ensure the working conditions of platform workers are addressed.

- You will coordinate the work on **digital taxation** to find a consensus at international level by the end of 2020 or to propose a fair European tax.

Competition

Your task over the next five years will be to ensure our competition policy and rules are fit for the modern economy, vigorously enforced and contribute to a strong European industry at home and in the world.

- Competition rules are only as effective as their implementation. I want you to focus on **strengthening competition enforcement** in all sectors. You should focus on improving case detection, speeding up investigations and facilitating cooperation with and between national competition authorities. You should also actively contribute to stronger global cooperation among competition authorities.

- You will evaluate and **review Europe's competition rules**. This will cover the antitrust regulations that will expire in the course of the mandate, the ongoing evaluation of merger control and the review of State aid rules and guidance.

- In the first part of your mandate, you should consider using the tool of sector inquiries into new and emerging markets that are shaping our economy and society.

- Competition will have an important role in our **industrial strategy**. The competitiveness of our industry depends on a level playing field that provides business with the incentive to invest, innovate and grow. EU State aid rules should support this where there are market failures and the need to strengthen value chains. As part of this, you should continue to work with the Member States to make the most of Important Projects of Common European Interest.

- As part of the industrial strategy, you should develop tools and policies to better tackle the distortive effects of **foreign state ownership and subsidies** in the internal market.

- While fully preserving the confidentiality of competition procedures, you will be expected to proactively share any relevant **general market knowledge** within the Commission, notably in the digital sector. This will help ensure new legislative proposals contribute to fair and open competition in the single market and support evidence-based policymaking.

You will work under my guidance on all of the above issues. The Secretariat-General will support you in your coordination tasks on a Europe fit for the Digital Age. For your tasks linked to the competition portfolio, the Directorate-General for Competition will support you in your work.

The way forward

The mission outlined above is not exhaustive or prescriptive. Other opportunities and challenges will no doubt appear over the course of the next five years. On all of these issues, I will ask you to work closely with me, and with other Members of the College.

Once there is more clarity, we should be ready to pave the way for an ambitious and strategic partnership with the United Kingdom.

I look forward to working closely together at what is an exciting and testing time for our Union. You can of course count on my full personal and political support ahead of your hearing at the European Parliament and throughout our mandate.

Yours sincerely,

Ursula v. d. L

Ursula von der Leyen

President-elect of the European Commission

Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings

(2008/C 265/07)

I. INTRODUCTION

1. Article 2 of Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings [1] (hereinafter: the 'Merger Regulation') provides that the Commission has to appraise concentrations within the scope of the Merger Regulation with a view to establishing whether or not they are compatible with the common market. For that purpose, the Commission must assess, pursuant to Article 2(2) and (3), whether or not a concentration would significantly impede effective competition, in particular as a result of the creation or strengthening of a dominant position in the common market or a substantial part of it.

2. This document develops guidance as to how the Commission assesses concentrations [2] where the undertakings concerned are active on different relevant markets [3]. In this document, these concentrations will be called 'non-horizontal mergers'.

3. Two broad types of non-horizontal mergers can be distinguished: vertical mergers and conglomerate mergers.

4. Vertical mergers involve companies operating at different levels of the supply chain. For example, when a manufacturer of a certain product (the 'upstream firm') merges with one of its distributors (the 'downstream firm'), this is called a vertical merger [4].

5. Conglomerate mergers are mergers between firms that are in a relationship which is neither horizontal (as competitors in the same relevant market) nor vertical (as suppliers or customers) [5]. In practice, the focus of the present guidelines is on mergers between companies that are active in closely related markets (e.g. mergers involving suppliers of complementary products or products that belong to the same product range).

6. The general guidance already given in the Notice on horizontal mergers is also relevant in the context of non-horizontal mergers. The purpose of the present document is to concentrate on the competition aspects that are relevant to the specific context of non-horizontal mergers. In addition, it will set out the Commission's approach to market shares and concentration thresholds in this context.

7. In practice, mergers may entail both horizontal and non-horizontal effects. This may for instance be the case where the merging firms are not only in a vertical or conglomerate relationship, but are also actual or potential competitors of each other in one or more of the relevant markets concerned [6]. In such a case, the Commission will appraise horizontal, vertical and/or conglomerate effects in accordance with the guidance set out in the relevant notices [7].

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(1) Council Regulation (EC) No 139/2004 of 20 January 2004 (OJ L 24, 29.1.2004, p. 1).

(2) The term *concentration* used in the Merger Regulation covers various types of transactions such as mergers, acquisitions, takeovers, and certain types of joint ventures. In the remainder of this Document, unless otherwise specified, the term 'merger' will be used as a synonym for concentration and therefore cover all the above types of transactions.

(3) Guidance on the assessment of mergers involving undertakings which are actual or potential competitors on the same relevant market ('horizontal mergers') is given in the Commission Notice: Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (OJ C 31, 5.2.2004, p. 5) ('Notice on Horizontal Mergers').

(4) In the present document, the terms 'downstream' and 'upstream' are used to describe the (potential) commercial relationship that the merging entities have with each other. Generally the commercial relationship is one where the 'downstream' firm purchases the output from the 'upstream' firm and uses it as an input in its own production, which it then sells on to its customers. The market where the former transactions take place is referred to as the intermediate market (upstream market). The latter market is referred to as the downstream market.

(5) The distinction between conglomerate mergers and horizontal mergers may be subtle, e.g. when a conglomerate merger involves products that are weak substitutes for each other. The same holds true for the distinction between conglomerate mergers and vertical mergers. For instance, products may be supplied by some companies with the inputs already integrated (vertical relationship), whereas other producers leave it to the customers to select and assemble the inputs themselves (conglomerate relationship).

(6) For instance, in certain markets upstream or downstream firms are often well-placed potential entrants. See e.g. in the electricity and gas sector, Case COMP/M.3440 — EDP/ENI/GDP (2004). The same may hold for producers of complementary products. See e.g. in the liquid packaging sector, Case COMP/M.2416 — TetraLaval/Sidel (2001).

(7) Guidance on the assessment of mergers with a potential competitor is given in the Notice on horizontal mergers, in particular at paragraphs 58 to 60 thereof.

8. The guidance set out in this document draws and elaborates on the Commission's evolving experience with the appraisal of non-horizontal mergers under Regulation (EEC) No 4064/89 since its entry into force on 21 September 1990, the Merger Regulation presently in force as well as on the case-law of the Court of Justice and the Court of First Instance of the European Communities. The principles contained here will be applied and further developed and refined by the Commission in individual cases. The Commission may revise the notice on non-horizontal mergers from time to time in the light of future developments and of evolving insight.

9. The Commission's interpretation of the Merger Regulation as regards the appraisal of non-horizontal mergers is without prejudice to the interpretation which may be given by the Court of Justice or the Court of First Instance of the European Communities.

II. **OVERVIEW**

10. Effective competition brings benefits to consumers, such as low prices, high quality products, a wide selection of goods and services, and innovation. Through its control of mergers, the Commission prevents mergers that would be likely to deprive customers of these benefits by significantly increasing the market power of firms. An 'increase in market power' in this context refers to the ability of one or more firms to profitably increase prices, reduce output, choice or quality of goods and services, diminish innovation, or otherwise negatively influence parameters of competition ([1]).

11. Non-horizontal mergers are generally less likely to significantly impede effective competition than horizontal mergers.

12. First, unlike horizontal mergers, vertical or conglomerate mergers do not entail the loss of direct competition between the merging firms in the same relevant market ([2]). As a result, the main source of anti-competitive effect in horizontal mergers is absent from vertical and conglomerate mergers.

13. Second, vertical and conglomerate mergers provide substantial scope for efficiencies. A characteristic of vertical mergers and certain conglomerate mergers is that the activities and/or the products of the companies involved are complementary to each other ([3]). The integration of complementary activities or products within a single firm may produce significant efficiencies and be pro-competitive. In vertical relationships for instance, as a result of the complementarity, a decrease in mark-ups downstream will lead to higher demand also upstream. A part of the benefit of this increase in demand will accrue to the upstream suppliers. An integrated firm will take this benefit into account. Vertical integration may thus provide an increased incentive to seek to decrease prices and increase output because the integrated firm can capture a larger fraction of the benefits. This is often referred to as the 'internalisation of double mark-ups'. Similarly, other efforts to increase sales at one level (e.g. improve service or stepping up innovation) may provide a greater reward for an integrated firm that will take into account the benefits accruing at other levels.

14. Integration may also decrease transaction costs and allow for a better co-ordination in terms of product design, the organisation of the production process, and the way in which the products are sold. Similarly, mergers which involve products belonging to a range or portfolio of products that are generally sold to the same set of customers (be they complementary products or not) may give rise to customer benefits such as one-stop-shopping.

([1]) In this document, the expression 'increased prices' is often used as shorthand for these various ways in which a merger may result in competitive harm. The expression should also be understood to cover situations where, for instance, prices are decreased less, or are less likely to decrease, than they otherwise would have without the merger and where prices are increased more, or are more likely to increase, than they otherwise would have without the merger.

([2]) Such a loss of direct competition can, nevertheless, arise where one of the merging firms is a potential competitor in the relevant market where the other merging firm operates. See paragraph 7 above.

([3]) In this document, products or services are called 'complementary' (or 'economic complements') when they are worth more to a customer when used or consumed together than when used or consumed separately. Also a merger between upstream and downstream activities can be seen as a combination of complements which go into the final product. For instance, both production and distribution fulfil a complementary role in getting a product to the market.

15. However, there are circumstances in which non-horizontal mergers may significantly impede effective competition, in particular as a result of the creation or strengthening of a dominant position. This is essentially because a non-horizontal merger may change the ability and incentive to compete on the part of the merging companies and their competitors in ways that cause harm to consumers.

16. In the context of competition law, the concept of 'consumers' encompasses intermediate and ultimate consumers ([1]). When intermediate customers are actual or potential competitors of the parties to the merger, the Commission focuses on the effects of the merger on the customers to which the merged entity and those competitors are selling. Consequently, the fact that a merger affects competitors is not in itself a problem. It is the impact on effective competition that matters, not the mere impact on competitors at some level of the supply chain ([2]). In particular, the fact that rivals may be harmed because a merger creates efficiencies cannot in itself give rise to competition concerns.

17. There are two main ways in which non-horizontal mergers may significantly impede effective competition: non-coordinated effects and coordinated effects ([3]).

18. Non-coordinated effects may principally arise when non-horizontal mergers give rise to *foreclosure*. In this document, the term 'foreclosure' will be used to describe any instance where actual or potential rivals' access to supplies or markets is hampered or eliminated as a result of the merger, thereby reducing these companies' ability and/or incentive to compete. As a result of such foreclosure, the merging companies — and, possibly, some of its competitors as well — may be able to profitably increase the price ([4]) charged to consumers. These instances give rise to a significant impediment to effective competition and are therefore referred to hereafter as 'anticompetitive foreclosure'.

19. Coordinated effects arise where the merger changes the nature of competition in such a way that firms that previously were not coordinating their behaviour, are now significantly more likely to coordinate to raise prices or otherwise harm effective competition. A merger may also make coordination easier, more stable or more effective for firms which were coordinating prior to the merger.

20. In assessing the competitive effects of a merger, the Commission compares the competitive conditions that would result from the notified merger with the conditions that would have prevailed without the merger ([5]). In most cases the competitive conditions existing at the time of the merger constitute the relevant comparison for evaluating the effects of a merger. However, in some circumstances, the Commission will take into account future changes to the market that can reasonably be predicted. It may, in particular, take account of the likely entry or exit of firms if the merger did not take place when considering what constitutes the relevant comparison. The Commission may take into account future market developments that result from impending regulatory changes ([6]).

([1]) See Article 2(1)(b) of the Merger Regulation and paragraph 84 of the Communication from the Commission — Notice — Guidelines on the application of Article 81(3) of the Treaty (OJ C 101, 27.4.2004, p. 97).
([2]) One example of this approach can be found in the case COMP/M.3653 — Siemens/VA Tech (2005), in which the Commission assessed the effect of the transaction on the two complementary markets for electrical rail vehicles and electrical traction systems for rail vehicles, which combine into a full rail vehicle. While the merger allegedly reduced the independent supply of electrical traction systems, there would still be several integrated suppliers which could deliver the rail vehicle. The Commission thus concluded that even if the merger had negative consequences for independent suppliers of electrical rail vehicles 'sufficient competition would remain in the relevant downstream market for rail vehicles'.
([3]) See Section II of the Notice on Horizontal Mergers.
([4]) For the meaning of the expression 'increased prices' see footnote 8.
([5]) By analogy, in the case of a merger that has been implemented without having been notified, the Commission would assess the merger in the light of the competitive conditions that would have prevailed without the implemented merger.
([6]) This may be particularly relevant in cases where effective competition is expected to arise in the future as a result of market opening. See e.g. Case COMP/M.3696 — E.ON/MOL (2005), at points 457 to 463.

21. In its assessment, the Commission will consider both the possible anti-competitive effects arising from the merger and the possible pro-competitive effects stemming from substantiated efficiencies benefiting consumers [1]. The Commission examines the various chains of cause and effect with a view to ascertaining which of them is the most likely. The more immediate and direct the perceived anti-competitive effects of a merger, the more likely the Commission is to raise competition concerns. Likewise, the more immediate and direct the pro-competitive effects of a merger, the more likely the Commission is to find that they counteract any anti-competitive effects.

22. This document describes the main scenarios of competitive harm and sources of efficiencies in the context of vertical mergers and, subsequently, in the context of conglomerate mergers.

III. MARKET SHARE AND CONCENTRATION LEVELS

23. Non-horizontal mergers pose no threat to effective competition unless the merged entity has a significant degree of market power (which does not necessarily amount to dominance) in at least one of the markets concerned. The Commission will examine this issue before proceeding to assess the impact of the merger on competition.

24. Market shares and concentration levels provide useful first indications of the market power and the competitive importance of both the merging parties and their competitors [2].

25. The Commission is unlikely to find concern in non-horizontal mergers, be it of a coordinated or of a non-coordinated nature, where the market share post-merger of the new entity in each of the markets concerned is below 30 % [3] and the post-merger HHI is below 2 000.

26. In practice, the Commission will not extensively investigate such mergers, except where special circumstances such as, for instance, one or more of the following factors are present:

(a) a merger involves a company that is likely to expand significantly in the near future, e.g. because of a recent innovation;

(b) there are significant cross-shareholdings or cross-directorships among the market participants;

(c) one of the merging firms is a firm with a high likelihood of disrupting coordinated conduct;

(d) indications of past or ongoing coordination, or facilitating practices, are present.

27. The Commission will use the above market share and HHI thresholds as an initial indicator of the absence of competition concerns. However, these thresholds do not give rise to a legal presumption. The Commission is of the opinion that it is less appropriate in this context to present market share and concentration levels above which competition concerns would be deemed to be likely, as the existence of a significant degree of market power in at least one of the markets concerned is a necessary condition for competitive harm, but is not a sufficient condition [4].

IV. VERTICAL MERGERS

28. This Section sets out the Commission's framework of analysis in the context of vertical mergers. In its assessment, the Commission will consider both the possible anti-competitive effects arising from vertical mergers and the possible pro-competitive effects stemming from efficiencies substantiated by the parties.

(1) See Section VII on efficiencies in the Notice on Horizontal Mergers.

(2) See also Section III of the Notice on Horizontal Mergers. The calculation of market shares depends critically on market definition (see Commission notice on the definition of the relevant market for the purposes of Community competition law (OJ C 372, 9.12.1997)). Special care must be taken in contexts where vertically integrated companies supply products internally.

(3) In analogy to the indications given in Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices (OJ L 336, 29.12.1999, p. 21). Where a merged entity would have a market share just above the 30 % threshold on one market but substantially below on other, related, markets competition concerns will be less likely.

(4) See Sections IV and V.

A. **Non-coordinated effects: foreclosure**

29. A merger is said to result in foreclosure where actual or potential rivals' access to supplies or markets is hampered or eliminated as a result of the merger, thereby reducing these companies' ability and/or incentive to compete. Such foreclosure may discourage entry or expansion of rivals or encourage their exit. Foreclosure thus can be found even if the foreclosed rivals are not forced to exit the market: It is sufficient that the rivals are disadvantaged and consequently led to compete less effectively. Such foreclosure is regarded as anti-competitive where the merging companies — and, possibly, some of its competitors as well — are as a result able to profitably increase the price charged to consumers ([1]).

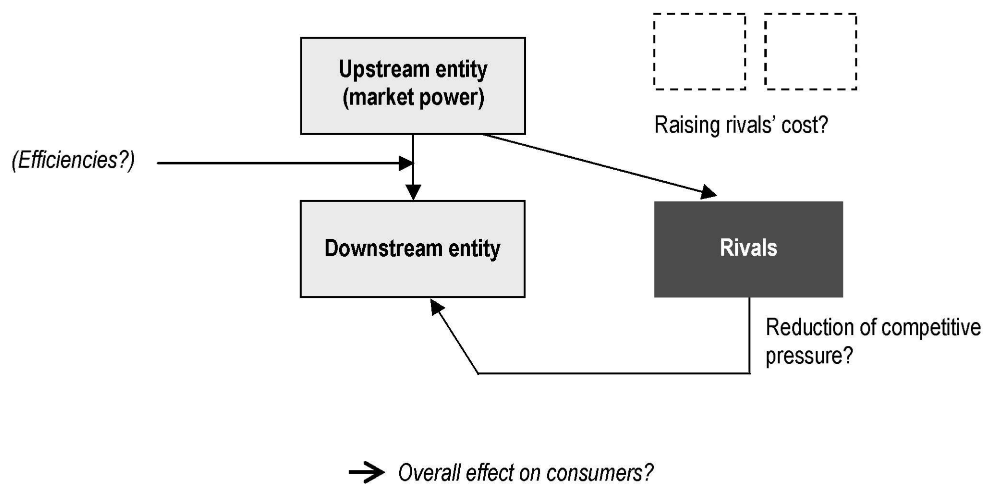
30. Two forms of foreclosure can be distinguished. The first is where the merger is likely to raise the costs of downstream rivals by restricting their access to an important input (input foreclosure). The second is where the merger is likely to foreclose upstream rivals by restricting their access to a sufficient customer base (customer foreclosure) ([2]).

1. *Input foreclosure*

31. Input foreclosure arises where, post-merger, the new entity would be likely to restrict access to the products or services that it would have otherwise supplied absent the merger, thereby raising its downstream rivals' costs by making it harder for them to obtain supplies of the input under similar prices and conditions as absent the merger. This may lead the merged entity to profitably increase the price charged to consumers, resulting in a significant impediment to effective competition. As indicated above, for input foreclosure to lead to consumer harm, it is not necessary that the merged firm's rivals are forced to exit the market. The relevant benchmark is whether the increased input costs would lead to higher prices for consumers. Any efficiencies resulting from the mergermay, however, lead the merged entity to reduce price, so that the overall likely impact on consumers is neutral or positive. A graphical presentation of this mechanism is provided in Figure 1.

Figure 1

Input foreclosure



([1]) For the meaning of the expression 'increased prices' see footnote 8. For the meaning of 'consumers', see footnote 16.
([2]) See Merger Regulation, Article 2(1)(b), referring to 'access to supplies' and 'access to [...] markets', respectively.

32. In assessing the likelihood of an anticompetitive input foreclosure scenario, the Commission examines, first, whether the merged entity would have, post-merger, the ability to substantially foreclose access to inputs, second, whether it would have the incentive to do so, and third, whether a foreclosure strategy would have a significant detrimental effect on competition downstream ([1]). In practice, these factors are often examined together since they are closely intertwined.

A. Ability to foreclose access to inputs ([2])

33. Input foreclosure may occur in various forms. The merged entity may decide not to deal with its actual or potential competitors in the vertically related market. Alternatively, the merged firm may decide to restrict supplies and/or to raise the price it charges when supplying competitors and/or to otherwise make the conditions of supply less favourable than they would have been absent the merger ([3]). Further, the merged entity may opt for a specific choice of technology within the new firm which is not compatible with the technologies chosen by rival firms ([4]). Foreclosure may also take more subtle forms, such as the degradation of the quality of input supplied ([5]). In its assessment, the Commission may consider a series of alternative or complementary possible strategies.

34. Input foreclosure may raise competition problems only if it concerns an important input for the downstream product ([6]). This is the case, for example, when the input concerned represents a significant cost factor relative to the price of the downstream product. Irrespective of its cost, an input may also be sufficiently important for other reasons. For instance, the input may be a critical component without which the downstream product could not be manufactured or effectively sold on the market ([7]), or it may represent a significant source of product differentiation for the downstream product ([8]). It may also be that the cost of switching to alternative inputs is relatively high.

35. For input foreclosure to be a concern, the vertically integrated firm resulting from the merger must have a significant degree of market power in the upstream market. It is only in these circumstances that the merged firm can be expected to have a significant influence on the conditions of competition in the upstream market and thus, possibly, on prices and supply conditions in the downstream market.

36. The merged entity would only have the ability to foreclose downstream competitors if, by reducing access to its own upstream products or services, it could negatively affect the overall availability of inputs for the downstream market in terms of price or quality. This may be the case where the remaining upstream suppliers are less efficient, offer less preferred alternatives, or lack the ability to expand output in response to the supply restriction, for example because they face capacity constraints or, more generally, face decreasing returns to scale ([9]). Also, the presence of exclusive contracts between the merged entity and independent input providers may limit the ability of downstream rivals to have adequate access to inputs.

([1]) See e.g. Case COMP/M.4300 — Philips/Intermagnetics, COMP/M.4314 — Johnson & Johnson/Pfizer Consumer Healthcare, COMP/M.4389 — WLR/BST, COMP/M.4403 — Thales/Finmeccanica/Alcatel Alenia Space and Telespazio, COMP/M.4494 — Evraz/Highveld, and COMP/M.4561 — GE/Smiths Aerospace.

([2]) The term 'inputs' is used here as a generic term and may also cover services, access to infrastructure and access to intellectual property rights.

([3]) See e.g. Case COMP/M.1693 — Alcoa/Reynolds (2000), Case COMP/M.4403 — Thales/Finmeccanica/Alcatel Alenia Space/Telespazio, points 257-260.

([4]) See e.g. Case COMP/M.2861 — Siemens/Drägerwerk/JV (2003), Case COMP/M.3998 — Axalto, point 75.

([5]) See e.g. Case COMP/M.4314 — Johnson & Johnson/Pfizer Consumer Healthcare, points 127-130.

([6]) See e.g. Case COMP/M.3868 — Dong/Elsam/Energi E2, Case COMP/M.4094 — Ineos/BP Dormagen, points 183-184, Case COMP/M.4561 — GE/Smiths Aerospace, points 48-50.

([7]) For instance, an engine starter can be considered a critical component to an engine (Case T-210/01, *General Electric v Commission* [2005] ECR II-000); see also, e.g. Case COMP/M.3410 — Total/GDF, points 53-54 and 60-61.

([8]) For instance, personal computers are often sold with specific reference to the type of microprocessor they contain.

([9]) See e.g. Case COMP/M.4494 — Evraz/Highveld, point 92 and points 97-112.

37. When determining the extent to which input foreclosure may occur, it must be taken into account that the decision of the merged entity to rely on its upstream division's supply of inputs may also free up capacity on the part of the remaining input suppliers from which the downstream division used to purchase before. In fact, the merger may merely realign purchase patterns among competing firms.

38. When competition in the input market is oligopolistic, a decision of the merged entity to restrict access to its inputs reduces the competitive pressure exercised on remaining input suppliers, which may allow them to raise the input price they charge to non-integrated downstream competitors. In essence, input foreclosure by the merged entity may expose its downstream rivals to non-vertically integrated suppliers with increased market power ([1]). This increase in third-party market power will be greater the lower the degree of product differentiation between the merged entity and other upstream suppliers and the higher the degree of upstream concentration. However, the attempt to raise the input price may fail when independent input suppliers, faced with a reduction in the demand for their products (from the downstream division of the merged entity or from independent downstream firms), respond by pricing more aggressively ([2]).

39. In its assessment, the Commission will consider, on the basis of the information available, whether there are effective and timely counter-strategies that the rival firms would be likely to deploy. Such counterstrategies include the possibility of changing their production process so as to be less reliant on the input concerned or sponsoring the entry of new suppliers upstream.

B. Incentive to foreclose access to inputs

40. The incentive to foreclose depends on the degree to which foreclosure would be profitable. The vertically integrated firm will take into account how its supplies of inputs to competitors downstream will affect not only the profits of its upstream division, but also of its downstream division. Essentially, the merged entity faces a trade-off between the profit lost in the upstream market due to a reduction of input sales to (actual or potential) rivals and the profit gain, in the short or longer term, from expanding sales downstream or, as the case may be, being able to raise prices to consumers.

41. The trade-off is likely to depend on the level of profits the merged entity obtains upstream and downstream ([3]). Other things constant, the lower the margins upstream, the lower the loss from restricting input sales. Similarly, the higher the downstream margins, the higher the profit gain from increasing market share downstream at the expense of foreclosed rivals ([4]).

42. The incentive for the integrated firm to raise rivals' costs further depends on the extent to which downstream demand is likely to be diverted away from foreclosed rivals and the share of that diverted

([1]) The analysis of the likely effect of the removal of a competitive constraint is similar to the analysis of non-coordinated effects with horizontal mergers (see Section IV of the Notice on Horizontal Mergers).

([2]) Also the nature of the supply contracts between upstream suppliers and the downstream independent firms may be important in this respect. For instance, when these contracts use a price system combining a fixed fee and a per-unit supply price, the effect on downstream competitors' marginal costs may be affected less than when these contracts involve only per-unit supply prices.

([3]) See e.g. Case COMP/M.4300 — Philips/Intermagnetics, points 56-62, Case COMP/M.4576 — AVR/Van Gansewinkel, points 33-38.

([4]) It has to be considered that upstream and downstream margins may change as a result of the merger. This may impact upon the merged entity's incentive to engage in foreclosure.

demand that the downstream division of the integrated firm can capture [1]. This share will normally be higher the less capacity constrained the merged entity will be relative to non-foreclosed downstream rivals and the more the products of the merged entity and foreclosed competitors are close substitutes. The effect on downstream demand will also be higher if the affected input represents a significant proportion of downstream rivals' costs or if the affected input represents a critical component of the downstream product [2].

43. The incentive to foreclose actual or potential rivals may also depend on the extent to which the downstream division of the integrated firm can be expected to benefit from higher price levels downstream as a result of a strategy to raise rivals' costs [3]. The greater the market shares of the merged entity downstream, the greater the base of sales on which to enjoy increased margins [4].

44. An upstream monopolist that is already able to fully extract all available profits in vertically related markets may not have any incentive to foreclose rivals following a vertical merger. The ability to extract available profits from the consumers does not follow immediately from a very high market share [5]. Such a finding would require a more thorough analysis of the actual and future constraints under which the monopolist operates. When all available profits cannot be extracted, a vertical merger — even if it involves an upstream monopolist — may give the merged entity the incentive to raise the costs of downstream rivals, thereby reducing the competitive constraint they exert on the merged entity in the downstream market.

45. In its assessment of the likely incentives of the merged firm, the Commission may take into account various considerations such as the ownership structure of the merged entity [6], the type of strategies adopted on the market in the past [7] or the content of internal strategic documents such as business plans.

(1) See e.g. Case COMP/M.3943 — Saint-Gobain/BPB (2005), point 78. The Commission noted that it would be very unlikely that BPB, the main supplier of plaster board in the UK, would cut back on supplies to rival distributors of Saint-Gobain, in part because expansion of Saint-Gobain's distribution capacity was difficult.

(2) Conversely, if the input accounts only for a small share of the downstream product and is not a critical component, even a high market share upstream may not give the merged entity the incentive to foreclose downstream rivals because few, if any, sales would be diverted to the integrated firm's downstream unit. See e.g. Case COMP/M.2738 — GEES/Unison; Case COMP M.4561 — GE/Smiths Aerospace, points 60-62.

(3) See e.g. Case COMP/M.4314 — Johnson & Johnson/Pfizer Consumer Healthcare, points 131-132.

(4) It must be noted that the less the merged firm can target a specific downstream market, the less it is likely to raise its prices for the input it supplies, as it would have to incur opportunity costs in other downstream markets. In this respect, the extent to which the merged entity can price discriminate when the merged entity supplies several downstream markets and/or ancillary markets may be taken into account (e.g. for spare parts).

(5) One situation in which this may not be the case would be when the monopolist has a so-called commitment problem which it is unable to solve. For example, a downstream buyer may be willing to pay a high price to an upstream monopolist if the latter does not subsequently sell additional quantities to a competitor. But once the terms of supply are fixed with one downstream firm, the upstream supplier may have an incentive to increase its supplies to other downstream firms, thereby making the first purchase unprofitable. Since downstream firms will anticipate this kind of opportunistic behavior, the upstream supplier will be unable to fully exploit its market power. Vertical integration may restore the upstream supplier's ability to commit not to expand input sales as this would harm its own downstream division. Another case in which the monopolist cannot obtain all available monopoly profits may arise when the company cannot differentiate its prices among customers.

(6) For instance, in cases where two companies have joint control over a firm active in the upstream market, and only one of them is active downstream, the company without downstream activities may have little interest in foregoing input sales. In such cases, the incentive to foreclose is smaller than when the upstream company is fully controlled by a company with downstream activities. See e.g. Case COMP/M.3440 — EDP/ENI/GDP (2004), Case COMP/M.4403 — Thales/Finmeccanica/Alcatel Alenia Space/Telespazio, points 121 and 268.

(7) The fact that, in the past, a competitor with a similar market position as the merged entity has stopped supplying inputs may demonstrate that it is commercially rational to adopt such a strategy (see e.g. COMP/M.3225 — Alcan/Pechiney (2004), at point 40).

46. In addition, when the adoption of a specific course of conduct by the merged entity is an essential step in foreclosure, the Commission examines both the incentives to adopt such conduct and the factors liable to reduce, or even eliminate, those incentives, including the possibility that the conduct is unlawful. Conduct may be unlawful *inter alia* because of competition rules or sector-specific rules at the EU or national levels. This appraisal, however, does not require an exhaustive and detailed examination of the rules of the various legal orders which might be applicable and of the enforcement policy practised within them ([1]). Moreover, the illegality of a conduct may be likely to provide significant disincentives for the merged entity to engage in such conduct only in certain circumstances. In particular, the Commission will consider, on the basis of a summary analysis: (i) the likelihood that this conduct would be clearly, or highly probably, unlawful under Community law ([2]), (ii) the likelihood that this illegal conduct could be detected ([3]), and (iii) the penalties which could be imposed.

C. Overall likely impact on effective competition

47. In general, a merger will raise competition concerns because of input foreclosure when it would lead to increased prices in the downstream market thereby significantly impeding effective competition.

48. First, anticompetitive foreclosure may occur when a vertical merger allows the merging parties to increase the costs of downstream rivals in the market thereby leading to an upward pressure on their sales prices. Significant harm to effective competition normally requires that the foreclosed firms play a sufficiently important role in the competitive process on the downstream market. The higher the proportion of rivals which would be foreclosed on the downstream market, the more likely the merger can be expected to result in a significant price increase in the downstream market and, therefore, to significantly impede effective competition therein ([4]). Despite a relatively small market share compared to other players, a specific firm may play a significant competitive role compared to other players ([5]), for instance because it is a close competitor of the vertically integrated firm or because it is a particularly aggressive competitor.

49. Second, effective competition may be significantly impeded by raising barriers to entry to potential competitors ([6]). A vertical merger may foreclose potential competition on the downstream market when the merged entity would be likely not to supply potential downstream entrants, or only on less favourable terms than absent the merger. The mere likelihood that the merged entity would carry out a foreclosure strategy post-merger may already create a strong deterrent effect on potential entrants ([7]). Effective competition on the downstream market may be significantly impeded by raising barriers to entry, in particular if input foreclosure would entail for such potential competitors the need to enter at both the downstream and the upstream level in order to compete effectively on either market. The concern of raising entry barriers is particularly relevant in those industries that are opening up to competition or are expected to do so in the foreseeable future ([8]).

([1]) Case C-12/03 P, *Commission v Tetra Laval BV* [2003] ECR I-000, paragraphs 74-76. Case T-210/01, *General Electric v Commission* [2005] ECR II-000, at paragraph 73.
([2]) Case T-210/01, *General Electric v Commission* [2005] ECR II-000, specifically at points 74-75 and 311-312.
([3]) For instance, in Case COMP/M.3696 — E.ON/MOL (2005), points 433 and 443-446, the Commission attached importance to the fact that the national Hungarian regulator for the gas sector indicated that in a number of settings, although it has the right to control and to force market players to act without discrimination, it would not be able to obtain adequate information on the commercial behaviour of the operators. See also Case COMP/M.3440 — EDP/ENI/GDP (2004), point 424.
([4]) See e.g. Case COMP/M.4494 — Evraz/Highveld, points 97-112.
([5]) See e.g. Case COMP/M.3440 — EDP/ENI/GDP (2004).
([6]) See e.g. Case COMP/M.4180 — Gaz de France/Suez, points 876-931, Case COMP/M.4576 — AVR/Van Gansewinkel, points 33-38.
([7]) See Case COMP/M.3696 — E.ON/MOL (2005), at point 662 *et seq*.
([8]) See paragraph 20. It is important that regulatory measures aimed at opening a market are not rendered ineffective through vertically-related incumbent companies merging and thereby closing off the market, or eliminating each other as potential entrants.

50. If there remain sufficient credible downstream competitors whose costs are not likely to be raised, for example because they are themselves vertically integrated [1] or they are capable of switching to adequate alternative inputs, competition from those firms may constitute a sufficient constraint on the merged entity and therefore prevent output prices from rising above pre-merger levels.

51. The effect on competition on the downstream market must also be assessed in light of countervailing factors such as the presence of buyer power [2] or the likelihood that entry upstream would maintain effective competition [3].

52. Further, the effect on competition needs to be assessed in light of efficiencies substantiated by the merging parties [4] The Commission may decide that, as a consequence of the efficiencies that the merger brings about, there are no grounds for declaring the merger incompatible with the common market pursuant to Article 2(3) of the Merger Regulation. This will be the case when the Commission is in a position to conclude on the basis of sufficient evidence that the efficiencies generated by the merger are likely to enhance the ability and incentive of the merged entity to act pro-competitively for the benefit of consumers, thereby counteracting the adverse effects on competition which the merger might otherwise have.

53. When assessing efficiencies in the context of non-horizontal mergers, the Commission applies the principles already set out in Section VII of the Notice on Horizontal Mergers In particular, for the Commission to take account of efficiency claims in its assessment of the merger, the efficiencies have to benefit consumers, be merger-specific and be verifiable. These conditions are cumulative [5].

54. Vertical mergers may entail some specific sources of efficiencies, the list of which is not exhaustive.

55. In particular, a vertical merger allows the merged entity to internalise any pre-existing double mark-ups resulting from both parties setting their prices independently pre-merger [6]. Depending on the market conditions, reducing the combined mark-up (relative to a situation where pricing decisions at both levels are not aligned) may allow the vertically integrated firm to profitably expand output on the downstream market [7].

56. A vertical merger may further allow the parties to better coordinate the production and distribution process, and therefore to save on inventories costs.

57. More generally, a vertical merger may align the incentives of the parties with regard to investments in new products, new production processes and in the marketing of products. For instance, whereas before the merger, a downstream distributor entity might have been reluctant to invest in advertising and informing customers about the qualities of products of the upstream entity when such investment would also have benefited the sale of other downstream firms, the merged entity may reduce such incentive problems.

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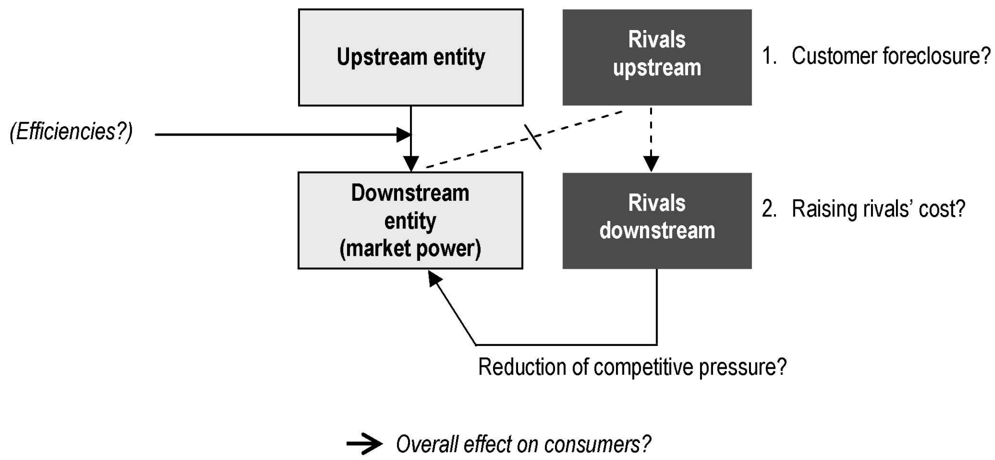
(1) See e.g. Case COMP/M.3653 — Siemens/VA Tech (2005), at point 164.
(2) See Section V on countervailing buyer power in the Notice on Horizontal Mergers.
(3) See Section VI on entry in the Notice on Horizontal Mergers.
(4) See Section VII on efficiencies in the Notice on Horizontal Mergers.
(5) See, more specifically, paragraphs 79 to 88 of the Notice on Horizontal Mergers.
(6) See also paragraph 13 above.
(7) It is important to recognise, however, that the problem of double mark-ups is not always present or significant pre-merger, for instance because the merging parties had already concluded a supply agreement with a price mechanism providing for volume discounts eliminating the mark-up. The efficiencies associated with the elimination of double mark-ups may thus not always be merger specific because vertical cooperation or vertical agreements may, short of a merger, achieve similar benefits with less anti-competitive effects. In addition, a merger may not fully eliminate the double mark-up when the supply of the input is limited by capacity constraints and there is an equally profitable alternative use for the input. In such circumstances, the internal use of the input entails an opportunity cost for the vertically integrated company: using more of the input internally to increase output downstream means selling less in the alternative market. As a result, the incentive to use the input internally and increase output downstream is less than when there is no opportunity cost.

2. *Customer foreclosure*

58. Customer foreclosure may occur when a supplier integrates with an important customer in the downstream market [1]. Because of this downstream presence, the merged entity may foreclose access to a sufficient customer base to its actual or potential rivals in the upstream market (the input market) and reduce their ability or incentive to compete. In turn, this may raise downstream rivals' costs by making it harder for them to obtain supplies of the input under similar prices and conditions as absent the merger. This may allow the merged entity profitably to establish higher prices on the downstream market. Any efficiencies resulting from the merger, however, may lead the merged entity to reduce price, so that there is overall not a negative impact on consumers. For customer foreclosure to lead to consumer harm, it is thus not necessary that the merged firm's rivals are forced to exit the market. The relevant benchmark is whether the increased input costs would lead to higher prices for consumers. A graphical presentation of this mechanism is provided in Figure 2.

Figure 2

Customer foreclosure



59. In assessing the likelihood of an anticompetitive customer foreclosure scenario, the Commission examines, first, whether the merged entity would have the ability to foreclose access to downstream markets by reducing its purchases from its upstream rivals, second, whether it would have the incentive to reduce its purchases upstream, and third, whether a foreclosure strategy would have a significant detrimental effect on consumers in the downstream market [2].

A. Ability to foreclose access to downstream markets

60. A vertical merger may affect upstream competitors by increasing their cost to access downstream customers or by restricting access to a significant customer base. Customer foreclosure may take various forms. For instance, the merged entity may decide to source all of its required goods or services from its upstream division and, as a result, may stop purchasing from its upstream competitors. It may also reduce its purchases from upstream rivals, or purchase from those rivals on less favourable terms than it would have done absent the merger [3].

(1) See footnote 4 for the definition of 'downstream' and 'upstream'.
(2) See e.g. Case COMP/M.4389 — WLR/BST.
(3) For instance, in cases involving distribution, the merged entity may be less likely to grant access to its outlets under the same conditions as absent the merger.

61. When considering whether the merged entity would have the ability to foreclose access to downstream markets, the Commission examines whether there are sufficient economic alternatives in the downstream market for the upstream rivals (actual or potential) to sell their output ([1]). For customer foreclosure to be a concern, it must be the case that the vertical merger involves a company which is an important customer with a significant degree of market power in the downstream market ([2]). If, on the contrary, there is a sufficiently large customer base, at present or in the future, that is likely to turn to independent suppliers, the Commission is unlikely to raise competition concerns on that ground ([3]).

62. Customer foreclosure can lead to higher input prices in particular if there are significant economies of scale or scope in the input market or when demand is characterised by network effects ([4]). It is mainly in such circumstances that the ability to compete of upstream rivals, be they actual or potential, can be impaired.

63. For instance, customer foreclosure can lead to higher input prices when existing upstream rivals operate at or close to their minimum efficient scale. To the extent that customer foreclosure and the corresponding loss of output for the upstream rivals increases their variable costs of production, this may result in an upward pressure on the prices they charge to their customers operating in the downstream market.

64. In the presence of economies of scale or scope, customer foreclosure may also render entry upstream by potential entrants unattractive by significantly reducing the revenue prospects of potential entrants. When customer foreclosure effectively results in entry deterrence, input prices may remain at a higher level than otherwise would have been the case, thereby raising the cost of input supply to downstream competitors of the merged firm.

65. Further, when customer foreclosure primarily impacts upon the revenue streams of upstream rivals, it may significantly reduce their ability and incentive to invest in cost reduction, R & D and product quality ([5]). This may reduce their ability to compete in the long run and possibly even cause their exit from the market.

66. In its assessment, the Commission may take into account the existence of different markets corresponding to different uses for the input. If a substantial part of the downstream market is foreclosed, an upstream supplier may fail to reach efficient scale and may also operate at higher costs in the other market(s). Conversely, an upstream supplier may continue to operate efficiently if it finds other uses or secondary markets for its input without incurring significantly higher costs.

([1]) The loss of the integrated firm as a customer is normally less significant if that firm's pre-merger purchases from non-integrated firms are a small share of the available sales base for those firms. In that case, sufficient alternative customers are more likely to be available. The presence of exclusive contracts between the merged entity and other downstream firms may limit the ability of upstream rivals to reach a sufficient sales volume.

([2]) See e.g. Case COMP/M.2822 — ENBW/ENI/GVS (2002) at points 54-57.

([3]) See e.g. Case COMP/M.81 — VIAG/Continental Can (1991), point 51, see e.g. Case COMP/M.4389 — WLR/BST, points 33-35.

([4]) Economies of scale or scope exist when an increase in scale or scope of production leads to a reduction in average unit cost. Network effects occur when the value of a product for a customer increases when the number of other customers also using it increases. Examples include communication devices, specific software programmes, products requiring standardisation, and platforms bringing together buyers and sellers.

([5]) An input supplier foreclosed from an important customer may prefer to stay out of the market if it fails to reach some minimum viable scale following the investment. Such minimum viable scale may be achieved, however, if a potential entrant has access to a broader customer base including customers in other relevant markets. See Case COMP/M.1879 — Boeing/Hughes (2000); Case COMP/M.2978 — Lagardère/Natexis/VUP (2003).

67. In its assessment, the Commission will consider, on the basis of the information available, whether there are effective and timely counter-strategies, sustainable over time, that the rival firms would be likely to deploy. Such counterstrategies include the possibility that upstream rivals decide to price more aggressively to maintain sales levels in the downstream market, so as to mitigate the effect of foreclosure ([1]).

B. Incentive to foreclose access to downstream markets

68. The incentive to foreclose depends on the degree to which it is profitable. The merged entity faces a trade-off between the possible costs associated with not procuring products from upstream rivals and the possible gains from doing so, for instance, because it allows the merged entity to raise price in the upstream or downstream markets.

69. The costs associated with reducing purchases from rival upstream suppliers are higher, when the upstream division of the integrated firm is less efficient than the foreclosed suppliers. Such costs are also higher if the upstream division of the merged firm is capacity constrained or rivals' products are more attractive due to product differentiation.

70. The incentive to engage in customer foreclosure further depends on the extent to which the upstream division of the merged entity can benefit from possibly higher price levels in the upstream market arising as a result of upstream rivals being foreclosed. The incentive to engage in customer foreclosure also becomes higher, the more the downstream division of the integrated firm can be expected to enjoy the benefits of higher price levels downstream resulting from the foreclosure strategy. In this context, the greater the market shares of the merged entity's downstream operations, the greater the base of sales on which to enjoy increased margins ([2]).

71. When the adoption of a specific conduct by the merged entity is an essential step in foreclosure, the Commission examines both the incentives to adopt such conduct and the factors liable to reduce, or even eliminate, those incentives, including the possibility that the conduct is unlawful ([3]).

C. Overall likely impact on effective competition

72. Foreclosing rivals in the upstream market may have an adverse impact in the downstream market and harm consumers. By denying competitive access to a significant customer base for the foreclosed rivals' (upstream) products, the merger may reduce their ability to compete in the foreseeable future. As a result, rivals downstream are likely to be put at a competitive disadvantage, for example in the form of raised input costs. In turn, this may allow the merged entity to profitably raise prices or reduce the overall output on the downstream market.

([1]) For instance, in Case COMP/M.1879 — Boeing/Hughes (2000), point 100, it was considered, among several other factors, that in view of the high fixed costs involved, if competing satellite launch vehicle providers were to become less cost-competitive relative to the merged entity, they would try to cut prices in order to salvage volume and recoup at least part of their fixed costs rather than accept losing a contract and incur a higher loss. The most likely impact would therefore be greater price competition rather than market monopolisation.

([2]) If the vertically integrated firm partially supplies inputs to downstream competitors it may benefit from the ability to expand sales, or as the case may be, to increase input prices.

([3]) The analysis of these incentives will be conducted as set out in paragraph 46 above.

73. The negative impact on consumers may take some time to materialise when the primary impact of customer foreclosure is on the revenue streams of upstream rivals, reducing their incentives to make investments in cost reduction, product quality or in other competitive dimensions so as to remain competitive.

74. It is only when a sufficiently large fraction of upstream output is affected by the revenue decreases resulting from the vertical merger that the merger may significantly impede effective competition on the upstream market. If there remain a number of upstream competitors that are not affected, competition from those firms may be sufficient to prevent prices from rising in the upstream market and, consequently, in the downstream market. Sufficient competition from these non-foreclosed upstream firms requires that they do not face barriers to expansion e.g. through capacity constraints or product differentiation ([1]). When the reduction of competition upstream affects a significant fraction of output downstream, the merger is likely, as with input foreclosure, to result in a significant increase of the price level in the downstream market and, therefore, to significantly impede effective competition ([2]).

75. Effective competition on the upstream market may also be significantly impeded by raising barriers to entry to potential competitors. This may be so in particular if customer foreclosure would entail for such potential competitors the need to enter at both the downstream and the upstream level in order to compete effectively on either market. In such a context, customer foreclosure and input foreclosure may thus be part of the same strategy. The concern of raising entry barriers is particularly relevant in those industries that are opening up to competition or are expected to do so in the foreseeable future ([3]).

76. The effect on competition must be assessed in light of countervailing factors such as the presence of countervailing buyer power ([4]) or the likelihood that entry would maintain effective competition in the upstream or downstream markets ([5]).

77. Further, the effect on competition needs to be assessed in light of efficiencies substantiated by the merging parties ([6]).

B. **Other non-coordinated effects**

78. The merged entity may, by vertically integrating, gain access to commercially sensitive information regarding the upstream or downstream activities of rivals ([7]). For instance, by becoming the supplier of a downstream competitor, a company may obtain critical information, which allows it to price less aggressively in the downstream market to the detriment of consumers ([8]). It may also put competitors at a competitive disadvantage, thereby dissuading them to enter or expand in the market.

([1]) The analysis of such non-coordinated effects bears similarities with the analysis of non-coordinated effects in horizontal mergers (see Section IV of the Notice on Horizontal Mergers).
([2]) See paragraph 47-50 of the present Notice.
([3]) It is important that regulatory measures aimed at opening a market are not rendered ineffective through vertically-related incumbent companies merging and thereby closing off the market, or eliminating each other as potential entrants.
([4]) See Section V on countervailing buyer power in the Notice on Horizontal Mergers.
([5]) See Section VI on entry in the Notice on Horizontal Mergers.
([6]) For the assessment of efficiencies in a vertical context, see Section V.A.1 above.
([7]) See Case COMP/M.1879 — Boeing/Hughes (2000); Case COMP/M.2510 — Cendant/Galileo, point 37; Case COMP/M.2738 — Gees/Unison, point 21; Case COMP/M.2925 — Charterhouse/CDC/Telediffusion de France, point 37-38; Case COMP/M.3440 — EDP/ENL/GDP (2004).
([8]) See e.g. Case COMP/M.2822 — ENBW/ENI/GVS (2002), at point 56; Case COMP/M.3440 — EDP/ENI/GDP (2004), points 368-379; Case COMP/M.3653 — Siemens/VA Tech (2005) points 159-164.

C. **Coordinated effects**

79. As set out in Section IV of the Notice on Horizontal Mergers, a merger may change the nature of competition in such a way that firms that previously were not coordinating their behaviour, are now significantly more likely to coordinate and raise prices or otherwise harm effective competition. A merger may also make coordination easier, more stable or more effective for firms which were coordinating prior to the merger ([1]).

80. Market coordination may arise where competitors are able, without entering into an agreement or resorting to a concerted practice within the meaning of Article 81 of the Treaty, to identify and pursue common objectives, avoiding the normal mutual competitive pressure by a coherent system of implicit threats. In a normal competitive setting, each firm constantly has an incentive to compete. This incentive is ultimately what keeps prices low, and what prevents firms from jointly maximising their profits. Coordination involves a departure from normal competitive conditions in that firms are able to sustain prices in excess of what independent short term profit maximisation would yield. Firms will refrain from undercutting the high prices charged by their competitors in a coordinated way because they anticipate that such behaviour would jeopardise coordination in the future. For coordinated effects to arise, the profit that firms could make by competing aggressively in the short term ('deviating') has to be less than the expected reduction in revenues that this behaviour would entail in the longer term, as it would be expected to trigger an aggressive response by competitors ('a punishment').

81. Coordination is more likely to emerge in markets where it is relatively simple to reach a common understanding on the terms of coordination. In addition, three conditions are necessary for coordination to be sustainable. First, the coordinating firms must be able to monitor to a sufficient degree whether the terms of coordination are being adhered to. Second, discipline requires that there is some form of deterrent mechanism that can be activated if deviation is detected. Third, the reactions of outsiders, such as current and future competitors not participating in the coordination, as well as customers, should not be able to jeopardise the results expected from the coordination ([2]).

Reaching terms of coordination

82. A vertical merger may make it easier for the firms in the upstream or downstream market to reach a common understanding on the terms of coordination ([3]).

83. For instance, when a vertical merger leads to foreclosure ([4]), it results in a reduction in the number of effective competitors in the market. Generally speaking, a reduction in the number of players makes it easier to coordinate among the remaining market players.

84. Vertical mergers may also increase the degree of symmetry between firms active in the market ([5]). This may increase the likelihood of coordination by making it easier to reach a common understanding on the terms of coordination. Likewise, vertical integration may increase the level of market transparency, making it easier to coordinate among the remaining market players.

85. Further, a merger may involve the elimination of a maverick in a market. A maverick is a supplier that for its own reasons is unwilling to accept the co-ordinated outcome and thus maintains aggressive competition. The vertical integration of the maverick may alter its incentives to such an extent that co-ordination will no longer be prevented.

([1]) See Case COMP/M.3101 — Accor/Hilton/Six Continents, points 23-28.
([2]) See Case T-342/99, *Airtours v Commission* [2002] ECR II-2585, paragraph 62.
([3]) See e.g. Case COMP/M.3314 — Air Liquide/Messer Targets, points 91-100.
([4]) Foreclosure would have to be shown by the Commission along the lines of Part A of this Section.
([5]) See Case COMP/M.2389 — Shell/DEA; Case COMP/M.2533 — BP/EON. Alternatively, vertical integration may also decrease the degree of symmetry between firms active in the market, rendering coordination more difficult.

Monitoring deviations

86. Vertical integration may facilitate coordination by increasing the level of market transparency between firms through access to sensitive information on rivals or by making it easier to monitor pricing. Such concerns may arise, for example, if the level of price transparency is higher downstream than upstream. This could be the case when prices to final consumers are public, while transactions at the intermediate market are confidential. Vertical integration may give upstream producers control over final prices and thus monitor deviations more effectively.

87. When it leads to foreclosure, a vertical merger may also induce a reduction in the number of effective competitors in a market. A reduction in the number of players may make it easier to monitor each other's actions in the market.

Deterrent mechanisms

88. Vertical mergers may affect coordinating firms' incentives to adhere to the terms of coordination. For instance, a vertically integrated company may be in a position to more effectively punish rival companies when they choose to deviate from the terms of coordination, because it is either a crucial customer or supplier to them ([1]).

Reactions of outsiders

89. Vertical mergers may reduce the scope for outsiders to destabilise the coordination by increasing barriers to enter the market or otherwise limiting the ability to compete on the part of outsiders to the coordination.

90. A vertical merger may also involve the elimination of a disruptive buyer in a market. If upstream firms view sales to a particular buyer as sufficiently important, they may be tempted to deviate from the terms of co-ordination in an effort to secure their business. Similarly, a large buyer may be able to tempt the co-ordinating firms to deviate from these terms by concentrating a large amount of its requirements on one supplier or by offering long term contracts. The acquisition of such a buyer may increase the risk of co-ordination in a market.

V. **CONGLOMERATE MERGERS**

91. Conglomerate mergers are mergers between firms that are in a relationship which is neither purely horizontal (as competitors in the same relevant market) nor vertical (as supplier and customer). In practice, the focus is on mergers between companies that are active in closely related markets ([2]) (e.g. mergers involving suppliers of complementary products or of products which belong to a range of products that is generally purchased by the same set of customers for the same end use).

92. Whereas it is acknowledged that conglomerate mergers in the majority of circumstances will not lead to any competition problems, in certain specific cases there may be harm to competition. In its assessment, the Commission will consider both the possible anti-competitive effects arising from conglomerate mergers and the possible pro-competitive effects stemming from efficiencies substantiated by the parties.

([1]) For instance, in a case that was subsequently withdrawn (Case COMP/M.2322 — CRH/Addtek (2001)) the merger involved an upstream dominant supplier of cement and a downstream producer or pre-cast concrete products, both active in Finland. The Commission provisionally took the view in the administrative procedure that the new entity would be able to discipline the downstream rivals by using the fact that they would be highly dependent on cement supplies of the merged entity. As a result, the downstream entity would be able to increase the price of its pre-cast concrete products while making sure that the competitors would follow these price increases and avoiding that they turn to cement imports from the Baltic States and Russia.

([2]) See also Form CO, Section IV, 6.3(c).

A. **Non-coordinated effects: foreclosure**

93. The main concern in the context of conglomerate mergers is that of foreclosure. The combination of products in related markets may confer on the merged entity the ability and incentive to leverage ([1]) a strong market position from one market to another by means of tying or bundling or other exclusionary practices ([2]). Tying and bundling as such are common practices that often have no anticompetitive consequences. Companies engage in tying and bundling in order to provide their customers with better products or offerings in cost-effective ways. Nevertheless, in certain circumstances, these practices may lead to a reduction in actual or potential rivals' ability or incentive to compete. This may reduce the competitive pressure on the merged entity allowing it to increase prices.

94. In assessing the likelihood of such a scenario, the Commission examines, first, whether the merged firm would have the ability to foreclose its rivals, second, whether it would have the economic incentive to do so and, third, whether a foreclosure strategy would have a significant detrimental effect on competition, thus causing harm to consumers ([3]). In practice, these factors are often examined together as they are closely intertwined.

A. *Ability to foreclose*

95. The most immediate way in which the merged entity may be able to use its market power in one market to foreclose competitors in another is by conditioning sales in a way that links the products in the separate markets together. This is done most directly either by tying or bundling.

96. 'Bundling' usually refers to the way products are offered and priced by the merged entity. One can distinguish in this respect between pure bundling and mixed bundling. In the case of pure bundling the products are only sold jointly in fixed proportions. With mixed bundling the products are also available separately, but the sum of the stand-alone prices is higher than the bundled price ([4]). Rebates, when made dependent on the purchase of other goods, may be considered a form of mixed bundling.

97. 'Tying' usually refers to situations where customers that purchase one good (the tying good) are required to also purchase another good from the producer (the tied good). Tying can take place on a technical or contractual basis. For instance, technical tying occurs when the tying product is designed in such a way that it only works with the tied product (and not with the alternatives offered by competitors). Contractual tying entails that the customer when purchasing the tying good undertakes only to purchase the tied product (and not the alternatives offered by competitors).

98. The specific characteristics of the products may be relevant for determining whether any of these means of linking sales between separate markets are available to the merged entity. For instance, pure bundling is very unlikely to be possible if products are not bought simultaneously or by the same customers ([5]). Similarly, technical tying is only an option in certain industries.

99. In order to be able to foreclose competitors, the new entity must have a significant degree of market power, which does not necessarily amount to dominance, in one of the markets concerned. The effects of bundling or tying can only be expected to be substantial when at least one of the merging

(1) There is no received definition of 'leveraging' but, in a neutral sense, it implies being able to increase sales of a product in one market (the 'tied market' or 'bundled market'), by virtue of the strong market position of the product to which it is tied or bundled (the 'tying market' or 'leveraging market').

(2) These concepts are defined further below.

(3) See Case T-210/01, *General Electric v Commission* [2005] ECR II-000, paragraphs 327, 362-363, 405; Case COMP/M.3304 — GE/Amersham (2004), point 37, and Case COMP/M.4561 — GE/Smiths Aerospace, points 116-126.

(4) The distinction between mixed bundling and pure bundling is not necessarily clear-cut. Mixed bundling may come close to pure bundling when the prices charged for the individual offerings are high.

(5) See e.g. Case COMP/M.3304 — GE/Amersham (2004), point 35.

parties' products is viewed by many customers as particularly important and there are few relevant alternatives for that product, e.g. because of product differentiation (1) or capacity constraints on the part of rivals.

100. Further, for foreclosure to be a potential concern it must be the case that there is a large common pool of customers for the individual products concerned. The more customers tend to buy both products (instead of only one of the products), the more demand for the individual products may be affected through bundling or tying. Such a correspondence in purchasing behaviour is more likely to be significant when the products in question are complementary.

101. Generally speaking, the foreclosure effects of bundling and tying are likely to be more pronounced in industries where there are economies of scale and the demand pattern at any given point in time has dynamic implications for the conditions of supply in the market in the future. Notably, where a supplier of complementary goods has market power in one of the products (product A), the decision to bundle or tie may result in reduced sales by the non-integrated suppliers of the complementary good (product B). If further there are network externalities at play (2) this will significantly reduce these rivals' scope for expanding sales of product B in the future. Alternatively, where entry into the market for the complementary product is contemplated by potential entrants, the decision to bundle by the merged entity may have the effect of deterring such entry. The limited availability of complementary products with which to combine may, in turn, discourage potential entrants to enter market A.

102. It can also be noted that the scope for foreclosure tends to be smaller where the merging parties cannot commit to making their tying or bundling strategy a lasting one, for example through technical tying or bundling which is costly to reverse.

103. In its assessment, the Commission considers, on the basis of the information available, whether there are effective and timely counter-strategies that the rival firms may deploy. One such example is when a strategy of bundling would be defeated by single-product companies combining their offers so as to make them more attractive to customers (3). Bundling is further less likely to lead to foreclosure if a company in the market would purchase the bundled products and profitably resell them unbundled. In addition, rivals may decide to price more aggressively to maintain market share, mitigating the effect of foreclosure (4).

104. Customers may have a strong incentive to buy the range of products concerned from a single source (one-stop-shopping) rather than from many suppliers, e.g. because it saves on transaction costs.The fact that the merged entity will have a broad range or portfolio of products does not, as such, raise competition concerns (5).

B. *Incentive to foreclose*

105. The incentive to foreclose rivals through bundling or tying depends on the degree to which this strategy is profitable. The merged entity faces a trade-off between the possible costs associated with bundling or tying its products and the possible gains from expanding market shares in the market(s) concerned or, as the case may be, being able to raise price in those market(s) due to its market power.

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(1) For instance, in the context of branded products, particularly important products are sometimes referred to as 'must stock' products. See e.g. Case COMP/M.3732 — Procter&Gamble/Gillette (2005), point 110.

(2) When a product features network externalities, this means that customers or producers derive benefit from the fact that other customers or producers are using the same products as well. Examples include communication devices, specific software programmes, products requiring standardisation, and platforms bringing together buyers and sellers.

(3) See e.g. Case COMP/M.3304 — GE/Amersham (2004), point 39.

(4) See e.g. Case COMP/M.1879 — Boeing/Hughes (2000), point 100; Case COMP/M.3304 — GE/Amersham (2004), point 39. The resulting loss of revenues may, however, in certain circumstances, have an impact on the ability of rivals to compete. See Section C.

(5) See e.g. Case COMP/M.2608 — INA/FAG, point 34.

106. Pure bundling and tying may entail losses for the merged company itself. For instance, if a significant number of customers are not interested in buying the bundle, but instead prefers to buy only one product (e.g. the product used to leverage), sales of that product (as contained in the bundle) may significantly fall. Furthermore, losses on the leveraging product may arise where customers who, before the merger, used to 'mix and match' the leveraging product of a merging party with the product of another company, decide to purchase the bundle offered by rivals or no longer to purchase at all ([1]).

107. In this context it may thus be relevant to assess the relative value of the different products. By way of example, it is unlikely that the merged entity would be willing to forego sales on one highly profitable market in order to gain market shares on another market where turnover is relatively small and profits are modest.

108. However, the decision to bundle and tie may also increase profits by gaining market power in the tied goods market, protecting market power in the tying goods market, or a combination of the two (see Section C below).

109. In its assessment of the likely incentives of the merged firm, the Commission may take into account other factors such as the ownership structure of the merged entity ([2]), the type of strategies adopted on the market in the past or the content of internal strategic documents such as business plans.

110. When the adoption of a specific conduct by the merged entity is an essential step in foreclosure, the Commission examines both the incentives to adopt such conduct and the factors liable to reduce, or even eliminate, those incentives, including the possibility that the conduct is unlawful ([3]).

C. *Overall likely impact on prices and choice*

111. Bundling or tying may result in a significant reduction of sales prospects faced by single-component rivals in the market. The reduction in sales by competitors is not in and of itself a problem. Yet, in particular industries, if this reduction is significant enough, it may lead to a reduction in rivals' ability or incentive to compete. This may allow the merged entity to subsequently acquire market power (in the market for the tied or bundled good) and/or to maintain market power (in the market for the tying or leveraging good).

112. In particular, foreclosure practices may deter entry by potential competitors. They may do so for a specific market by reducing sales prospects for potential rivals in that market to a level below minimum viable scale. In the case of complementary products, deterring entry in one market through bundling or tying may also allow the merged entity to deter entry in another market if the bundling or tying forces potential competitors to enter both product markets at the same time rather than entering only one of them or entering them sequentially. The latter may have a significant impact in particular in those industries where the demand pattern at any given point in time has dynamic implications for the conditions of supply in the market in the future.

113. It is only when a sufficiently large fraction of market output is affected by foreclosure resulting from the merger that the merger may significantly impede effective competition. If there remain effective single-product players in either market, competition is unlikely to deteriorate following a conglomerate merger. The same holds when few single-product rivals remain, but these have the ability and incentive to expand output.

(1) See e.g. Case COMP/M.3304 — GE/Amersham (2004), point 59.
(2) For instance, in cases where two companies have joint control over a firm active in one market, and only one of them is active on the neighbouring market, the company without activities on the latter market may have little interest in foregoing sales in the former market. See e.g. Case T-210/01, *General Electric v Commission* [2005] ECR II-000, paragraph 385 and Case COMP/M.4561 — GE/Smiths Aerospace, point 119.
(3) The analysis of these incentives will be conducted as set out in paragraph 46 above.

114. The effect on competition needs to be assessed in light of countervailing factors such as the presence of countervailing buyer power ([1]) or the likelihood that entry would maintain effective competition in the upstream or downstream markets ([2]).

115. Further, the effect on competition needs to be assessed in light of the efficiencies substantiated by the merging parties ([3]).

116. Many of the efficiencies identified in the context of vertical mergers may, mutatis mutandis, also apply to conglomerate mergers involving complementary products.

117. Notably, when producers of complementary goods are pricing independently, they will not take into account the positive effect of a drop in the price of their product on the sales of the other product. Depending on the market conditions, a merged firm may internalise this effect and may have a certain incentive to lower margins if this leads to higher overall profits (this incentive is often referred to as the 'Cournot effect'). In most cases, the merged firm will make the most out of this effect by means of mixed bundling, i.e. by making the price drop conditional upon whether or not the customer buys both products from the merged entity ([4]).

118. Specific to conglomerate mergers is that they may produce cost savings in the form of economies of scope (either on the production or the consumption side), yielding an inherent advantage to supplying the goods together rather than apart ([5]). For instance, it may be more efficient that certain components are marketed together as a bundle rather than separately. Value enhancements for the customer can result from better compatibility and quality assurance of complementary components. Such economies of scope however are necessary but not sufficient to provide an efficiency justification for bundling or tying. Indeed, benefits from economies of scope frequently can be realised without any need for technical or contractual bundling.

B. **Co-ordinated effects**

119. Conglomerate mergers may in certain circumstances facilitate anticompetitive co-ordination in markets, even in the absence of an agreement or a concerted practice within the meaning of Article 81 of the Treaty. The framework set out in Section IV of the Notice on Horizontal Mergers also applies in this context. In particular, co-ordination is more likely to emerge in markets where it is fairly easy to identify the terms of co-ordination and where such co-ordination is sustainable.

120. One way in which a conglomerate merger may influence the likelihood of a coordinated outcome in a given market is by reducing the number of effective competitors to such an extent that tacit coordination becomes a real possibility. Also when rivals are not excluded from the market, they may find themselves in a more vulnerable situation. As a result, foreclosed rivals may choose not to contest the situation of co-ordination, but may prefer instead to live under the shelter of the increased price level.

121. Further, a conglomerate merger may increase the extent and importance of multi-market competition. Competitive interaction on several markets may increase the scope and effectiveness of disciplining mechanisms in ensuring that the terms of co-ordination are being adhered to.

([1]) See Section V on countervailing buyer power in the Notice on Horizontal Mergers.
([2]) See e.g. Case COMP/M.3732 — Procter&Gamble/Gillette (2005), point 131. See also Section VI on entry in the Notice on Horizontal Mergers.
([3]) See Section VII on efficiencies in the Notice on Horizontal Mergers.
([4]) It is important to recognise however that the problem of double mark-ups is not always present or significant pre-merger. In the context of mixed bundling, it must further be noted that while the merged entity may have an incentive to reduce the price for the bundle, the effect on the prices of the individual products is less clear cut. The incentive for the merged entity to raise its single product prices may come from the fact that it counts on selling more bundled products instead. The merged entity's bundle price and prices of the individually sold products (if any) will further depend on the price reactions of rivals in the market.
([5]) See e.g. Case COMP/M.3732 — Procter&Gamble/Gillette (2005), point 131.

DG COMPETITION

Best Practices

on

the conduct of EC merger control proceedings

1. SCOPE AND PURPOSE OF THE BEST PRACTICES

1. The principal aim of these Best Practices is to provide guidance for interested parties on the day-to-day conduct of EC merger control proceedings. They are intended to foster and build upon a spirit of co-operation and better understanding between DG Competition and the legal and business community. In this regard, the Best Practices seek to increase understanding of the investigation process and thereby to further enhance the efficiency of investigations and to ensure a high degree of transparency and predictability of the review process. In particular, they aim at making the short time available in EC merger procedures as productive and efficient as possible for all parties concerned.

2. The Best Practices are built on the experience to date of DG Competition in the application of Council Regulation (EEC) No 4064/89[1] (the Merger Regulation) and replace the current Best Practices of 1999. They reflect the views and practice of DG Competition at the time of publication[2].

   The specificity of an individual case may require an adaptation of, or deviation from these Best Practices depending on the case at hand.

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[1] Council Regulation No 4064/89, OJ L 395, 30.12.1989 p. 1; corrigendum OJ L 257 of 21.9.1990, p. 13; Regulation as last amended by Regulation (EC) No 1310/97 (OJ L 180, 9. 7. 1997, p. 1, corrigendum OJ L 40, 13.2.1998, p. 17).

[2] It is to be noted that a recast Merger Regulation replacing Regulation 4064/89 will apply from 1 May 2004. The Best Practices are equally applicable under Regulation 4064/89 and will continue to be applicable, possibly with further amendments, under the recast Merger Regulation. Appropriate references to the recast Merger Regulation are made throughout the Best Practices by means of footnotes. Those references will only become applicable from 1st of May 2004.

2. RELATIONSHIP TO COMMUNITY LAW

3. These Best Practices should not be taken as a full or comprehensive account of the relevant legislative, interpretative and administrative measures which govern Community merger control. They should be read in conjunction with such measures.

4. The Best Practices do not create or alter any rights or obligations as set out in the Treaty establishing the European Community, the Merger Regulation, its Implementing Regulation[3] as amended from time to time and as interpreted by the case-law of the Community Courts. Nor do they alter the Commission's interpretative notices. The Best Practices do not apply to proceedings under Council Regulation No 17[4], to be replaced by Council Regulation No 1/2003[5] as of 1 May 2004, implementing Articles 81 and 82 of the Treaty.

3. PRE-NOTIFICATION

Purpose of pre-notification contacts

5. In DG Competition's experience the pre-notification phase of the procedure is an important part of the whole review process. As a general rule, DG Competition finds it useful to have pre-notification contacts with notifying parties even in seemingly non-problematic cases. DG Competition will therefore always give notifying parties and other involved parties the opportunity, if they so request, to discuss an intended concentration informally and in confidence prior to notification (cf. also Recital 10 Implementing Regulation).

6. Pre-notification contacts provide DG Competition and the notifying parties with the possibility, prior to notification, to discuss jurisdictional and other legal issues. They also serve to discuss issues such as the scope of the information to be submitted and to prepare for the upcoming investigation by identifying key issues and possible competition concerns (theories of harm) at an early stage.

7. Further, it is in the interests of DG Competition and the business and legal community to ensure that notification forms are complete from the outset so that declarations of incompleteness are avoided as far as possible. It is DG Competition's experience that in cases in which notifications have been declared incomplete, usually there were no or very limited pre-notification contacts. Accordingly, for this reason it is recommended that notifying parties contact DG Competition prior to notification.

8. Pre-notification discussions are held in strict confidence. The discussions are a voluntary part of the process and remain without prejudice to the handling and investigation of the case following formal notification. However, the mutual benefits

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[3] Commission Regulation (EC) No 447/98 of 1 March 1998 on the notifications, time limits and hearings provided for in the Merger Regulation, OJ L 61, 2.3.1998, p.1.

[4] OJ P 013, 21/02/1962, p. 204 – 211.

5 Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, OJ L 1, 04.01.2003, p. 1-25.

for DG Competition and the parties of a fruitful pre-notification phase can only materialise if discussions are held in an open and co-operative atmosphere, where all potential issues are addressed in a constructive way.

9. In DG Competition's experience it is generally preferable that both legal advisers and business representatives, who have a good understanding of the relevant markets, are available for pre-notification discussions with the case-team. This normally results in more informed discussions on the business rationale for the transaction and the functioning of the markets in question.

Timing and extent of pre-notification contacts

10. Pre-notification contacts should preferably be initiated at least two weeks before the expected date of notification. The extent and format of the pre-notification contacts required is, however, linked to the complexity of the individual case in question. In more complex cases a more extended pre-notification period may be appropriate and in the interest of the notifying parties. In all cases it is advisable to make contact with DG Competition as soon as possible as this will facilitate planning of the case.

11. Pre-notification contacts should be launched with a submission that allows the selection of an appropriate DG Competition case-team[6]. This memorandum should provide a brief background to the transaction, a brief description of the relevant sector(s) and market(s) involved and the likely impact of the transaction on competition in general terms. It should also indicate the case language. In straightforward cases, the parties may chose to submit a draft Form CO as a basis for further discussions with DG Competition.

12. After initial contacts have been made between the case-team and the notifying parties, it will be decided, whether it will suffice for DG Competition to make comments orally or in writing on the submissions made. This would typically be considered in straightforward cases. In more complex cases and cases that raise jurisdictional or other procedural issues, one or more pre-notification meetings are normally considered appropriate.

13. The first pre-notification meeting is normally held on the basis of a more substantial submission or a first draft Form CO. This allows for a more fruitful discussion about the proposed transaction in question or potential issue in point. Subsequent meetings may cover additional information submitted or outstanding issues.

14. Any submission sent to DG Competition should be provided sufficiently ahead of meetings or other contacts in order to allow for well prepared and fruitful discussions. In this regard, preparatory briefing memoranda/ draft Form COs sent in preparation of meetings should be filed in good time before the meeting (at least three working days) unless agreed otherwise with the case team. In case of voluminous submissions and in less straightforward cases, this time may need to be extended to allow DG Competition to properly prepare for the meeting.

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6 Case teams for new cases are normally set up in weekly DG Competition's Merger Management Meetings.

15. Irrespective of whether pre-notification meetings have taken place or not, it is advisable that the notifying parties systematically provide a substantially complete draft Form CO before filing a formal notification. DG Competition would thereafter normally require five working days to review the draft before being asked to comment, at a meeting or on the telephone, on the adequacy of the draft. In case of voluminous submissions, this time will normally be extended.

Information to be provided / preparation of the Form CO

16. The format and the timing of all prenotification submissions should be decided together with the case-team. Notifying parties are advised to fully and frankly disclose information relating to all potentially affected markets and possible competition concerns, even if they may ultimately consider that they are not affected and notwithstanding that they may take a particular view in relation to, for example, the issue of market definition. This will allow for an early market testing of alternative market definitions and/or the notifying parties' position on the market/s in question. In DG Competition's experience this approach minimises surprise submissions from third parties, and may avoid requests for additional information from the notifying parties at a late stage in the procedure and possible declarations of incompleteness under Article 4(2) of the Implementing Regulation or a decision under Article 11(5) of the Merger Regulation.

17. In addition, DG Competition recommends that notifying parties should, as early as possible in pre-notification, submit internal documents such as board presentations, surveys, analyses, reports and studies discussing the proposed concentration, the economic rationale for the concentration and competitive significance or the market context in which it takes place. Such documents provide DG Competition with an early and informed view of the transaction and its potential competitive impact and can thus allow for a productive discussion and finalisation of the Form CO.

18. Where appropriate, it is also recommended that notifying parties put forward, already at the pre-notification stage, any elements demonstrating that the merger leads to efficiency gains that they would like the Commission to take into account for the purposes of its competitive assessment of the proposed transaction. Such claims are likely to require extensive analysis. It is thus in the interests of the notifying parties to present these claims as early as possible to allow sufficient time for DG Competition to appropriately consider these elements in its assessment of a proposed transaction.

19. Pre-notification discussions provide the opportunity for the Commission and the notifying parties to discuss the amount of information to be provided in a notification. The notifying parties may in pre-notification request the Commission to waive the obligation to provide certain information that is not necessary for the examination of the case. All requests to omit any part of the information specified should be discussed in detail and any waiver has to be agreed with DG Competition prior to notification[7].

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[7] See Article 3(2) Implementing Regulation. See also Commission Notice on a simplified procedure for treatment of certain concentrations under Council Regulation (EEC) No 4064/89, OJ C217, 29.07.2000, p. 32.

Completeness of the notification

20. Given that a notification is not considered effective until the information to be submitted in Form CO is complete in all material respects, the notifying parties and their advisers should ensure that the information contained in Form CO has been carefully prepared and verified: incorrect and misleading information is considered incomplete information[8]. In this regard, the notifying parties should take special care that the appropriate contact details are provided for customers, suppliers and competitors. If such information is not correct or provided in full it will significantly delay the investigation and therefore may lead to a declaration of incompleteness.

21. Further, to facilitate the effective and expeditious handling of their notification, notifying parties should also endeavour to provide the contact details required in Form CO electronically, at the latest on the day of notification, using the appropriate electronic form which can be provided by the case team.

22. Provided that the notifying parties follow the above described guidance, DG Competition will in principle, be prepared to confirm informally the adequacy of a draft notification at the pre-notification stage or, if appropriate, to identify in what material respects the draft Form CO is incomplete. However it has to be recognised that it will not be possible for DG Competition to exclude the fact that it may have to declare a notification incomplete in appropriate cases after notification.

23. In the event that DG Competition discovers omissions in the Form CO after formal notification, the notifying parties may be given an opportunity to urgently put right such omissions before a declaration of incompleteness is adopted. Due to the time constraints in merger procedures, the time allowed for such rectification is normally limited to 1 or 2 days. This opportunity will not be granted, however, in cases where DG Competition finds that the omissions immediately hinder the proper investigation of the proposed transaction.

Procedural questions and inter-agency co-operation

24. In addition to substantive issues, the notifying parties may in the pre-notification phase seek DG Competition's opinion on procedural matters such as jurisdictional questions.

25. Informal guidance may be provided if they are directly related to an actual, planned transaction and if sufficiently detailed background information is submitted by the notifying parties to properly assess the issue in question[9]. Further matters for pre-notification discussions include the possibility of referrals to or from national EU jurisdictions[10], parallel proceedings in other non-EU jurisdictions and the issue of

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[8] In addition, the Commission may impose fines on the notifying parties where they supply incorrect or misleading information in a notification under Article 14 (1)(b) Merger Regulation.

[9] Such informal guidance cannot be regarded as creating legitimate expectations regarding the proper interpretation of applicable jurisdictional or other rules.

[10] Such jurisdictional discussions will become particularly pertinent under the recast Merger Regulation, which becomes applicable from 1 May 2004. Pursuant to Articles 4(4) and 4(5) of the recast Merger Regulation, notifying parties may, before notification, request on the basis of a

waivers on information sharing with other jurisdictions. As regards transactions likely to be reviewed in more than one jurisdiction, DG Competition invites the notifying parties to discuss the timing of the case with a view to enhance efficiency of the respective investigations, to reduce burdens on the merging parties and third parties, and to increase overall transparency of the merger review process. In this regard, notifying parties should also have regard to the EU-US Best Practices on co-operation in merger investigations[11].

4. FACT FINDING / REQUESTS FOR INFORMATION

26. In carrying out its duties the Commission may obtain all necessary information from relevant persons, undertakings, associations of undertakings and competent authorities of Member States (see Article 11(1) Merger Regulation). That investigation normally starts after the notification of a proposed concentration. However, DG Competition may exceptionally decide that, in the interest of its investigation, market contacts could be initiated informally prior to notification. Such pre-notification contacts/enquiries would only take place if the existence of the transaction is in the public domain and once the notifying parties have had the opportunity to express their views on such measures.

27. The Commission's investigation is mainly conducted in the form of written Requests for Information (requests pursuant to Article 11 of the Merger Regulation) to customers, suppliers, competitors and other relevant parties. Such requests may also be addressed to the notifying parties. In addition to such Article 11 requests, the views of the notifying parties, other involved parties and third parties are also sought orally.

28. In the interest of an efficient investigation, DG Competition may consult the notifying parties, other involved parties or third parties on methodological issues regarding data and information gathering in the relevant economic sector. It may also seek external economic and/or industrial expertise and launch its own economic studies.

5. COMMUNICATION AND MEETINGS WITH THE NOTIFYING PARTIES, OTHER INVOLVED PARTIES AND 3RD PARTIES

29. One of the aims of these Best Practices is to enhance transparency in the day to day handling of merger cases and in particular, to ensure good communication between DG Competition, the merging parties and third parties. In this regard, DG Competition endeavours to give all parties involved in the proceeding ample opportunity for open and frank discussions and to make their points of view known throughout the procedure.

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reasoned submission, referral of a case to or from the Commission. DG Competition will be ready to discuss with notifying parties informally the possibility of such pre-notification referrals and to guide them through the pre-notification referral process.

11 http://europa.eu.int/comm/competition/mergers/others/eu_us.pdf

5.1. State of Play meetings with notifying parties

Aim and format of the State of Play meetings

30. The objective of the State of Play meetings is to contribute to the quality and efficiency of the decision-making process and to ensure transparency and communication between DG Competition and the notifying parties. As such these meetings should provide a forum for the mutual exchange of information between DG Competition and the notifying parties at key points in the procedure. They are entirely voluntary in nature.

31. State of Play meetings may be conducted in the form of meetings at the Commission's premises, or alternatively, if appropriate, by telephone or videoconference. In order for the meetings to operate properly they should be carefully prepared on the basis of an agenda agreed in advance. Further, senior DG Competition management will normally chair the meetings.

32. The State of Play meetings will not exclude discussions and exchanges of information between the notifying parties and DG Competition at other occasions throughout the procedure as appropriate. In this regard, notifying parties are advised to inform DG Competition, as soon as possible, about any important procedural or substantive developments that may be of relevance for the assessment of the proposed transaction. Such developments may include any remedy proposals the notifying parties are offering or are considering to offer in other jurisdictions, so as to facilitate co-ordination of the timing and substance of such remedy proposals. This also concerns matters already discussed at a State of Play meeting, in respect of which the parties consider it necessary to provide additional comments.

Timing of the State of Play meetings

33. Notifying parties will normally be offered the opportunity of attending a State of Play meeting at the following five different points in the Phase I and Phase II procedure:

a) where it appears that "serious doubts" within the meaning of Article 6(1)(c) of the Merger Regulation are likely to be present a meeting will be offered <u>before the expiry of 3 weeks[12] into Phase I</u>. In addition to informing the notifying parties of the preliminary result of the initial investigation, this meeting provides an opportunity for the notifying parties to prepare the formulation of a possible remedy proposal in Phase I before expiry of the deadline provided in Article 18 of the Implementing Regulation.

b) <u>normally within 2 weeks following the adoption of the Article 6(1)(c) decision</u>. In order to prepare for this meeting, the notifying parties should provide DG Competition with their comments on the Article 6(1)(c) decision and on any documents in the Commission's file, which they may have had the opportunity to review (see below section 7.2) by way of a written memorandum in advance of the meeting. The notifying parties should contact the case team to discuss an appropriate schedule for the filing of this memorandum.

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12 Fifteen working days under the recast Merger Regulation.

The main purpose of the post Article 6(1)(c) meeting is to facilitate the notifying parties' understanding of the Commission's concerns at an early stage of the Phase II proceedings. The meeting also serves to assist DG Competition in deciding the appropriate framework for its further investigation by discussing with the notifying parties matters such as the market definition and competition concerns outlined in the Article 6(1)(c) decision. The meeting is also intended to serve as a forum for mutually informing each other of any planned economic or other studies. The approximate timetable of the Phase II procedure may also be discussed[13].

c) before the issuing of a Statement of Objections (SO). This pre-SO meeting gives the notifying parties an opportunity to understand DG Competition's preliminary view on the outcome of the Phase II investigation and to be informed of the type of objections DG Competition may set out in the SO. The meeting may also be used by DG Competition to clarify certain issues and facts before it finalises its proposal on the issuing of a SO.

d) following the reply to the SO and the Oral Hearing. This post-SO State of Play meeting provides the notifying parties with an opportunity to understand DG Competition's position after it has considered their reply and heard them at an Oral Hearing. If DG Competition indicates that it is minded to maintain some or all of its objections, the meeting may also serve as an opportunity to discuss the scope and timing of possible remedy proposals[14].

e) before the Advisory Committee meets. The primary purpose of this meeting is to enable the notifying parties to discuss with DG Competition its views on any proposed remedies and where relevant, the results of the market testing of such remedies. It also provides the notifying parties where necessary, with the opportunity to formulate improvements to their remedies proposal[15].

5.2. Involvement of third parties

34. According to Community merger control law, third parties considered as having a “sufficient interest” in the Commission’s procedure include customers, suppliers, competitors, members of the administration or management organs of the undertakings concerned or recognised workers’ representatives of those undertakings[16]. Their important role in the Commission’s procedure is stressed in particular in Article 18(4) of the Merger Regulation and Articles 16(1) and (2) of the

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[13] Once the recast Merger Regulation becomes applicable, this post Article 6(1)(c) State of Play meeting will also serve to discuss the possibility of any extensions to the Phase II deadline pursuant to Article 10(3) of the recast Merger Regulation.

[14] It is to be noted that, under the recast Merger Regulation (Article 10(3)), the submission of remedies could lead to an automatic extension of the Phase II deadline.

[15] Modifications to remedies are only possible under those conditions set out in Article 18 of the Implementing Regulation and point 43 of the Commission’s Notice on Remedies.

[16] See Article 11 of the Implementing Regulation.

Implementing Regulation. In addition, the Commission also welcomes the views of any other interested third parties including consumer organisations[17].

35. The primary way for third parties to contribute to the Commission's investigation is by means of replies to requests for information (Article 11 Merger Regulation)[18]. However, DG Competition also welcomes any individual submission apart from direct replies to questionnaires, where third parties provide information and comments they consider relevant for the assessment of a given transaction. DG Competition may also invite third parties for meetings to discuss and clarify specific issues raised.

36. In addition, DG Competition may in the interest of the investigation in appropriate cases provide third parties that have shown a sufficient interest in the procedure with an edited version of the SO from which business secrets have been removed, in order to allow them to make their views known on the Commission's preliminary assessment. In such cases, the SO is provided under strict confidentiality obligations and restrictions of use, which the third parties have to accept prior to receipt.

37. If third parties wish to express competition concerns as regards the transaction in question or to put forward views on key market data or characteristics that deviate from the notifying parties' position, it is essential that they are communicated as early as possible to DG Competition, so that they can be considered, verified and taken into account properly. Any point raised should be substantiated and supported by examples, documents and other factual evidence. Furthermore, in accordance with Article 17(2) of the Implementing Regulation, third parties should always provide the DG Competition with a non-confidential version of their submissions at the time of filing or shortly thereafter to facilitate access to the file and other measures intended to ensure transparency for the benefit of the decision making process (see further below section 7).

5.3. "Triangular" and other meetings

38. In addition to bilateral meetings between DG Competition and the notifying parties, other involved parties or third parties, DG Competition may decide to invite third parties and the notifying parties to a "triangular" meeting where DG Competition believes it is desirable, in the interests of the fact-finding investigation, to hear the views of the notifying parties and such third parties in a single forum. Such triangular meetings, which will be on a voluntary basis and which are not intended to replace the formal oral hearing, would take place in situations where two or more opposing views have been put forward as to key market data and characteristics and the effects of the concentration on competition in the markets concerned.

39. Triangular meetings should ideally be held as early in the investigation as possible in order to enable DG Competition to reach a more informed conclusion as to the

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[17] Article 16(3) Implementing Regulation. To this effect, DG Competition has appointed a Consumer Liaison Officer responsible for contacts with consumer organisations.

[18] Article 11(7) of the recast Merger Regulation expressly provides for the Commission's competence to interview any natural or legal person who consents to be interviewed for the purpose of collecting information relating to the subject-matter of an investigation.

relevant market characteristics and to clarify issues of substance before deciding on the issuing of an SO. Triangular meetings are normally chaired by senior DG Competition management. They are prepared in advance on the basis of an agenda established by DG Competition after consultation of all parties that agreed to attend the meeting. The preparation will normally include a mutual exchange of non-confidential submissions between the notifying parties and the third party in question sufficiently in advance of the meeting. The meeting will not require the disclosure of confidential information or business secrets, unless otherwise agreed by the parties.

6. REMEDIES DISCUSSIONS

40. As stated above, the State of Play meetings in both Phase I and Phase II, in addition to providing a forum for discussing issues related to the investigation, also serve to discuss possible remedy proposals. Detailed guidance on the requirements for such proposals is set out in the Commission Notice on remedies acceptable under Council Regulation (EEC) No 4064/89 and under Commission Regulation (EC) No 447/98[19] (the Remedies Notice). In particular, the Remedies Notice sets out the general principles applicable to remedies, the main types of commitments that have previously been accepted by the Commission, the specific requirements which proposals of remedies need to fulfil in both phases of the procedure, and guidance on the implementation of remedies. As regards the design of divestiture commitment proposals, the notifying parties are advised to take due account of the Commission's "Best Practice Guidelines on Divestiture Commitments"[20].

41. Although it is for the notifying parties to formulate suitable remedies proposals, DG Competition will provide guidance to the parties as to the general appropriateness of their draft proposal in advance of submission. In order to allow for such discussions, a notifying party should contact DG Competition in good time before the relevant deadline in Phase I or Phase II, in order to be able to address comments DG Competition may have on the draft proposal[21].

7. PROVISION OF DOCUMENTS IN THE COMMISSION'S FILE / CONFIDENTIALITY

7.1. Access to the file

42. According to Community law, the notifying parties have upon request a right to access the Commission's file after the Commission has issued an SO (see Article 18(3) of the Merger Regulation and Article 13(3) of the Implementing Regulation).

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19 OJ C 68, 02.03.2001, p. 3-11.

20 Available under http://europa.eu.int/comm/competition/mergers/legislation/divestiture_commitments/

21 It is to be noted that under the recast Merger Regulation (Articles 10(1) and (3)), the submission of remedies could lead to an automatic extension of the Phase I and II deadlines.

43. Further, the notifying parties will be given the opportunity to have access to documents received after the issuing of the SO up until the consultation of the Advisory Committee.

44. Access to the file will be provided subject to the legitimate interest of the protection of third parties' business secrets and other confidential information.

7.2. Review of key documents

45. DG Competition believes in the merits of an open exchange of views with ample opportunities for the notifying parties and third parties to make their points of view known throughout the procedure. This enables DG Competition to assess the main issues arising during the investigation with as much information at its disposal as possible. In this spirit, DG Competition's objective will be to provide the notifying parties with the opportunity of reviewing and commenting on "key documents" obtained by the Commission. Such documents would comprise substantiated submissions of third parties running counter to the notifying parties' own contentions received during Phase I and thereafter[22], including key submissions to which specific reference is made in the Article 6(1)(c) decision and market studies.

46. DG Competition will use its best endeavours to provide notifying parties in a timely fashion, with the opportunity to review such documents following the initiation of proceedings and thereafter on an *ad hoc* basis. DG Competition will respect justified requests by third parties for non-disclosure of their submissions prior to the issuing of the SO relating to genuine concerns regarding confidentiality, including fears of retaliation and the protection of business secrets.

7.3. Confidentiality Rules

47. In accordance with Article 287 of the EC Treaty and Article 17(1) of the Implementing Regulation, the Commission will, throughout its investigation, protect confidential information and business secrets contained in submissions provided by all parties involved in EC merger proceedings. Given the short legal deadlines of EC merger procedures, parties are encouraged to clarify as soon as possible any queries related to confidentiality claims with members of the case team. Guidance on what is considered to be business secrets or other confidential information is provided in the Commission's Notice on Access to file[23].

8. RIGHT TO BE HEARD AND OTHER PROCEDURAL RIGHTS

48. The right of the parties concerned to be heard before a final decision affecting their interests is taken is a fundamental principle of Community law. That right is also set

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[22] This would in particular include substantiated "complaints" contending that the notified transaction may give rise to competition concerns. The word "complaint" is to be understood in the non-technical sense of the term as no formal complaints procedure exists in merger cases.

[23] OJ C 23, 23/01/97, p. 3.

out in the Merger Regulation (Article 18) and the Implementing Regulation (Articles 14-16). These Best Practices do not alter any such rights under Community law.

49. Any issues related to the right to be heard and other procedural issues, including access to the file, time limits for replying to the SO and the objectivity of any enquiry conducted in order to assess the competition impact of commitments proposed in EC merger proceedings can be raised with the Hearing Officer, in accordance with Commission Decision of 23 May 2001 on the terms of reference of hearing officers in certain competition proceedings[24].

9. FUTURE REVIEW

50. These Best Practices may be revised to reflect changes to legislative, interpretative and administrative measures or due to case law of the European Courts, which govern EC merger control or any experience gained in applying such framework. DG Competition further intends to engage, on a regular basis, in a dialogue with the business and legal community on the experience gained through the application of the Merger Regulation in general, and these Best Practices in particular.

[24] Official Journal L 162, 19/06/2001 p. 21–24. The text can also be found at: http://europa.eu.int/comm/competition/hearings/officers/

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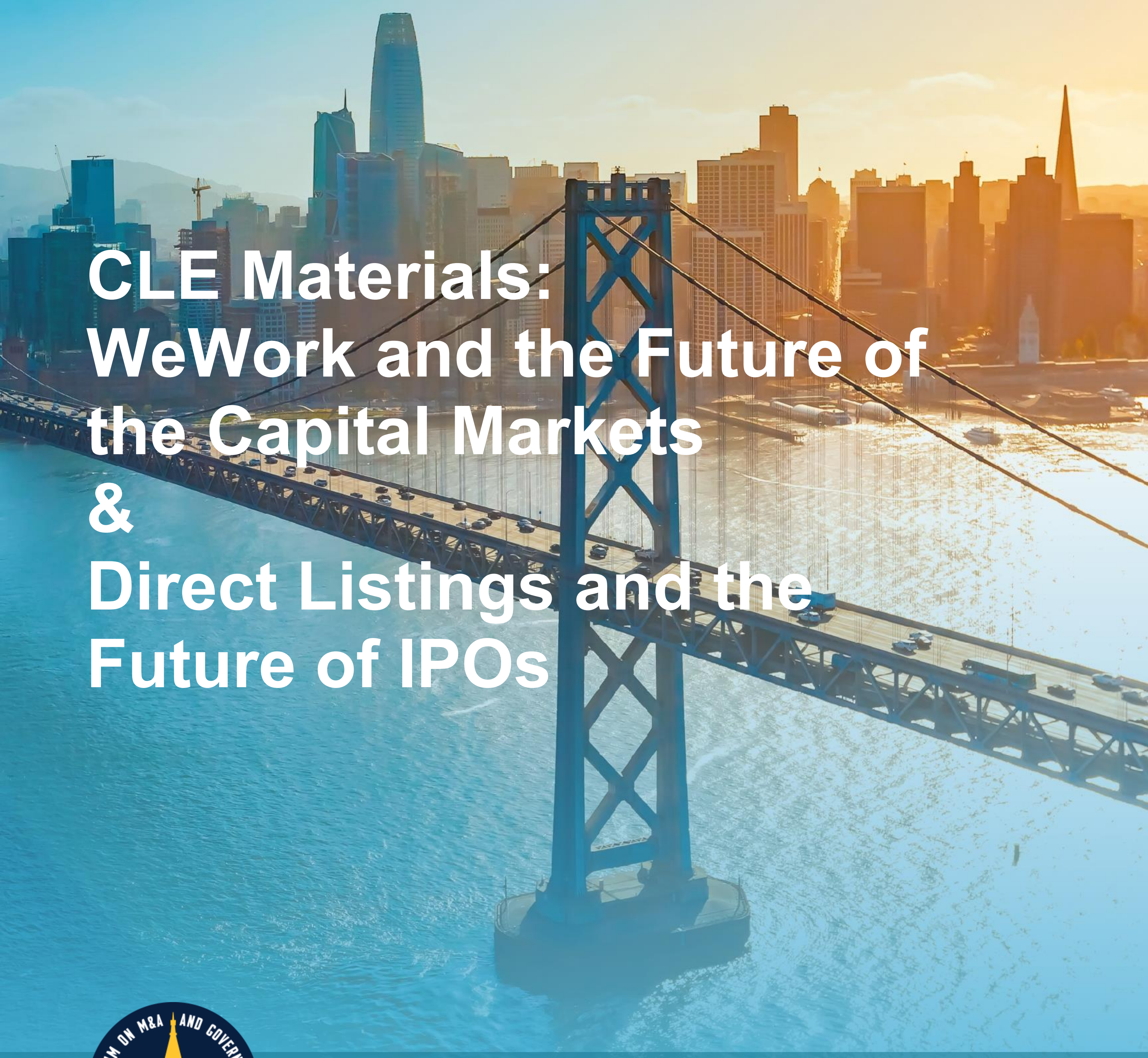

CLE Materials: WeWork and the Future of the Capital Markets & Direct Listings and the Future of IPOs

FEB 6, 2020 | SAN FRANCISCO

Freshfields Bruckhaus Deringer

Shareholder proposals

A renewed focus on process

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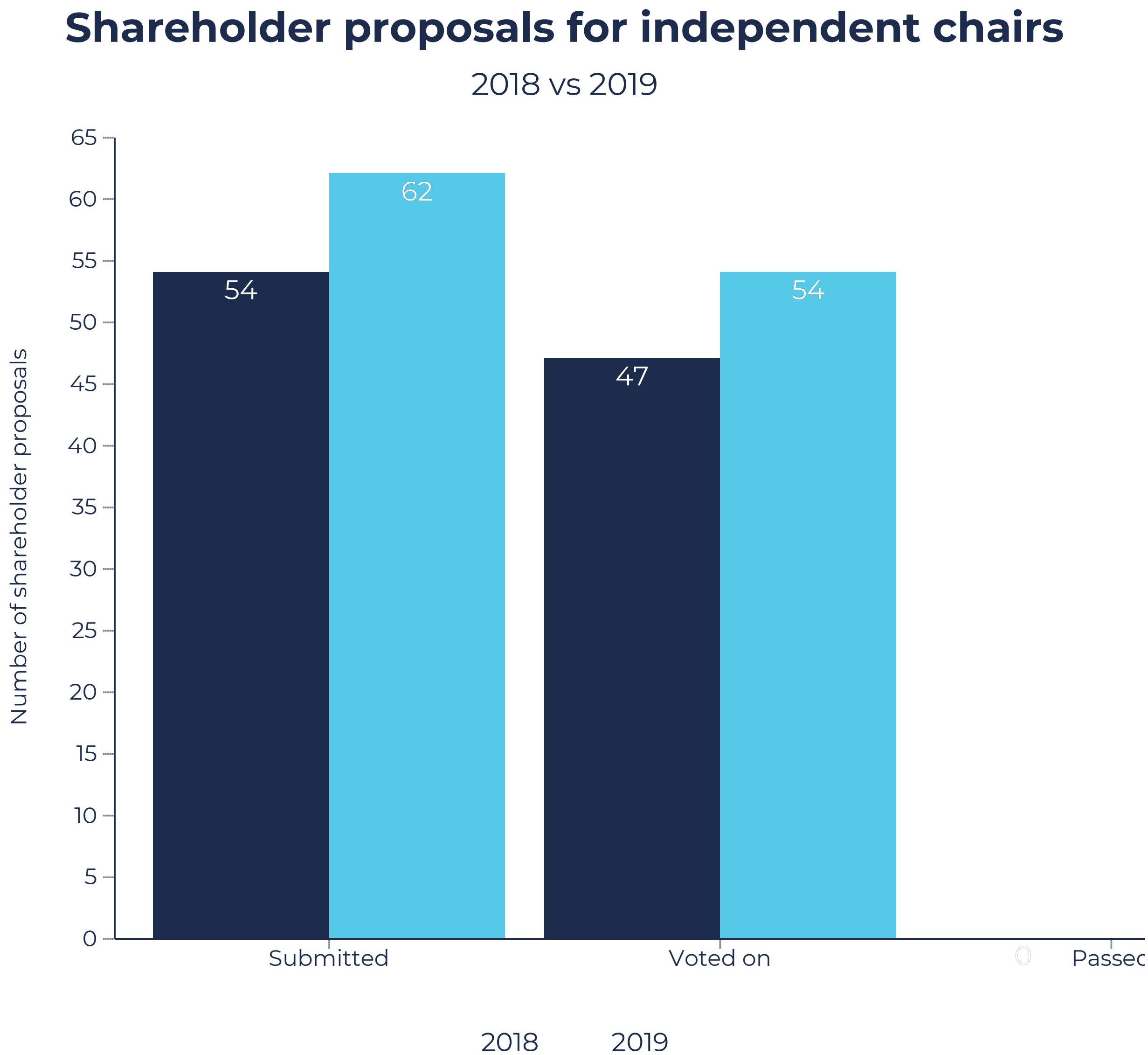
While early indications from the 2020 proxy season are that existing substantive trends in shareholder proposals are likely to continue, there have been some significant changes to the SEC's process for reviewing and responding to no-action letter requests, as well as proposed new rules relating to the submission and resubmission of shareholder proposals. If passed, these measures are likely to have a major impact on how the landscape evolves.

Early indicators: trends in shareholder proposals

Initial trends in shareholder proposals seem consistent with those of the last few years. However some notable developments for this proxy season include the following.

Governance – separation of chair and CEO. Investors and shareholder proponents continue to focus on independent leadership. Since 2015, shareholder proposals relating to this issue have been unsuccessful, but there remains a steady submission of proposals for independent board chairs, evidenced by the incoming requests for no-action relief through mid-December 2019.

Interestingly, for the 2020 proxy season, Legal & General Investment Management, a large asset manager based in the UK, announced that it will vote against or withhold in connection with all combined chair/CEOs.



Governance – shareholder ability to effect governance changes. For the 2020 proxy season, proponents continue to submit proposals requesting changes that provide shareholders with greater power to enact governance changes, including the ability to act by written consent and via lowering the threshold by which special meetings can be called by shareholders. While such proposals generally have not succeeded (only 10 of the 64 combined proposals w passed in 2019), they continue to generate significant support from shareholders. Companies that have received these proposals (or are at risk of doing so) should engage with their shareholders to determine the best course of action. Because support can be high – and companies often face repeat proposals – companies should also engage with their shareholders after the vote and ensure that disclosure about any next steps and rationale is included in their following year's proxy statement.

E&S – environmental. Environmental shareholder proposals are not going away, and it can be difficult in many cases to exclude proposals under Rule 14a-8, in part because repeat proponents have become skilled at developing submissions for which there is little basis to request noaction relief. The good news for companies is that in the 2019 season, environmental proposals were withdrawn at the highest rates after engagement, and those that went to a vote received majority support relatively rarely. As companies have increased their efforts and related disclosure in these areas, investors have shown slightly less appetite for such shareholder moves.

E&S – diversity. In 2019 the New York City Comptroller launched Boardroom Accountability 3.0, which requested the adoption of the Rooney Rule for board candidates and CEOs at 56 companies. In this context, the Rooney Rule would require companies to adopt a policy requiring the consideration of women and diverse candidates for every director and CEO search. Combined with related shareholder proposals and increasing focus among investors on diversity at board, committee, leadership and executive management levels, we expect the topic to remain top of mind in 2020. Companies should continue to review and revise board policies and nominating and governance committee charters, as well as proxy disclosure on these issues.

E&S – lobbying. In a significant election year, scrutiny of political lobbying disclosure is likely to increase (as it tends to whenever voters go to the polls). In 2020, this builds on momentum from an already robust 2019 proxy season on this issue.

The SEC's procedural changes for responding to no-action requests in the 2020 proxy season

In 2019, the SEC released additional guidance as it relates to shareholder proposals and related requests for no-action relief.

- The SEC Division of Corporation Finance released informal guidance that its Staff may decide not to respond by letter to all requests for no-action relief. In some cases the Staff will email the company and proponent that its response will be posted to an online chart. The Staff also noted that it may decline to take a view on a request, but that companies should not interpret the declination as a requirement to include the proposal in the company's proxy materials.

What the SEC's proposed changes to shareholder proposals rules mean in practice

In November 2019 the SEC released proposed rules on, among other things, procedural requirements for submission of shareholder proposals and resubmission thresholds. They reflect the SEC's focus over the last few years on modernizing the shareholder proposal process.

Potential changes to shareholder proposal procedural requirements.

- Ownership requirements would be a multi-tiered system that would depend on the dollar amount held as a factor of time, reflecting a connection between economic commitment and investment horizon rather than the current $2,000-held-for-one-year rule. Unlike the now ubiquitous proxy access construct, shareholders would not be permitted to aggregate ownership to meet any of the thresholds.

Value of stock	No. of years continuously held
$2k	3 years
$15k	2 years
$25k	1 year

- Proponents would be required to provide information regarding their availability to engage with the issuer within 10 to 30 calendar days after submitting the proposal.
- Each person would be limited to one proposal per company per year, whether as a proponent or representative. Currently, proponents may also serve as representatives for other shareholders.
- Representatives and the proponent would be required to provide additional information about themselves and their proposal.

If adopted as proposed, we expect that the revised requirements will impact the number of shareholder proposals that are submitted annually by serial proponents. The decrease is likely to be most acute for governancerelated proposals, which have long been a particular focus for gadfly shareholders.

Shareholder proposal resubmission thresholds.

- The SEC also proposed changes to increase the minimum level of support for a proposal that has been put to a vote when a proponent wishes to resubmit it.

Submission	Current resubmission threshold	Proposed resubmission threshold
1st	3%	5%
2nd	6%	15%
3rd	10%	25%

- The proposed rules would also allow registrants to exclude proposals that have been voted on more than three times and have received between 25 and 50 percent shareholder support, but whose backing has declined by more than 10 percent between the last two votes.

Unlike the previous change, these reforms are not expected to impact the number of proposals that are resubmitted and eventually receive majority support, which was a key factor in the SEC's choice of revised thresholds.

The SEC's focus on board analysis in no-action letter requests

For the third year in a row, the Staff released a Staff Legal Bulletin discussing the provision of board analysis in company no-action letter requests, particularly those that argue for exclusion under the ordinary business exception. Many companies found the focus on board analysis challenging; the timing of the receipt of shareholder proposals and the typical board calendar do not align particularly well, and many boards would not ordinarily dedicate significant meeting time to individual proposals. As a result, in the first year that the Staff mentioned board analysis, many companies that put in the work to provide the information on short notice were disappointed with the Staff's response. The most recent Staff Legal Bulletin provided clarity on the factors the Staff would find helpful in such analysis, which include the possibility that management provide information about the board's prior analysis or actions taken. This would alleviate some of the timing issues, and although the Staff admits that the inclusion of board analysis does not guarantee concurrence with a company's argument, as it continues to focus on and refine what it is seeking in requests for no-action relief, a company that is considering submitting a request under the ordinary business exception should think about whether it can make a cogent argument that includes considerations that relate to the board.

What sustainability means for business

ESG, climate change and litigation risk

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The legal risks associated with climate change and other environmental, social and governance (ESG) factors will continue to feature prominently in 2020 for three primary reasons.

1

Investors continue to request increasing amounts of information on ESG issues;

2

National and regional regulators are beginning to expand their ESG purview; and

3

Climate-related litigation is evolving beyond claims for historical emissions to failures relating to disclosures and permitting requirements.

Pressure from investors and other stakeholders grows

One of the greatest challenges that companies face regarding disclosure of environmental and sustainability issues is the lack of uniformity in what stakeholders are seeking. Sustainability is not a consistently defined term, with each stakeholder ascribing to it a different meaning and, therefore, a different set of expectations.

In recent years we have seen increasing interest among investors in these issues, yet each has a particular view of what information they would find useful and what topics they would like to discuss during their engagements. At the same time the number of stakeholders focused on ESG has spiked. For example, consumers and other customers have become very focused on sustainability, particularly in relation to packaging, water usage and energy. Employees, long focused on the mission of their companies, are becoming more vocal about ESG matters. Supply chain issues have been catapulted to the forefront of public consciousness following high-profile scandals. And regulators often find themselves squarely in the middle of the debate.

Against this backdrop, the disclosure agenda is currently more stakeholder- than regulation-led; various constituencies are seeking more clarity on material ESG risks while the regulatory environment is still developing. In the US, there are no line-item disclosure requirements when it comes to sustainability. Back in 2010, the SEC published Commission Guidance Regarding Disclosure Related to Climate Change, which underscores that existing disclosure requirements already cover environmental and sustainability issues and that the threshold for disclosure is materiality. At the same time, several organizations, including the Sustainability Accounting Standards Board (SASB), have attempted to devise frameworks that could assist companies in determining and disclosing material sustainability risks in a way that enables investors to compare them across companies and industry sectors.

The focus on material disclosures is also reflected in the work of the Task Force on Climate-related Financial Disclosures (TCFD) which seeks to develop voluntary, consistent climate-related financial risk disclosures by which companies can provide information to investors, lenders, insurers and other stakeholders. TCFD members – which include leading corporates and financial institutions – are seeking to both show leadership in disclosure and influence regulators for pending disclosure regimes.

In some jurisdictions, stock exchanges are also steering disclosure, either by making ESG transparency a listing requirement (e.g. Euronext France) or by proposing a set of guidelines for voluntary disclosure (such as on the London Stock Exchange and NASDAQ).

So, what should companies do? In a world of overlapping (and sometimes competing) expectations, both boards and management need to determine for themselves what issues are material to their company and ensure that they satisfy their disclosure obligations and risk oversight duties. But they cannot stop there – in this ever-evolving landscape, they should also acknowledge that there are many other issues that, while not material, may nevertheless be important to investors and other stakeholders. (Click here to read our report on how institutional investors currently treat the flood of ESG quantitative data). For these issues, rather than responding to the constant requests for disparate information, companies should develop their own disclosure and define their own engagement strategies to provide stakeholders with the information they seek. Being proactive in this way gives boards and management the opportunity to have a meaningful dialogue with their stakeholders about the issues that important to them and to the company, without diluting the message with less useful information.

Regulators are catching up

National and regional regulators are looking to meet the obligations of the Paris Climate Agreement, and, to a lesser extent, the UN Sustainable Development Goals.

In some jurisdictions, especially in Europe, lawmakers are seeking to expand disclosure requirements to include ESG considerations. The EU's Sustainable Finance Action Plan, for example, provides recommendations to companies on reporting how their activities impact climate change and the effect climate change is having on their business through a classification system (or taxonomy) of what constitutes sustainable business activity. Critics of the EU plan however question whether the detailed classification system is sufficiently clear or meaningful to guide companies or investors.

Central banks are also weighing in, driven by concerns about physical risks to assets and supply chains caused by extreme weather events and transition risks that will arise as regulators', investors' and consumers' demands shift to address the threat of climate change. To date, 46 central banks and regulators have joined the Network for Greening the Financial System, launched by Mark Carney, governor of the Bank of England (until March), and his counterparts in France and China, among others.

Hong Kong regulator requires mandatory ESG reporting

In December 2019, Hong Kong's front-line regulator, the Hong Kong Stock Exchange (HKEX), announced that boards of listed companies will now be required to issue statements setting out their consideration of ESG issues.

ESG reporting started as a voluntary exercise in Hong Kong in 2012, evolving into a "comply or explain" regime with recommended disclosures in 2016. However, a periodic review of ESG reporting by 400 public companies during the 2017/18 financial year revealed a "mechanical, box-ticking" approach that lacked "a desirable level of quality and depth of detail". In response the HKEX imposed its mandatory reporting obligation, which establishes ESG disclosure and risk management as an issue on which boards must take the lead.

HKEX's plea for boards to disclose what is material (or in its own words, "truly material") is helpful, as is the regulator's position that comply or explain are both "acceptable options". Boards and management now need to take a thoughtful approach to reviewing all the subject areas, aspects, general disclosures and KPIs in the HKEX's ESG reporting guide, so that the assessment, consideration, determination, and follow-through expected by the regulator can be achieved.

There is a fairly long transition period as it is acknowledged that issuers will need to put internal infrastructure in place to capture the data required. The first enhanced ESG reports will have to be published by issuers for any financial year starting after July 1, 2020 (i.e. the first reports will cover the period from January 1, 2021 to December 31, 2021 for issuers that have a December 31 year-end), although the HKEX is encouraging issuers to start the process as early as possible.

Legal risk and climate change

According to data from Columbia University and the London School of Economics, there have been almost 1,400 climate-related lawsuits launched around the world, with more than 130 aimed at companies by the start of December 2019. Broadly speaking, climate-related cases can be split into three groups.

1

Common law tort and public nuisance cases of the type that emerged in the US around 20 years ago and have since begun to spread in Europe. These claims are primarily designed to hold companies to account for allegations related to their past environmental conduct, and have often failed to get past initial hearings. In the US, this is primarily because federal law and regulators like the Environmental Protection Agency take precedence over state legislation – and because US courts view responding to climate change as a matter for government policy. In other countries, litigants have generally been unable to satisfy the causation and other legal tests required to bring their claims.

2

Cases that take aim at future corporate conduct, for example by demanding improved disclosures around climate-related risk and/or changes in strategic direction in relation to carbon emissions. These claims may be more attractive to plaintiffs where issues of material non-disclosure are present, but are still challenged by the struggle to meet strict causation tests.

3

Cases that involve challenges to the granting of industrial permits on the grounds that climate change impacts have not been properly considered. Although not as high profile, suits that target the "licence to operate" are potentially more significant for businesses.

There are likely to be more “behavior-moderating” cases in 2020 in which litigants expand the focus of their claims from past emissions to current corporate revenue-generating activities. Furthermore, claims will no longer be brought just by governments and NGOs; we expect a growing number of individuals to launch shareholder suits, and institutional investors to add their voices to calls for greater transparency.

For more information on legal risk and climate change take a look at our research report on the climate risk landscape, which examines the emerging threat of litigation against multinational corporations.

Freshfields Bruckhaus Deringer

Reforming the US corporation

Can boards serve more than their shareholders?

Ethan Klingsberg
Partner, New York

In 2019, we witnessed, in a year of rocky IPOs, the success beyond all expectations of the Beyond Meat listing. The differentiator: socially conscious investors (focused, in this instance, on the environmental benefits of a shift to plant-based food) comprised the critical component of the underwriters' IPO order book that was missing from other, less successful, flotations. Estimates put the assets under management of impact investing at more than $500 billion, dwarfing the $143 billion dedicated to activist equity strategies.

As the magnitude of funds aimed at socially beneficial businesses has grown, investors and their intermediaries (such as proxy advisory firms like ISS and Glass Lewis, independent designers of best practices for disclosure like the Sustainability Accounting Standards Board, and watchdog and rating organizations like Sustainalytics) have contributed to the proliferation of ways to measure and evaluate each corporation's impacts on the environment, customers, workers and local communities.

Countering the focus on short-term growth

The companies in the IPO pipeline for 2020 – and indeed lots of existing publicly-traded corporations – are now considering how to harness this development to improve relations with their spectrum of stakeholders. But to achieve this objective, they will need to take innovative steps to manage two countervailing forces.

First, a slice of the market remains focused on metrics that indicate rapid, short-term growth to the exclusion of all other objectives. Up until now, companies have failed to counter this dynamic. Yes, fluffy statements by founders and CEOs about long-termism and values regularly take up space in IPO prospectuses and follow-up communications. But these well-intentioned sentiments are at risk of being overwhelmed by management's widespread distribution of powerful data that is often incompatible with these sentiments and ironically does not even make it into the IPO prospectus: internal financial projections.

All the founders' letters and statements of corporate values in the world are not going to alter the commitment to near-term growth at all costs that is necessary if management hands analysts and investors sets of aggressively optimistic management projections. This syndrome is especially problematic in connection with IPOs, where there is pressure to provide the best possible financial forecasts during roadshows.

Are directors who think beyond shareholders in breach of their fiduciary duties?

Second, corporate law in most states provides that directors and officers must act in the best interests of the corporation and its shareholders, not other constituencies. There is a limit to how much a director can squeeze the square peg of benefiting "other constituencies" into the round hole of a duty to maximize shareholder value at every turn.

Interestingly, in advance of the Business Roundtable's recent pronouncement that looking out for stakeholders other than shareholders is part of the corporate mission, a number of clients called to ask whether their companies' support of the Roundtable's position would put their directors and officers in conflict with their fiduciary duties.

The answer was an easy, "No problem."

Because most states' corporate law provides that directors and officers must act in the best interests of the corporation and its shareholders, the Roundtable's statement relies on a realization that has been around for over a century: a company's actions that benefit non-shareholder constituencies may simultaneously be in the best interests of the corporation and its stockholders. Absent this realization, all acts of corporate charity and responsibility would constitute corporate waste.

But as the power of impact investing grows and the market's measurement of corporations' impact on "other constituencies" becomes more precise (but also more disparate), fiduciaries of corporations are at risk of being driven to make decisions that benefit "other constituencies" to an untenable extent. The answer to clients' questions may start to become, "Actually, you may *not* be complying with your fiduciary duties if you take *that* step."

How boards can flip the narrative

In 2020, successful IPO issuers, and even some courageous companies that are already publicly traded, will have the opportunity to take strong steps to counter these two forces. First, management can moderate the growth projections they provide to the market, especially during IPO roadshows, and be comfortable that the cost of this decision will be offset by compelling, substantive disclosure that both details the company's public benefit and sustainability mission and is sufficient to attract a healthy layer of impact investors into the IPO order book and long-term shareholder profile.

Second, the limits of corporate law can be overcome by taking advantage of a Delaware statute that has until now been virtually ignored by publicly traded companies. It provides that a corporation may amend its charter to become a public benefit corporation (or PBC) and redefine fiduciary duties to focus on not only the interests of shareholders but also the interests of other constituencies (and, even better, of whatever public benefits the charter specifies). Moreover, this statute generously insulates directors and officers from claims for breach of duty so long as no self-dealing is involved.

Delaware legislature needs to help corporations make the shift

That said, there are a few fixes that the Delaware legislature needs to adopt urgently to permit corporations to move in this direction. For one, modifications should be made that harmonize the process of conversion to a PBC with the provisions applicable to other charter amendments – the requisite shareholder approval should be reduced from 66 and two-thirds percent to a simple majority of the outstanding shares, and the conversion to a PBC should not trigger appraisal rights. In addition, the statutory protection of fiduciaries against liability should make clear that the holding of shares by a director or officer would not, by itself, result in her being deemed to be engaged in self-dealing that negates her insulation from liability if her balancing of shareholder value, other constituencies, and the designated public benefit ends up favoring shareholder value.

Finally, when a corporation's narrative is framed by detailed environmental and social impact disclosure and the adoption of an alternative fiduciary duty paradigm, the insulation of this narrative through structural features (such as high-vote shares for the pre-IPO stockholders and a classified board arrangement whereby only a third of the directors are up for re-election each year) becomes justifiable rather than a source of controversy. It is no longer the ability of self-centered founders to do whatever they want that is being insulated – rather it is a well-articulated and designed mission to serve a broader purpose than short-term growth.

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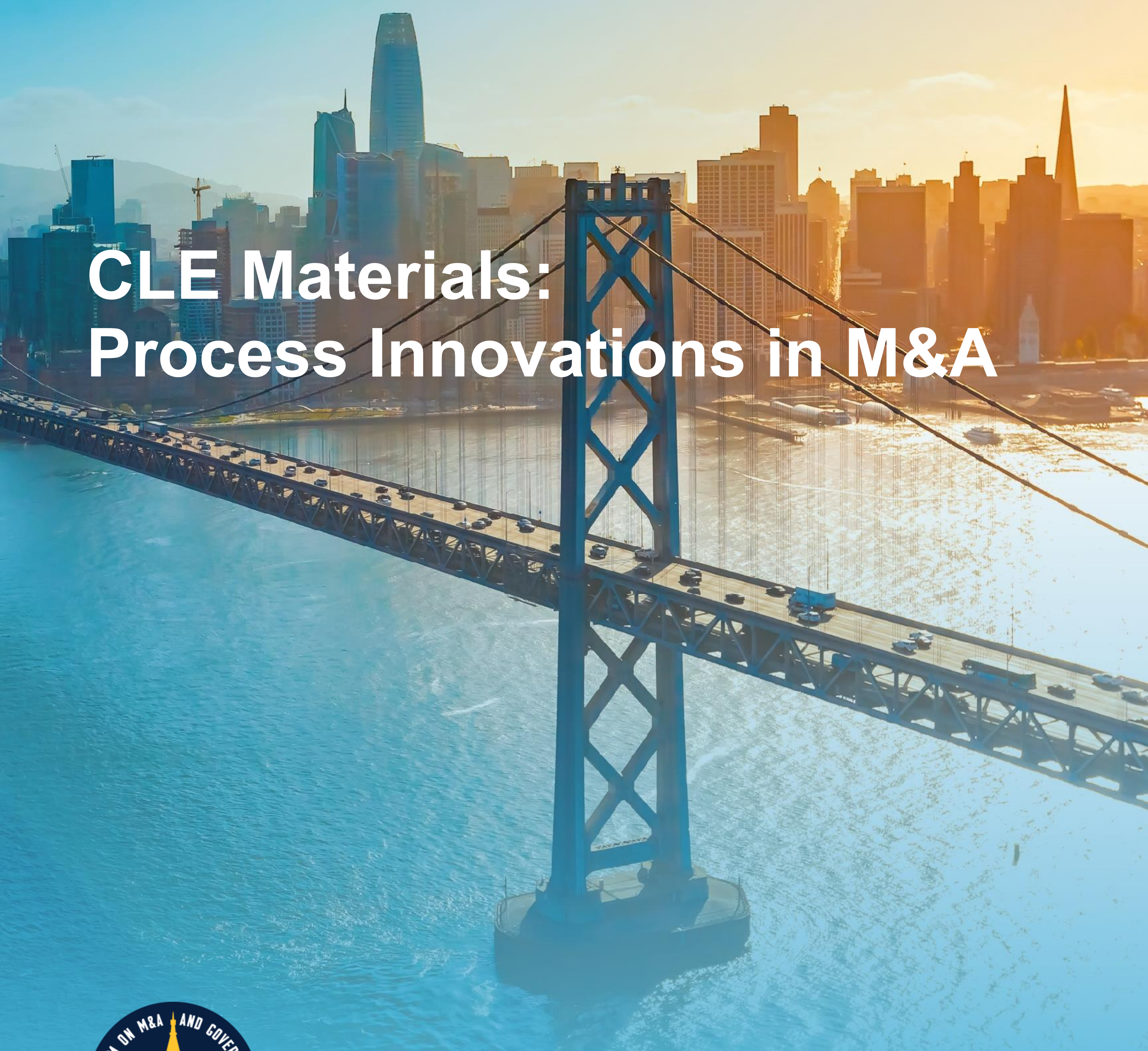


CLE Materials: Process Innovations in M&A

FORUM ON M&A AND GOVERNANCE 2020 U.C. BERKELEY

FEB 6, 2020 | SAN FRANCISCO

The M&A process is broken

It's outdated, inefficient, and combative. Which is why we're publishing the Atlassian Term Sheet to fix it.

PUBLISHED JUNE 17, 2019 IN TECHNOLOGY

TOM KENNEDY

Chief Legal Officer

CHRIS HECHT

Head of Corporate Development

Atlassian is built on the belief that there are better ways to get work done. If we find a way of working to be ineffective, we will change it. This belief is fundamental to how we build and sell our products, and now we're applying it to how we acquire companies (aka mergers and acquisitions, or "M&A").

M&A is a key part of our strategy – over our history, we've acquired more than 20 companies for approximately $1 billion, including Trello, Opsgenie, and AgileCraft. And one thing has become very clear to us about the M&A process – it's outdated, inefficient, and unnecessarily combative, with too much time and energy spent negotiating deal terms and not enough on what matters most: **building great products together and delivering more customer value**.

We want to change that.

We’ve studied data from hundreds of technology acquisitions from the past 5+ years. The data makes two things clear:

1. **Big buyers are bullies:** Large tech companies exert negotiating power over founders and selling companies because they can, and stack the deck in their favor with buyer-favorable terms.
2. **Big buyers get more protection than they need:** Many of these terms are unnecessarily one-sided. For instance, buyers hold back a much higher portion of the purchase price to cover potential liabilities than they need.

Here’s why this matters: these one-sided terms are introduced at the outset of the M&A process and require a disproportionate amount of time and goodwill to resolve. This needlessly introduces friction and mistrust, making the far more important task – getting our people and products to work well together – more challenging.

We know there’s a better way to do this.

In an effort to reduce this unnecessary friction and increase trust, we’re doing something that, to our knowledge, no company has done before: we’ve crafted a new M&A term sheet and we’re making it public. **The Atlassian Term Sheet** is more favorable to selling companies than any we’ve seen among strategic acquirers in technology. It’s guided by our research and includes explanations to make our approach more understandable. We’ve done this because we want to be fair to our future team members and we don’t want to spend energy and goodwill on things that almost never matter. And we believe that by being fair and transparent, we can make the M&A process more efficient, human, and aligned with why we acquire companies (and the incredible founders and teams behind them) in the first place.

The Atlassian Term Sheet is more favorable to selling companies than any we’ve seen among strategic acquirers in technology.

Why be open?

The M&A process can be confusing and intimidating, especially for founders who are selling a company for the first time. Term sheets can read like a different language, and when founders ask buyers why a term is the way it is, buyers often say things like “this is market” or “this is our form” (i.e., this is standard, it’s just how we do things). The reality is that because of the leverage that many buyers exert over sellers, certain “market” terms have evolved to buyers’ advantage, even though, based on the data, it’s simply not necessary.

We believe we can cut some of the friction by focusing on the terms that actually matter to us, not the terms we can get just because we’re bigger than the companies we acquire. The Atlassian Term Sheet has the protections Atlassian needs and reflects the values we live by. It’s comprehensive — we don’t want to hide anything during term sheet negotiations. And it includes explanations to help you understand why we care about these terms. And now, it’s public.

Why bother sharing the Atlassian Term Sheet publicly? The answer is simple: we want to approach M&A with the same open spirit with which we offer our products. We publish prices and standard terms for our products on our website, which we believe promotes trust and makes customers more comfortable with our low-touch sales model. We don't negotiate these prices and terms, so our customers know they're being treated fairly. This has resulted in one of the most efficient enterprise software sales models in the world, which has allowed us to invest more in R&D and deliver more customer value.

Now, with the Atlassian Term Sheet, we're providing tremendous visibility into our approach to M&A. We hope it gives founders a sense of what to expect during initial deal discussions and confidence that we're treating them equitably. And similar to our sales model, we believe this transparency will enable all parties to spend more time on the things that matter most: building great products together and delivering more customer value.

Our term sheet is fair and informed by data, so instead of spending time and emotional energy negotiating things like indemnity, we can focus on things like diligence and integration planning, organizational structure (including founders' roles), and retention strategies. By beginning with terms that are more favorable to sellers and avoiding needless contention, we'll put more effort into shaping what success looks like after the actual acquisition and laying the groundwork to get it done.

Being open also demonstrates the trust that we're placing in you, the founder (and future leader at Atlassian). We want to do things more collaboratively and need you to help us. This is no longer about either side putting points on the board, or satisfying ego – it's about getting this done right for both of us and focusing on what matters most from the start.

Want to geek out on M&A deal terms and the data that drives our approach? If so, read on! Keep in mind that the next few sections assume familiarity with M&A terminology, so if it's confusing, check out the annotations in our term sheet for more explanation.

What does the data say?

When you actually look into it, many of the key "market terms" established by strategic tech acquirers are unnecessarily protective of buyers, at the expense of founders, the selling company, and its shareholders.

Beyond key business points like purchase price, founders' roles within Atlassian, stock vs. cash consideration, and retention equity, there are a range of other terms that are vital to understand. Some of the most important ones — and often the most heated negotiations — are around indemnification, escrow, and risk allocation, so we focused a lot on those in our research. We looked at data from hundreds of deals with a focus on technology and software. Here's some of what we found:

Escrows funds are *much* bigger than necessary

- In software transactions, the median escrow is 10% of the purchase price and gets up to 20% at the higher end.
- In the data set we examined for software deals, the substantial majority of transactions had no indemnification claims made at all, and there was no single transaction where the entire escrow fund was exhausted.
- Even when claims are made, they rarely come close to exhausting the escrow fund. We found that even in the worst case scenarios, amounts returned to buyers out of escrow still amounted to an estimated 2% of the total purchase price.

What does this mean? Buyers are holding back way more escrow than they need. While there are prominent examples of M&A deals going very wrong, buyers tend to focus on these worst case scenarios or edge cases that rarely materialize.

IP and privacy don’t need to be special reps

- In nearly 60% of tech transactions, IP and privacy are “special reps” that aren’t capped at escrow and survive for longer than the escrow period. In other words, a buyer can go after a seller’s shareholders after the closing of the deal for more than the escrow amount if the buyer suffers damages from an IP or privacy breach, and it has a longer period than the escrow period in which to do so.
- Of technology deals that have IP and privacy as a special rep, almost 50% of acquirers protect themselves with between 25-50% of the purchase price, and almost 20% protect themselves up to the full purchase price.

What does this mean? In the event of an IP or privacy claim, if the amount of the claim exceeds the escrow, then a buyer can then go after selling shareholders for that excess amount. This is a hard one for a seller to stomach, because money that has been deposited into an employee’s bank account and spent, perhaps for a down payment on a house, could be clawed back by the buyer. Buyers do this because of the leverage they exert, but the data indicates that this is absolutely unnecessary and we found no examples in the data we reviewed of buyers actually going beyond escrow to recover additional amounts for IP or privacy claims.

Our terms

Based on the data, we landed on terms that we believe in. There’s a lot more in the Atlassian Term Sheet, but we’ll highlight a few of the most important terms here. The bottom line is we’re focused on getting away from the typical nickel-and-diming and trying to cover every potential edge case. We want to approach the M&A process in the most efficient and fair way we can.

Indemnity, escrow, and insurance: Choose your own adventure*! We’ll leave the choice to you: either provide a 5% escrow for 15 months or pay for a buy-side rep and warranty insurance policy and provide a 1% escrow for 15 months (insurance will cover the remaining 4%). Either choice is far better than what other strategic acquirers are offering in today’s market. The 15-month escrow period is shorter than the market median and enough time for us to get through an audit cycle, which is when the majority of claims (if any) shake out. Most important, outside of fundamental reps and items that are within sellers' control, such as covenants, or serious issues that we discover in diligence that result in special indemnities (a rare occurrence), you'll have no exposure beyond the escrow. We're taking on that incremental risk.

* As long as your transaction is over $50M. If the price is under $50M it's not cost-effective to get insurance, and we'll go the 5% escrow route.

IP and privacy: IP and privacy are not special reps, and are capped at escrow. This means we can't claim more than the escrow for IP and privacy claims, and once the escrow period has passed, we can't go after a seller at all for IP and privacy claims. Put differently, you will bear only up to 1% (or 5%, if you don't choose the insurance route) of the cost of damages for IP and privacy rep breaches. Atlassian/insurance would be on the hook for the rest.

It's worth emphasizing how different our approach is versus other strategic acquirers. It has become common practice among tech acquirers to have protection for IP and privacy claims above and beyond the escrow which, in our experience, can lead to a ton of heartburn for founders and endless cycles of negotiation. So we're not asking for that because the data tells us we don't need it, and we feel confident in our thorough diligence process.

Fraud: We'll protect ourselves against fraud up to the purchase price. It's unlikely that companies we work with will commit fraud, but this is really about values for us. Bottom line: don't commit fraud.

Documentation: Regardless of your choice of 5% escrow vs. 1% escrow with insurance, the legal agreements will read essentially the same. We expect comprehensive reps & warranties along with fulsome disclosure schedules as part of the transaction process.

Let's do this!

Selling a company is always emotional, especially for the founders who care so deeply about what they have built. We get that we won't always see eye to eye, and getting to a result that works for everyone will continue to be challenging and require flexibility. We understand that the diligence process is grueling for founders, a reality that can't be avoided because it's the only way for us to get to know their company and prepare for a successful integration. But even if we can't eliminate all the tussling and late nights that are the hallmarks of M&A, we believe our open approach can substantially improve the process and allow all of us to focus on the things that actually matter. And because this is Atlassian, we're excited to try.

The Atlassian Term Sheet

THE ATLASSIAN TERM SHEET

We are excited that [Company Name] (the "**Company**") is considering joining the TEAM!

This Term Sheet lays out the main terms of a potential transaction between the Company and Atlassian Corporation Plc or one of its subsidiaries ("**Atlassian**"). In this Term Sheet, Atlassian and the Company are sometimes referred to as the "**Parties**" or individually as a "**Party**."

NON-BINDING PROVISIONS

Proposed Transaction:	**Atlassian anticipates that it would acquire the Company through a reverse triangular merger (the "Proposed Transaction").**
Deal Documents:	Atlassian and its legal counsel would be the primary drafter of the definitive agreement ("**Definitive Agreement**") and other legal documents for the Proposed Transaction (collectively, with the Definitive Agreement, the "**Deal Documents**"). The Definitive Agreement would contain representations and warranties, covenants, closing conditions, indemnities and other typical provisions for a transaction of this nature.
Closing:	The Closing of the Proposed Transaction ("**Closing**") would take place after all closing conditions in the Definitive Agreement are satisfied or waived. In no event would the Closing occur during the last month of any Atlassian financial quarter.
Due Diligence:	As soon as possible after the date this Term Sheet is executed (the "**Term Sheet Date**"), the Company would provide Atlassian and its representatives with access to the Company (and its representatives, personnel, subsidiaries, assets, properties, documents, and other information) so Atlassian can conduct a thorough diligence investigation.
Proposed Purchase Price:	The aggregate purchase price to be paid by Atlassian for all of the Company's outstanding equity securities, whether vested or unvested, would be $[__________] (the "**Purchase Price**"). For the avoidance of doubt, cash on the Company's balance sheet would be factored into the Purchase Price and the associated valuation. On a dollar-for-dollar basis, the Purchase Price would be adjusted as follows: (i) increased by the aggregate exercise price of all of the Company's vested equity awards as of the Closing, and (ii) reduced by (x) the Company's indebtedness (including accrued interest) at Closing, (y) the aggregate amount of Transaction Expenses and Change of Control Payments (each defined below), in each case whether paid or unpaid, and (z) the R&W Insurance Expenses (defined below). The Purchase Price would be paid in cash, except that (i) certain unvested equity awards would be substituted for Substitute Awards (defined below), and (ii) the Core Employees (defined below) would be issued Holdback Shares (defined below), each as described below.
Outstanding Equity Awards, and Other Equity Rights:	All vested Company equity awards (other than the Holdback Amount described below) would be cashed out at Closing, net of any exercise price and subject to any applicable tax withholding and Escrow Amount (defined below) obligations. All unvested equity awards held by Company employees who accept their Atlassian offer letters would be substituted for Atlassian equity awards (the "**Substitute Awards**"). All other outstanding rights to acquire equity securities of the Company that have not been exercised as of Closing would terminate.
Holdback:	In lieu of receiving cash for [__]% of the consideration otherwise payable to each of [Name] and [Name] (the "**Core Employees**") in the Proposed Transaction (the "**Holdback Amount**), these Core Employees would each be issued a number of Atlassian Class A ordinary shares equal to their Holdback Amount divided by the volume weighted average price of Atlassian Class A ordinary shares for the 10 trading days ending on the last trading day preceding the signing date of the Definitive Agreement (the "**Holdback Shares**"). The Holdback Shares would be issued pursuant to registration exemptions under U.S. and other securities laws, and would be subject to any resale and other trading restrictions that apply. Each Core Employee's Holdback Shares would vest over [__] months as follows: (i) [__]% of such Holdback Shares would vest on the first anniversary of the Closing, and (ii) [__] of such Holdback Shares would vest on a quarterly basis thereafter until all Holdback Shares have vested, subject to such Core Employee being employed by Atlassian on each vesting date. A Core Employee's unvested Holdback Shares would accelerate in full if they are terminated without "Cause" or terminate their employment for "Good Reason," or due to death or "Permanent Disability" (as such terms are defined in the Deal Documents), effective as of the date of such termination.

Employment Offer Letters and Non-Competes:	Concurrently with the signing of the Definitive Agreement: (i) Each of the Core Employees and other key employees of the Company to be identified by Atlassian in consultation with the CEO of the Company during diligence would enter into: (a) employment offer letters with Atlassian (“**Offer Letters**”); and (b) Atlassian’s standard form of employee confidential information and invention assignment agreement (an “**IP Assignment**”), each to become effective at the Closing; and (ii) Each Core Employee would enter into a [___]-year non-competition and non-solicitation agreement in favor of Atlassian (a “**Non-Compete**”), to become effective at the Closing. The following would be conditions to Closing: (i) At least [__]% of the Company’s employees who receive Offer Letters accept their Offer Letters and enter into an IP Assignment; and (ii) The Offer Letters, IP Assignments and Non-Competes remain effective as of the Closing. Atlassian would evaluate, on a case-by-case basis, whether to require Company employees to waive their vesting acceleration rights, change-in-control payments, severance compensation, or other payments that might be triggered by the Proposed Transaction.
Employee Retention Pool:	Atlassian would allocate an additional $[__] in Atlassian equity awards to some or all employees of the Company, in consultation with the CEO of the Company.
Indemnification, Escrow and Insurance:	Indemnification The Definitive Agreement would require all shareholders of the Company and all holders of vested equity securities that are cashed out at the Closing (collectively, the “**Sellers**”) to indemnify Atlassian against any damages arising out of or resulting from: (i) breaches of the Company’s representations and warranties; (ii) breaches of the Company’s covenants set forth in the Definitive Agreement (“**Covenants**”); (iii) tax-related matters, capitalization matters, purchase price allocation matters, third-party claims, exercise of dissenters’, appraisal or other similar rights, and other matters set forth in the Definitive Agreement (“**Other Indemnities**”); or (iv) fraud. Escrow and Insurance As partial security for Atlassian’s post-Closing indemnification rights, an amount equal to 1% of the Purchase Price (the “**Escrow Amount**”) would be held in a third party escrow fund for 15 months after the Closing. Atlassian would obtain a representations and warranties insurance policy (“**R&W Insurance**”) in connection with the Proposed Transaction. The premium, taxes, commissions and any other fees and expenses payable in connection with obtaining R&W Insurance coverage for a policy limit of 4% of the Purchase Price (the “**R&W Insurance Expenses**”) would be paid for by the Sellers. Limitations on Indemnification Obligations The Sellers’ indemnification obligations would be limited as set forth in **Schedule I**.
R&W Insurance Expenses, Transaction Expenses, Change of Control Payments:	The Sellers would be solely responsible for: (i) All R&W Insurance Expenses; (ii) All expenses (including all legal, accounting, financial advisory, consulting, regulatory and other fees, the cost of any D&O tail insurance policy, and the employer portion of any payroll taxes related to payments made in connection with the Proposed Transaction) incurred by or on behalf of the Company in connection with this Term Sheet, the Deal Documents, and the completion of the Proposed Transaction (“**Transaction Expenses**”); and (iii) All bonuses, severance payments and other similar cash benefits that are payable in connection with, or are triggered by, the Proposed Transaction, any payments required to obtain third-party consents, waivers or approvals under any of the Company's contracts in connection with the Proposed Transaction, and all termination, balloon or similar payments resulting from the early termination of any contract, or the repayment of outstanding indebtedness, in connection with the Proposed Transaction, if any (collectively, “**Change of Control Payments**”).

BINDING PROVISIONS

Upon execution of this Term Sheet by the Parties, the following provisions (collectively, the “**Binding Provisions**”) will constitute the legally binding and enforceable agreement of the Parties (in recognition of the significant costs to be borne by the Parties in pursuing the Proposed Transaction and in consideration of their mutual undertakings as to the matters described in the Binding Provisions).

Confidentiality:	**The Company and its representatives and advisors will hold this Term Sheet and the terms of any proposals made by or on behalf of Atlassian in strict confidence, in accordance with the Mutual Nondisclosure Agreement dated as of [_____] between Atlassian and the Company.**
Exclusive Dealing:	From and after the Term Sheet Date until the Expiration Date (as defined below), the Company (it being understood that "Company" in this "Exclusive Dealing" section refers to the Company and any of its subsidiaries) will not, and will ensure that its affiliates, officers, directors, employees, equity holders and representatives (collectively, the "**Company Representatives**") do not: (i) solicit, encourage or facilitate the initiation or submission of any proposal to directly or indirectly acquire any of the Company's businesses, properties, assets (other than sales of the Company's products in the ordinary course of business), or equity securities from any person or entity other than Atlassian (any such transaction, a "**Prohibit ed Transaction**"); (ii) participate in any discussions or negotiations or enter into any agreement with any person or entity relating to or in connection with a Prohibited Transaction; (iii) entertain, consider or accept any proposal or offer from any person or entity relating to a Prohibited Transaction; or (iv) disclose to any person or entity (other than Atlassian and its representatives) any information concerning any of the Company's businesses, properties, assets, or equity securities, or give any person or entity (other than Atlassian and its representatives) access to any of its properties, books, records or employees, other than in the ordinary course of the Company's business (any such disclosure or access, a "**Prohibited Disclosure**"). For purposes of this Term Sheet, "**Expiration Date**" means the earlier to occur of: • the date on which Atlassian advises the Company in writing that it does not wish to proceed with the Proposed Transaction; and • 5:00 p.m. Pacific Time on the date that is [ ] days after the Term Sheet Date, provided that such [ ]-day period will be automatically extended for one [ ]-day period so long as Atlassian is continuing good faith negotiations with respect to the Proposed Transaction. In the event that the Company or any of the Company Representatives receives any offer or proposal related to a Prohibited Transaction or any request for disclosure or access that would constitute a Prohibited Disclosure, the Company or such Company Representative shall promptly notify Atlassian. The Parties agree that irreparable damage will occur should the provisions of this "Exclusive Dealing" section be breached or not performed. Accordingly, the Parties agree that, in addition to all other remedies available (at law or otherwise) to the Parties, each Party will be entitled to equitable relief as a remedy for any breach or threatened breach of any of the provisions of this "Exclusive Dealing" section and neither Party will be required to obtain, furnish or post any bond or similar instrument in connection with or as a condition to obtaining any remedy referred to in this "Exclusive Dealing" section.
Entire Agreement; Amendment:	The Binding Provisions of this Term Sheet constitute the entire agreement between the Parties regarding the subject matter thereof, and supersede all prior oral or written agreements, understandings, representations and warranties, course of conduct and dealing between the Parties regarding the subject matter thereof. The Company acknowledges and agrees that neither this Term Sheet nor any action taken in connection with the matters referred to in this Term Sheet will give rise to any obligation on the part of Atlassian to continue any discussions or negotiations or to pursue or enter into any transaction or relationship of any nature. The Binding Provisions may be amended or modified only by written agreement executed by both of the Parties.
Governing Law:	This Term Sheet shall be construed and enforced in accordance with the laws of the State of Delaware, without regard to its conflict of laws principles. Each Party hereby irrevocably waives all rights to trial by jury in any action or proceeding arising out of or relating to the provisions of this Term Sheet.

(signature page follows)

IN WITNESS WHEREOF, the Parties have executed this Term Sheet as of the last date written below.

Atlassian Corporation PLC	**[COMPANY NAME]**
Signature: ________________________	Signature: ____________________________________

Print

Name: __________________________	**Name:** __________________________
Title: __________________________	**Title:** __________________________

Date: ___________________________	**Date:** ___________________________

____

Schedule I

Claim	Tipping Basket Applies	Cap	Survival
Breach of General Rep	Yes	Seller’s pro rata share of Escrow Amount	15 months
Breach of Fundamental Rep/ Other Indemnity	No	Seller’s pro rata share of Purchase Price	Later of (i) 6 years and (ii) 60 days after the expiration of the longest applicable statute of limitations (as it may be extended).
Covenant Breach	No	Seller’s pro rata share of Purchase Price	15 months for covenants to be performed at or prior to Closing. Covenants to be performed after Closing survive until fully performed, and any claims for breaches of those covenants will survive 15 months from full performance of those covenants.
Fraud	No	Seller’s pro rata share of Purchase Price, except for any Seller who committed, participated in or had actual knowledge of fraud (“**Bad Actor**”). No limitation on the liability of any Bad Actor.	Later of (i) 6 years and (ii) 60 days after the expiration of the longest applicable statute of limitations (as it may be extended).

The following terms are used in the table above:

"**Fundamental Reps**" refers to the Company’s representations and warranties relating to organization, capitalization, due authorization, brokers' and finders' fees, non-contravention with organizational documents, and taxes in the Definitive Agreement.

"**General Reps**" refers to the Company's representations and warranties in the Definitive Agreement that are not Fundamental Reps.

“**Tipping Basket**”: For claims to which the Tipping Basket applies, Atlassian would not be entitled to be indemnified unless and until the cumulative amount of all damages for breaches of all General Reps exceeds an amount equal to 0.5% of the Purchase Price, in which case Atlassian would be entitled to indemnification for the aggregate amount of all such damages from the first dollar up to the Escrow Amount.

“**Survival**” refers to the time period within which Atlassian would need to bring an indemnification claim.

“**Cap**” refers to the maximum monetary exposure for a Seller.

Guidance On Navigating The Atlassian Term Sheet: Understanding The Substantive Implications Behind The Virtues Of Standardization In M&A

mondaq.com | 16 September 2019

by Ethan A. Klingsberg , Michael Albano and Sharon Nyakundi

Cleary Gottlieb Steen & Hamilton LLP

Standardization can be a virtue and one that M&A lawyers, likely due to self-interest and ego, sometimes resist. If venture financing and derivatives practices can have widely accepted forms of legal documentation as a starting point, why should M&A be an exception? Ironically, agreements for takeovers of publicly traded companies – once revered as a rarified realm that only an elite group huddled in skyscrapers in Manhattan could navigate – has evolved considerably toward standard forms thanks to enhanced attention to these publicly filed agreements and an effort by Delaware courts to draw clearer guidelines about precisely what will and will not fly in the world of "public M&A."

However, the terms for private merger agreements, where the parties have more freedom to legislate their own rules, remain less standardized. Enter Atlassian, a NASDAQ-listed enterprise software company that likes to play in the "serial acquiror" space alongside many cash-rich tech companies, as well as an increasing number of industrial and retail companies, with business models that include regularly acquiring privately held startups for purchase prices ranging from single digit millions to double digit billions of dollars. Atlassian's stated goal is to distinguish itself as more seller-friendly and rational than the bidders against whom they are competing for these targets and, to achieve this objective, their general counsel and head of corp dev have committed the company publicly to a form of term sheet.

This commendable project to promote standardization in the world of private M&A is garnering attention among M&A professionals in the tech world. It is not inconceivable that this buzz will reach a tipping point where founders of targets and corp dev negotiators from acquirors will be reaching oral agreements on headline prices and a stay bonus pool amounts on the condition that the acquiror's corp dev team commit then and there that their legal team will use the "Atlassian term sheet" for the balance of the terms. What could be simpler and more efficient for the parties?

To help answer this question, here's some commentary on the terms that a buyer and the target/sellers are taking on when they opt for the "Atlassian approach":

- **Timing of Closing** — *No closing is permitted at any time during the last month of any Atlassian fiscal quarter*. For some cash-strapped start-ups, having to gut through an extra month of cash-burn may be stressful or even impractical.
- **Purchase Price Adjustments**. *The headline price is adjusted only by a reduction equal to the amount of the closing indebtedness, transaction expenses, change of control payments and costs of representations and warranties insurance*. The absence of an adjustment based on balance sheet items other than indebtedness leaves the buyer vulnerable to manipulative actions – e.g., if the purchase price goes up as debt is reduced but does not go down as accounts receivable go down during the pre-closing period, then the target is incentivized to accelerate collection of receivables and use the proceeds to pay down debt. (Asserting a claim under the ordinary course covenants to recover for this kind of activity is not nearly as predictable or efficient as a purchase price adjustment mechanic.) And what about protection of the buyer against the ballooning of liabilities (on- and off-balance sheet) before closing that are not in the categories specified above as meriting a purchase price reduction? It is not unreasonable for acquirors of start-ups, especially those targets in the pre-revenue phase, to protect against this risk through broad adjustments based on all balance sheet liabilities and, for really early stage targets, off-balance sheet liabilities.
- **Treatment of Target Equity Awards**. *Unvested equity held by those who will continue to work for the target after closing rolls over into acquiror equity awards while all other unvested equity awards terminate without any consideration, and all vested equity awards are cashed out subject to a portion of this cash consideration going into escrow to secure the indemnification obligations to acquiror.*
  - Receipt of equity of the acquiror may or may not be exciting to the target employees, depending on the size of target relative to the acquiror and the volatility of the acquiror's trading price. Moreover, granting rights to acquiror equity may trigger investor pressure on the acquiror to engage in offsetting share buybacks. Another possible concern arising from the use of equity may be the dilutive impact on the voting power of acquiror insiders. Accordingly, buyers may want to consider working around these concerns by converting unvested equity awards into rights under an "unvested payment plan" where the retention value is maintained through a vesting schedule, but the employees get certain value in cash (rather than buyer stock) upon vesting.
  - Meanwhile, participation in the escrow by holders of vested equity awards reduces slightly the pro rata exposure under the escrow of the larger

(typically VC fund) selling stockholders, but can lead to unintended challenges, including:

    - administrative complexity arising from the need to track the escrow release payments to all the employees and apply appropriate withholding and payroll taxes that would not apply in the case of escrow releases to selling stockholders
    - loss of value of the escrow to buyer arising from the withholding and payroll taxes required to be skimmed off the top of any release and the cost/benefit judgment that buyer will have to go through before electing to punish its new set of employees (typically a key, and sometimes the sole, basis for the acquisition) by taking these employees' escrowed money
    - potential conflicts with the target's equity incentive plan – not every equity incentive plan will permit the acquiror to escrow a portion of the pay-out to the vested awards in connection with a merger and employees may be eager to enforce these rights to receive the full pay-out

- **Holding Back Merger Consideration from Key Employees**. *A percentage of the merger consideration payable to key employees would be held back and vest in installments over a period to be specified and, upon pay out, would be in the form of a number of shares of acquiror stock calculated using the trading price shortly before the execution of the merger agreement. If the employee is terminated without "cause" or departs for "good reason" or due to death or disability, the vesting of these holdback shares would accelerate and, if the employee otherwise ceases employment, the employee would forfeit the unvested holdback consideration.*
  - Retention is the sole purpose of this increasingly common concept of holding back a portion of the merger consideration payable to key employees who are selling stockholders. But holdback consideration in the form of acquiror stock may be sub-optimal relative to cash as the employee bears the risk of the value of the stock consideration from the date that the merger agreement is signed through the post-closing vesting dates (assuming that, at those vesting times, an exemption from the Securities Act is available to permit immediate monetization on the stock exchange, as should be the case in most instances by six months after closing).
  - Moreover, acquirors offering acceleration of vesting upon certain departures by these key employees (as opposed to a blanket, "you leave, you lose it" approach) will have to pay attention to the definitions of "cause" and "good reason." For example, does a "#metoo" issue necessarily constitute "cause" and, if not, will the acquiror be in the awkward position of having to make a payout to a high profile employee upon his or her departure in connection with unpopular circumstances? Further consideration should be given to the fact that poor or inadequate performance often fails to constitute "cause," thus risking an accelerated payout to someone whose inability to adequately

perform duties and responsibilities led to his or her termination. Similarly, the parameters of "good reason" can be bright lines, such as compensation thresholds and specifically mapped geographies for location of employment, or vague references to duties and responsibilities that leave the retention objective at risk.
    - Finally, buyers should expect that key employees will not react uniformly to this holdback arrangement because the tax impacts on different key employees can vary as a result of each key employee's specific facts and circumstances.
- **Stay Bonus Pool**. *The form would be stock consideration.* Offering a cash bonus pool may be more competitive than a stock bonus pool for an acquiror in an auction process for the target and more effective at achieving retention objectives. See also the issues flagged above under "Treatment of Equity Awards."
- **Indemnification of the Acquiror for Breaches of Representations and Warranties**. *The indemnification obligations of the selling stockholders for breaches of representations and warranties would be almost entirely replaced by a representations and warranties insurance (RWI) policy, the cost of which would reduce the purchase price. (The cost for RWI is typically 3-4% of the coverage limit.) The policy would cover losses equal to only 4% of the purchase price.*
    - Although indemnification claims for breaches of representations and warranties are not common and claims for more than 4% of the purchase price are even more uncommon, one factor that may contribute to this historical data is that, during most of the historical period from which this data is derived, RWI was not prevalent and therefore the sellers had much more "skin in the game" and incentive to get the representations correct.
    - In addition, while claims for material breaches of representations are not common, catastrophes do occur and a solid indemnity with a cap beyond 4% provides acquiror deal teams, as well as their officer and director supervisors, with coverage against assertions that they were being cavalier in their approach to M&A.
    - Finally, M&A teams at the acquiror need to keep in mind that RWI typically has important limitations, including:
        - no coverage of known matters (including matters that become known after the signing of the agreement and before the policy is formalized between signing and closing as is frequently the case),
        - no or limited coverage of many representations focused on specific balance sheet matters such as accounts receivable and deferred revenue, and
        - potential limitations on coverage of GDPR matters, civil and criminal fines, environmental exposures, transfer pricing matters, tax matters, and underfunding of pensions.
    - In addition, insurers may push back on the breadth of some of the IP representations that are popular in tech M&A, including on coverage of IP

relating to future, not-yet-developed products, and on non-knowledge qualified "IP validity" representations. A creative and deliberate approach to negotiations by acquirors can bridge these gaps in coverage of IP representations, but acquirors need to be prepared for a potential second negotiation of these critical representations with the insurer after the negotiation with the target.

  - Furthermore, the insurers will scrutinize the level of diligence conducted by the acquiror and may not provide coverage for areas where the acquiror may have made a business judgment to conduct "due diligence-lite" and rely primarily on the representations and warranties in lieu of a deeper dive on diligence.

- **Escrow and Indemnification by the Sellers**. *The escrow, taken out of the merger consideration payable to the selling stockholders and equity award holders, is only 1% of the purchase price and, in the absence of unresolved claims, will be released 15 months after closing. The acquiror may recover from the escrow not only for breaches of representations and warranties (presumably for the deductible not covered by RWI) but also for the areas of indemnity that are capped at the purchase price amount (fundamental representations, covenant breaches, and fraud).*
  - While it is not typical to have claims under the indemnity that exceed 1% of the purchase price, when these claims occur (the most common instance where this occurs in our experience is when there is a "special indemnity" for a known risk), the result is usually a settlement of the indemnification claim. Acquirors should consider that the amount of escrow money that is being held back from release while the settlement negotiations are ongoing is a material lever in determining the results of these negotiations. A 1% escrow may be too small to contribute meaningfully to the acquiror's leverage in these settlement discussions.
  - In addition, once the escrow is depleted or released, the ability to recover directly from the indemnifying parties is subject to serious limitations. As detailed in our blog post following Delaware Chancery's *Cigna v. Audax* decision, recovery from outside the escrow is not legally enforceable in the absence of express joinders being signed by the indemnifying parties (since they are not parties to the merger agreement between the acquiror and the target). It is typically not practical to obtain joinders from all selling stockholders and equity award holders, especially as startups stay private longer and have increasingly large stockholder and equity award bases. Moreover, the funds that are indemnifying parties will distribute promptly their proceeds from the merger and may not even be in existence (depending on the nature and life cycle of the fund) by the time the indemnification claim is asserted against them. Finally, many of these indemnifying parties (former shareholders and equity award holders) will be valued employees of the acquiror at the time of the indemnification claim and therefore the retention and incentive costs to the acquiror of directly

suing these individuals may outweigh the monetary benefits. For all these reasons, the ability to recover from an escrow is more certain, cleaner, and less costly than reliance on recovery beyond the escrow.

- The justification for the 15-month survival period is that such a period is sufficient to assure that the release of the escrow would be preceded by at least one annual audit, which in theory would turn up all undisclosed liabilities and other inaccuracies in the representations. Interestingly though, a survey released last week by AIG's RWI unit indicated that approximately one quarter of all indemnity claims for breaches of representations and warranties are asserted more than 18 months after the closing.

Standardization is coming to M&A documentation. Accordingly, Atlassian's project is deservedly receiving growing attention. The consequence is increased pressure on M&A actors to understand what they are actually agreeing upon when they decide to embrace the efficiency of standardization.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

Freshfields Bruckhaus Deringer

Representation & Warranty Insurance

Agenda

Rep & Warranty Insurance ("RWI") Policies

- Introduction / Background
- Market Trends; Usage
- Overview of RWI Policies: Scope, Pricing and Limitations
- Process, Process, Process
- Key Considerations for Acquirors of Tech Companies
- Claims Overview
- Appendix: Comparison of RWI Policy Coverage to a Traditional Seller Indemnity

Introduction / Background

RWI policies developed overseas, particularly in Europe, given certain local M&A conventions that made carriers' underwriting easier:

- Generally, European buyers expect 'thinner' R&W packages than U.S. market practice
- R&Ws typically qualified by information provided in the dataroom

PE sellers also quickly understood the power of RWI policies to free up sale proceeds that they might otherwise be required to deposit in escrow for a period of time to secure a traditional seller indemnity, hurting the fund's ROI on exits

- Relatedly, some early policies were issued to sellers as the named insured, though practice is now predominantly buy-side policies (circa 95%)

RWI policies first championed in the U.S. by PE sponsors and other financial buyers, typically limited in their ability to compete on price, as a way to sweeten their bids

A virtuous cycle developed: additional carriers entered the RWI market, the resulting competition lowered pricing and cheaper RWI policies diminished the cost to sponsors to offer sellers the right to walk away cleanly

Market Trends: Usage

No longer a product buyers and sellers can ignore

- Policies issued by Marsh and Aon in North America in 2018 were up 40% from 2017
- Aon estimates that more than 75% of PE/financial sponsor deals now use R&W insurance
- Split between strategic and PE buyers in 2018 – roughly 45% are issued to strategic buyers
- Limits of insurance placed by Marsh in 2018 totalled $27 billion (~50% in North America, 38% in EMEA and 12% in APAC)

Target transactions

- Transaction headline price generally in the range of $25m to around $5bn (though some larger policies have been placed)
- Carve-outs historically more difficult to insure due to lack of audited financials, but now more common (even where no audit, QoE can suffice), particularly if the buyer can demonstrate the divested business is sufficiently 'stand-alone'
- Common in both private and public M&A (public M&A policies mostly limited to acquisitions of smallcaps/midcaps)

Overview of RWI Policies

Scope

Generally, RWI policies cover all reps & warranties in the purchase agreement

- But, subject-matter exclusions can be a trap for the unwary

Coverage not provided for known breaches of seller reps & warranties

- But, definition of "knowledge" typically requires both actual conscious awareness of the underlying facts and that they constitute a breach, with carrier bearing burden of proof
- Knowledge limited to enumerated list of deal team members

Pre-closing taxes may be covered

- RWI policies historically only covered breach of tax reps
- Now some policies offer broader coverage of pre-closing taxes akin to a traditional seller indemnity, but still subject to retention and coverage limit (and therefore not as valuable as an our-watch/your-watch first dollar indemnity); exclusions often also relevant on consideration of tax coverage

Breaches of covenants not covered

Exclusions are a key point of focus

- "Standard" exclusions generally not covered: wage & hour claims; underfunded pension costs, withdrawal; asbestos, PCB contamination; transfer pricing matters; availability of NOLs or other tax attributes; failure to meet projections
- Deal-specific concerns identified during the underwriting process, including, potentially:
  - self-imposed limitations on the buyer's due diligence process
  - areas of heightened risk identified in buyer's diligence or that carrier believes should be covered by other insurance (e.g., cyber)

Overview of RWI Policies

Pricing

Premia

- One-off premium (usually with 10% paid at time policy is incepted, 90% at closing)
- Typically, 2-4% of the coverage limit
- Generally, includes brokerage fees but need to confirm as some brokers charge additional
- Factors influencing the premium include:
  - level of coverage sought in proportion to the purchase price
  - level of retention and portion thereof borne by seller (if any)
  - duration of coverage
  - target's industry sector, complexity and geographical spread
- Generally borne by buyer, particularly in current M&A environment
  - But, in some deals where seller has less leverage, cost may be split in some proportion, often subject to a cap on amount paid by seller
- Sell-side policies generally offer worse pricing, given signalling effect of seller seeking to insure its own breaches

Overview of RWI Policies

Limitations: Scope of Coverage

Retention (aka Deductible)

- Policies cover the insured's losses above specified deductible (no tipping baskets in RWI policies)
- Typically, this is 1% - 1.5% of the headline price
- The retention amount often drops down 50% after a specified period – typically 12-18 months after closing

Sole Recourse for Buyer vs. Seller Retention of Risk

- Historically, carriers often sought to have seller retain 'skin-in-the-game' by offering better pricing if the seller retained responsibility for some portion of the retention (deductible) in the event of a breach
- However, this difference in pricing has lessened over time and fewer so-called 'baby indemnities' are seen as a result

Policy Limits

- Generally, 10% of the headline price but can be negotiated deal-by-deal
- Coverage limits as low as ~$5m
- Limits available on deals as large as ~$5b, and possibly larger in certain circumstances

Duration

- Policies generally survive for longer periods than a traditional seller indemnity
- Often, ~4 years for all reps

Overview of RWI Policies

Additional Scope Considerations

Definition of Loss

- Carriers will usually be willing to be silent with respect to the availability of consequential and multiple-based damages

Materiality Scrape

- Carriers are typically willing to accept materiality scrapes both for purposes of determining the existence of a breach and determination of the losses related thereto

Definition of Knowledge

- Generally limited to actual conscious awareness both of the underlying facts and that they constitute a breach (no constructive or imputed knowledge), with no duty to inquire and the carrier having the burden of proving knowledge
- Knowledge defined by reference to an enumerated list of deal team members

Failure to Comply by Insured

- Policies often contain a safe harbor provision, only permitting the carrier to deny coverage to the extent that the carrier is actually/materially prejudiced by an insured's failure to comply

Signing vs. Closing

- Carriers are typically willing to bind coverage at signing and cover 'signing date reps' (subject to an exclusion from coverage of interim breaches as to the closing date reps)

Process, Process, Process

Indicative Timeline

1-2 days	2-3 days	1-2 days	Generally, ~7-10 days
Execute NDA **Discuss Parameters of RWI Policy** **Engage Broker**	**Obtain Quotes from Lead Carrier** • In order to obtain quotes, insurers request: (i) a draft of the acquisition agreement, (ii) the confidential info memorandum, and (iii) the target's most recent financials **No Cost to Obtain Quotes**	**Review Quotes and Select Lead Carrier** • May be required to pay insurer its due diligence fee before lead carrier will begin underwriting	**Lead Carrier Underwriting** • Access to data room and legal, financial and tax DD reports (subj. to non-reliance letters) • Draft of disclosure schedules • Due diligence bring-down calls with buyer's external advisors **Policy negotiations** • Concurrent with underwriting • Work closely with outside counsel, broker

Process, Process, Process

Key Considerations

Not all brokers are created equally

- Limited pool of experienced brokers who regularly work in this space
- Those who do have key contacts at carriers that help with policy negotiations, see high volume of policies and can keep carriers ‘honest’ on claims, particularly given reputational concerns for carriers

Timing matters

- On buy-side, carriers generally won’t agree to start underwriting until a bidder has been identified as the winner
- Pre-empting an auction or gaining timing advantage may require the insured to agree to bear underwriting costs, typically then offset against premium of any policy subsequently issued

Lead carriers and excess markets

- Carriers generally only want to bear no more than $40-50m of exposure to any one particular deal
- For deals requiring larger limits, broker will assist in construction of a tower involving multiple layers offered by different carriers, with the ‘excess’ layers utilizing ‘follow-form’ policies that mirror the primary layer terms and the excess markets leveraging the lead carrier’s diligence/underwriting
- Lead carrier typically takes last layer (which of course is the least likely to incur claims); often viewed as ‘free’ money if the lead carrier has underwritten the deal correctly

Process, Process, Process

Additional Considerations for Strategic Buyers

Ownership of the RWI process

- In financial sponsor context, outside counsel will manage the RWI process, with some input from in-house counsel and deal team
- Often, for strategic buyers, treasury departments and/or risk officers may want input on 'insurance' being acquired by the company, often with differing considerations outside the four corners of the deal

Policy terms have not (yet) standardized

- High-volume, repeat players (i.e., large financial sponsors) get top-of-market terms from key carriers and often have bespoke, pre-negotiated forms with multiple lead carriers
- But experienced counsel with help of broker can meaningfully improve forms offered to strategic buyers, sometimes requiring sustained effort over the course of a number of deals

Avoiding the 'dead bird' diligence report

- Repeated debate in M&A circles that buyers of RWI policies have limited incentive to conduct due diligence given possibility of identifying known breaches and/or providing a roadmap to known risks (though carrier underwriting has generally evolved to sniff out any self-imposed limitations)
- Strategic buyers often experience a different phenomenon, as in-house functional teams may be diligencing areas they will 'own' post-closing and feel incentive to 'flag' these issues to chief M&A decision makers
- Can create awkwardness if not put in context of deal or provided with recommendations on how to address or cabin off
- Can often be addressed by embedding outside counsel experienced in RWI with functional teams to help steward them through the process

Key Considerations for Acquirors of Tech Companies

Anti-Sandbagging/Pro-Sandbagging

- Generally, accepting anti-sandbagging provision is not how acquiror has approached deals historically
- But recall, knowledge construct has evolved into very favorable terms for insureds

"Last Minute" Underwriting Surprises

- Tech acquirors often have heightened concerns about diligence memos providing roadmap to key risk areas, resulting in additional exclusions at the end/after RWI approach has been 'agreed'
- Can often be managed by experienced broker and counsel, by leveraging carrier reputational concerns

Specific Exclusions: Additional Scrutiny of Certain Reps

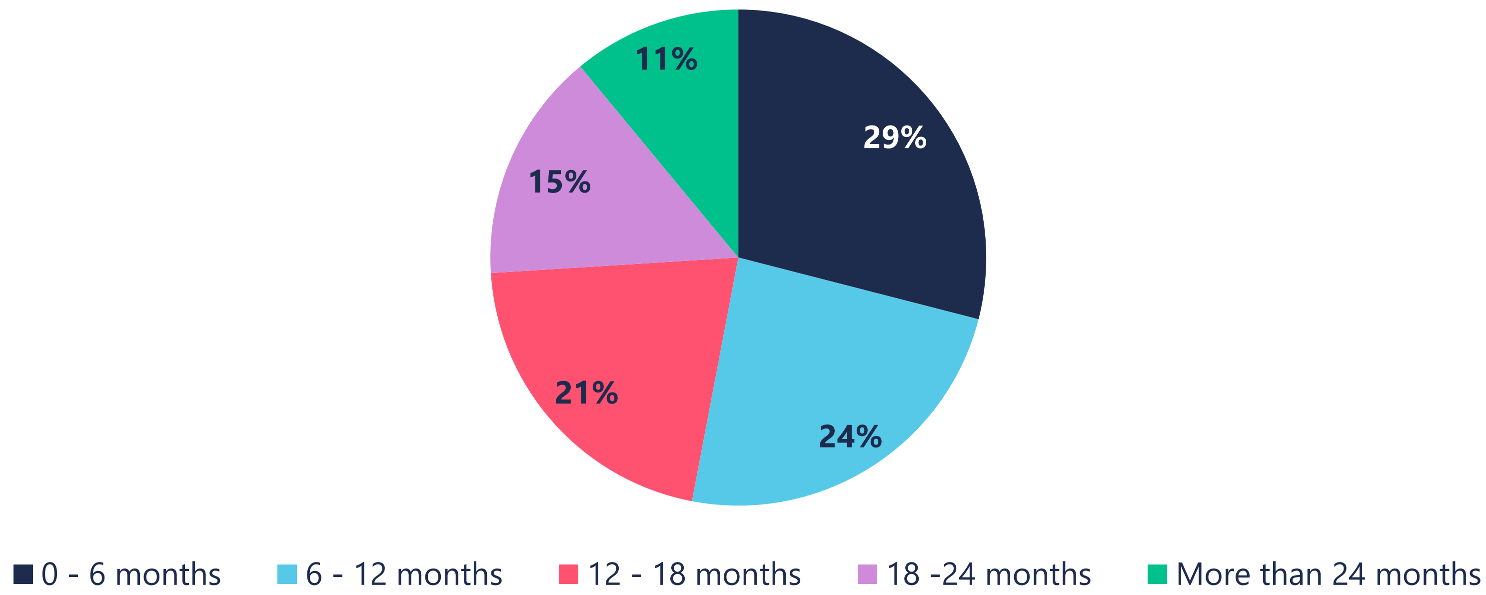
- Third-party infringement of company IP: roughly 80% of carriers will require knowledge qualifier, regardless of whether acquiror typically 'gets' this in its uninsured deals
- Sufficiency of company IP for business as currently conducted vs. as proposed to be conducted: may be addressed with discussion of plans with carrier and/or scheduling of new plans to be covered
- Cyber/data privacy: carrier often takes view that company should have a stand-alone cyber policy and is unwilling to be primary source of recovery; exacerbated by scope of cyber reps that have migrated from 'compliance with laws' approach to 'there has been no breach' approach

Higher Caps for Breach of IP Reps

- Some acquirors may seek special incremental limit (for additional premium) on IP reps in deals in $100-500m range, but pricing is inconsistent deal-to-deal as claims experience to date is limited

Claims Overview

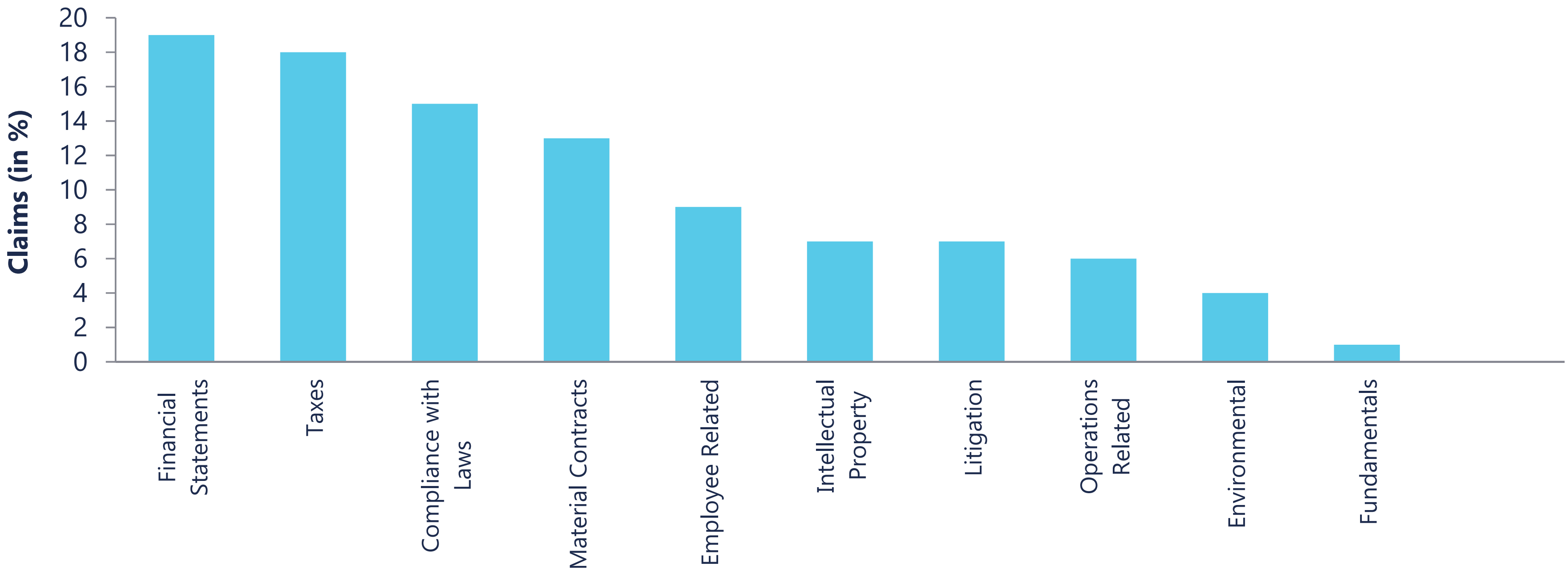
Timing of Claims



Source: AIG Global M&A Claims Study 2019

Claims Overview

Types of Claims



Source: AIG Global M&A Claims Study 2019

Appendix

Comparison of RWI policy coverage to a traditional seller indemnity

Traditional Seller Indemnity

- All reps are covered
- Claims for breach of general reps are subject to survival period, de minimis, deductible and cap
- Claims for breach of certain fundamental reps are typically subject to longer survival period but no dollar limitations
- Matters disclosed on the disclosure schedule not subject to breach of R&W indemnity but can be covered by special indemnity
- Typically includes a pre-closing tax indemnity, which is subject to longer survival period and no dollar limitations
- Typically includes indemnity for breach of covenants, which is not subject to dollar limitations

RWI Policies

- Coverage subject to subject-matter exclusions
- All claims subject to survival periods, retention and policy limits, though survival period of general reps typically longer in RWI
- Claims for breach of certain fundamental rep typically subject to similar survival period, but also subject to retention and policy limits
- All known breaches (whether or not on the disclosure schedule) are excluded, subject to two-prong knowledge definition, with burden borne by carrier
- Can have separate pre-closing tax indemnity, but subject to exclusions, retention and policy limits
- No coverage for breach of covenants

Thank you

The Atticus Project

Accelate Contract Review with AI

February 6, 2020

BerkeleyLaw
UNIVERSITY OF CALIFORNIA
EXECUTIVE EDUCATION

BERKELEY CENTER FOR
LAW & TECHNOLOGY

Unstructured Data of the Past

[redacted]

2015 STOCK PLAN

<u>NOTICE OF STOCK OPTION GRANT</u>

Jesse [redacted]

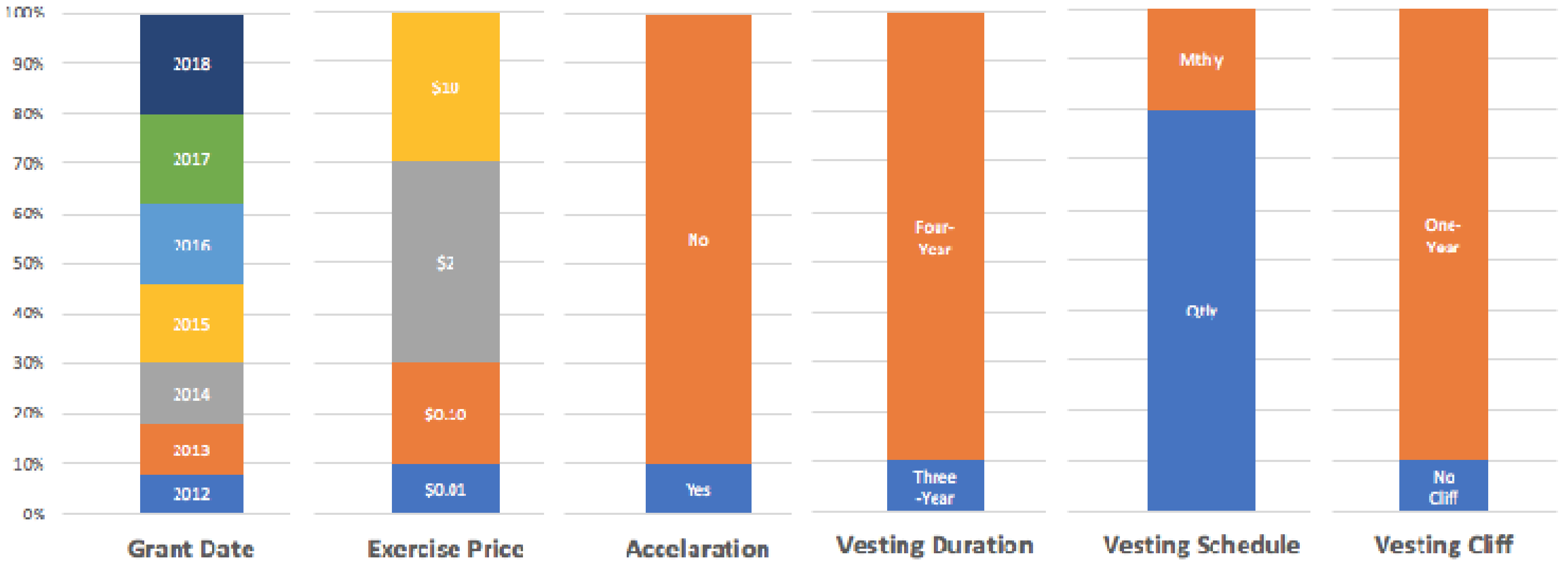
You have been granted an option to purchase Common Stock of [redacted], a Delaware corporation (the "<u>Company</u>"), as follows:

Date of Grant:	August 8, 2017	
Exercise Price Per Share:	$0.60	
Total Number of Shares:	50,000	
Total Exercise Price:	$30,000.00	
Type of Option:	50,000 Shares	Incentive Stock Option
	0 Shares	Nonstatutory Stock Option
Expiration Date:	August 7, 2027	
Vesting Commencement Date:	April 10, 2017	
Vesting/Exercise Schedule:	So long as your Continuous Service Status (as defined in the Plan) does not terminate (and provided that no vesting shall occur following the Termination Date (as defined in Section 5 of the Stock Option Agreement)), the Shares underlying this Option shall vest and become exercisable in accordance with the following schedule: 100% of the Shares shall be subject to vesting. 18/60th of the Shares shall vest and become exercisable on the 18-month anniversary of the Vesting Commencement Date, and 1/60th of the Shares shall vest and become exercisable on each monthly anniversary of the Vesting Commencement Date thereafter.	
Termination Period:	You may exercise this Option for 3 month(s) after the Termination Date except as set out in Section 5 of the Stock Option Agreement (but in no event later than the Expiration Date). You are responsible for keeping track of these exercise periods following the Termination Date. The Company will not provide further notice of such periods.	
Transferability:	You may not transfer this Option except as set forth in Section 6 of the Stock Option Agreement. You must obtain Company approval prior to any transfer of the Shares received upon exercise of this Option.	

[Signature Page Follows]

Structured Data of the Future

Imagine You have 500 Employees:



Input: -LRB- CNN -RRB- Gunshots were fired at rapper Lil Wayne 's tour bus early Sunday in Atlanta . No one was injured in the shooting , and no arrests have been made , Atlanta Police spokeswoman Elizabeth Espy said . Police are still looking for suspects . Officers were called to a parking lot in Atlanta 's Buckhead neighborhood , Espy said . They arrived at 3:25 a.m. and located two tour buses that had been shot multiple times . The drivers of the buses said the incident occurred on Interstate 285 near Interstate 75 , Espy said . Witnesses provided a limited description of the two vehicles suspected to be involved : a " Corvette style vehicle " and an SUV . Lil Wayne was in Atlanta for a performance at Compound nightclub Saturday night . CNN 's Carma Hassan contributed to this report .

BiLSTM+GNN → LSTM+Po ... per lil wayne 's tour bus early sunday in atlanta , police say . no one w ... d no arrests have been made , police say .

Acceleration

(*) ESOP Vesting with Acceleration” shall mean that the applicable Options shall vest in accordance with the ESOP Vesting, however, notwithstanding such ESOP Vesting, in the event that the Grantee’s employment shall be terminated by the Company (except for "Cause", as defined in the Offer Letter or any respective document) or if the Grantee will resign for Good Reason as defined in the Offer Letter or any respective document, in each case within 12 months following the consummation of a Deemed Liquidation Event of the Company (as defined in the Company's Certificate of Incorporation, as amended from time to time), then 50% of any then outstanding and unvested Options will immediately vest and become exercisable.

50% of unvested options accelera

It is an algorithm problem, but ultimately it is a data problem.

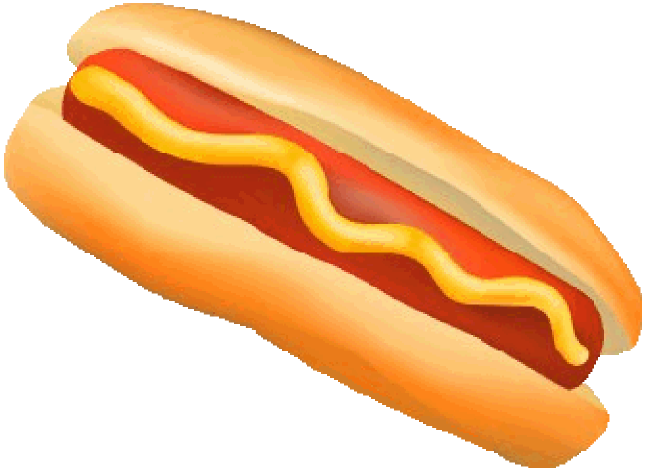
^

labelled


SILICON VALLEY
"NOT HOTDOG"
Not hotdog

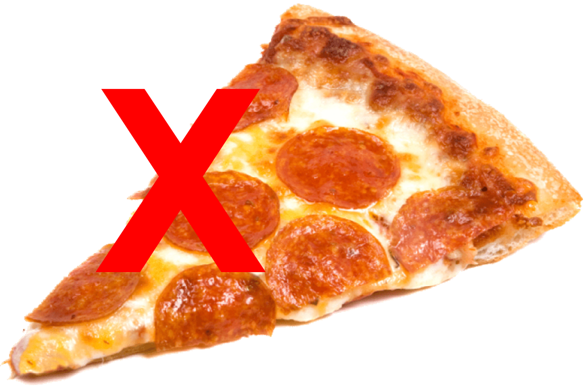
What is Labelled Data?

Hot Dog



V

Not a Hot Dog



WHO ARE WE?

A GROUP OF SEASONED M&A LAWYERS IN FORTUNE 500 COMPANIES AND LEADING LAW FIRMS THAT NO LONGER WANT TO SPEND RESOURCES ON LOW-VALUE, REPETITIVE CONTRACT REVIEW.

WHAT'S OUR VISION?

- SPEEDY AND ACCURATE M&A DILIGENCE REVIEW AT LOWER COST.
- COMPREHENSIVE REVIEW OF ENTIRE DATA ROOM.
- POWERFUL ANALYTICS THAT PROVIDES BIG-PICTURE TREND DATA.
- HIGH-RISK AREAS AND GAPS FLAGGED FOR EXPERT DEEPER DIVE.

The Atticus Project is a consortium of public company legal departments and law firms dedicated to achieving and accelerating high-quality, low-cost, accurate and timely contract review using ethical AI.

Check out our mission, newsletter and white paper at https://www.atticusprojectai.org/

Thank You

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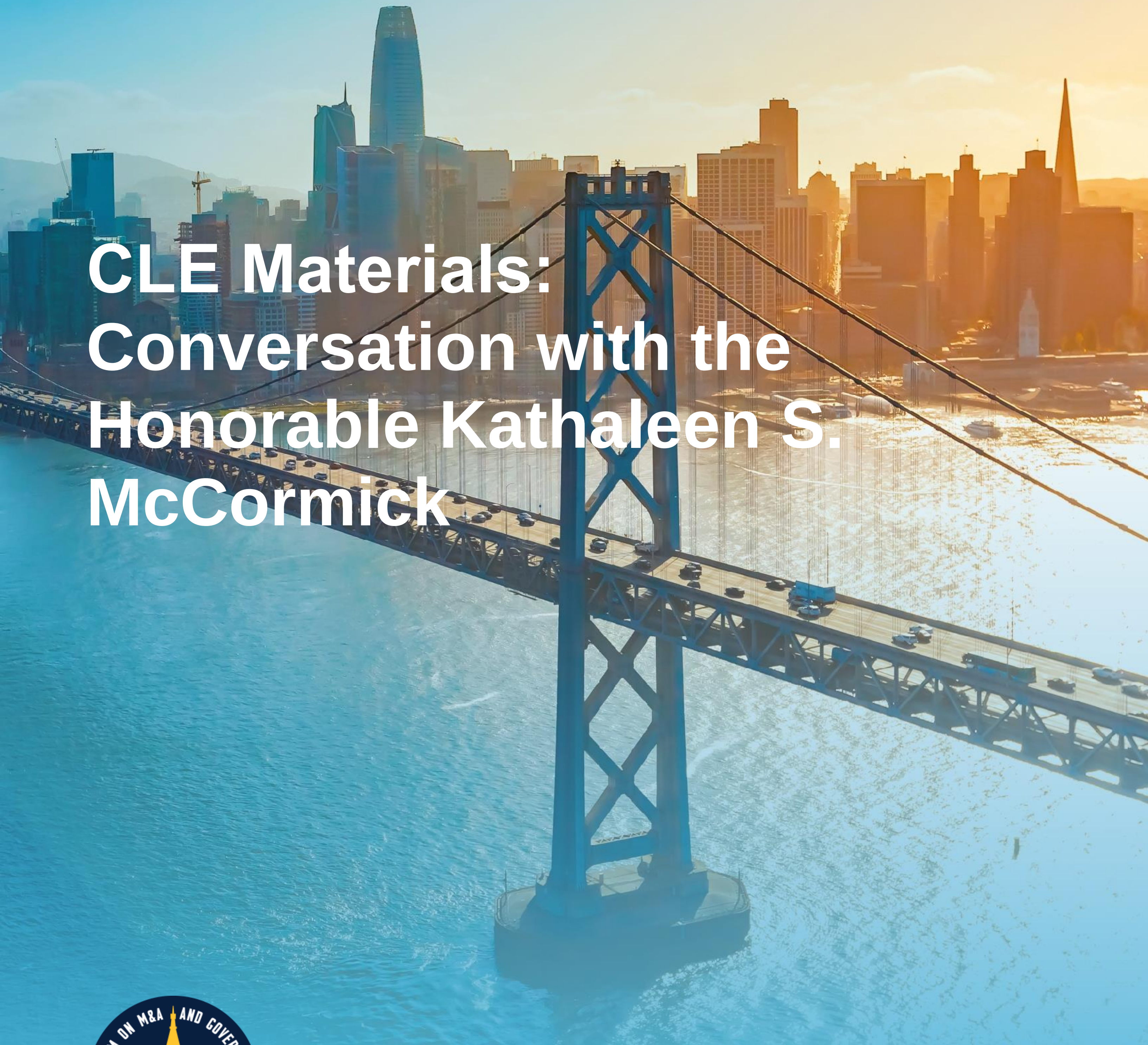

CLE Materials: Conversation with the Honorable Kathaleen S. McCormick

FEB 6, 2020 | SAN FRANCISCO

Horizon 2020

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Trends in Delaware litigation

Managing the threat of stockholder action

Meredith Kotler

Partner, New York

Several decisions from the Delaware courts in 2019 are relevant to boards as we head into 2020. Chief among them are a number of *Caremark*-related rulings that highlight the importance of active, engaged board oversight of "mission critical" risk and compliance issues, and the continued use of (and litigation surrounding) Section 220 requests for books and records.

What *Marchand* and *Clovis* mean for boards

Delaware courts have long acknowledged that *Caremark* claims – which allege failure of board oversight – are among the "toughest" for plaintiffs to plead and prove. More than a decade ago, the Delaware Supreme Court held that to survive the pleading stage and ultimately succeed, stockholders must show that boards either 1. "utterly failed to implement any reporting information restrictions or controls"; or 2. having implemented them, "consciously failed to monitor or oversee their operations, thus disabling themselves from being informed of risks or problems requiring their attention." Since then, virtually no cases alleging *Caremark* claims have survived the pleading stage.

However in 2019, in *Marchand v. Barnhill*, the Delaware Supreme Court ruled that claims under the first prong of *Caremark* against the directors of an ice cream manufacturer, Blue Bell Creameries, could go forward past the pleading stage, following a 2015 listeria outbreak in which three people died. The court ruled that the complaint had alleged facts from which it could be inferred that Blue Bell's directors had failed to put in place a board-level oversight system for food safety – which was "mission critical" for the monoline company – and as a result had not received official notices of deficiencies for several years.

Among other things, the Supreme Court noted that the complaint alleged that there was no board committee that addressed food safety; no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks or reports; and no schedule for the board to consider on a regular basis any key food safety risks that existed. The Supreme Court explained that "… as with any other disinterested business judgment, directors have great discretion to design context and industry-specific approaches" to compliance oversight, but "*Caremark* does have a bottom-line requirement that is important: the board must make a good faith effort – i.e. try – to put in place a reasonable board-level system of monitoring and reporting."

The *Clovis* case involved the second *Caremark* prong, and revolved around a monoline company's flagship lung cancer drug, Rociletinib ("Roci"). The complaint alleged that Clovis's management overstated Roci's efficacy in clinical trials, using unconfirmed data on tumor shrinkage (a violation of both accepted trial protocols and Federal Drug Administration standards). Clovis eventually came clean, with the subsequent $1bn drop in its market value sparking a securities class action, an SEC complaint and the derivative claim. In the latter, the Delaware Court of Chancery denied a motion to dismiss, ruling that the complaint alleged facts from which it could be inferred that while the company had compliance systems in place, directors "ignored multiple warning signs" that management was inaccurately reporting Roci's efficacy based on certain presentations that had been made to the board. As was the case in *Marchand*, it remains to be seen whether the allegations in both cases will be proven in later phases of the litigation.

So, what are the lessons from *Marchand* and *Clovis*? While neither signals any change in Delaware law, they are good reminders of the need for boards to implement and monitor a risk oversight system for material risks that a company faces. This is particularly true for boards of monoline companies, and boards of businesses in regulated sectors, who should pay close attention to any core risks and compliance requirements. In *Clovis*, the Court noted that where "externally imposed regulations govern a company's 'mission-critical' operations, the board's oversight function must be more rigorously exercised." As always, boards should map these critical risks and ensure that they have the right monitoring and reporting structures, and board expertise, in place.

Practical guidance for boards

1

Directors should identify any key or material risks to their business, set up board-level compliance and monitoring systems (including appointing directors with the knowledge to understand technical issues), and make good faith efforts to ensure that these mechanisms are working as they should.

2

Boards should also review the efficacy of their compliance and monitoring on a regular basis, whether biannually or even quarterly.

3

It is important to pay close attention to the documentation of board oversight and monitoring. Have the reporting and monitoring mechanisms been appropriately documented? Have all reported issues been noted, as well as any actions taken by the board to address known risks and deficiencies? Does the documentation show what directors are doing to stress-test their compliance systems?

Section 220 litigation

Section 220 demands relate to stockholders' statutory right to inspect certain corporate books and records for a "proper purpose". They are a tool for plaintiffs to obtain discovery ahead of litigation against directors, and are also utilized by activist investors.

2019 saw a further rise in Section 220 demands, as well as a continued increase in related litigation. While limits have been set around their use in recent years, the cases outlined below show that the Chancery Court will enforce Section 220 demands where it believes investors have met the statutory requirements.

1. *Inter-Local Pension Fund GCC/IBT v. Calgon Carbon Corp*. was filed after Calgon's board refused to produce information in connection with the company's sale to Kuraray. The Section 220 demand related to the board's process and knowledge before the deal was signed, and allegations of wrongdoing in connection with compensation and benefits paid to Calgon's senior officers. The Court held that the plaintiff's purported purposes to inspect were genuine and that they had established a credible basis to suspect mismanagement. Despite this, the Court ruled that the plaintiff was only entitled to limited production – and did not have the right to see emails between Calgon's management and Kuraray.
2. *In Kozinski v GGP Inc*. – which related to the merger between GGP and Brookfield – the defendant argued that the Section 220 demand and subsequent litigation were lawyer-driven, and that there was no credible basis to infer misconduct. Again, the Court permitted inspection, although this time the scope was left to be negotiated in the first instance between the parties.
3. Similarly, in *Donnelly v. Keryx Biopharmaceuticals Inc*., the stockholder sought books and records regarding suspected breaches of loyalty and improper disclosure by the board following Keryx's 2018 merger with Akebia. Once more the Court found a proper purpose for inspection and credible basis to suspect mismanagement or wrongdoing, rejecting the assertion that the demand was counsel-driven and pretextual. However, the Court declined to shift attorneys' fees, finding that the company had raised a good-faith dispute over the purpose and scope of the demand. The Court again left it to the parties to negotiate the proper scope of documents to be produced.
4. Finally, *Bucks County Employees Retirement Fund v. CBS Corp*. was filed after CBS's board refused to produce certain documents requested in connection with allegations surrounding the company's merger with Viacom. As with Calgon, the Court held that a proper purpose for inspection had been stated, but also ruled that a "narrow" set of certain emails linked to a specific meeting did have to be produced. The Court emphasized that it "[did] not mean to endorse the plaintiff's approach here as a 'playbook' that should be followed by other stockholders who may seek to challenge transactions preclosing."

Practical guidance for boards

1

The Delaware courts continue to enforce the use of Section 220 demands where the statutory requirements are met.

2

They have allowed shareholders access to board documents, and in limited circumstances to certain emails, including where there are gaps in official board documentation.

3

Directors should ensure that their minutes and corporate records are sufficiently detailed and complete to mitigate demands for email communications.

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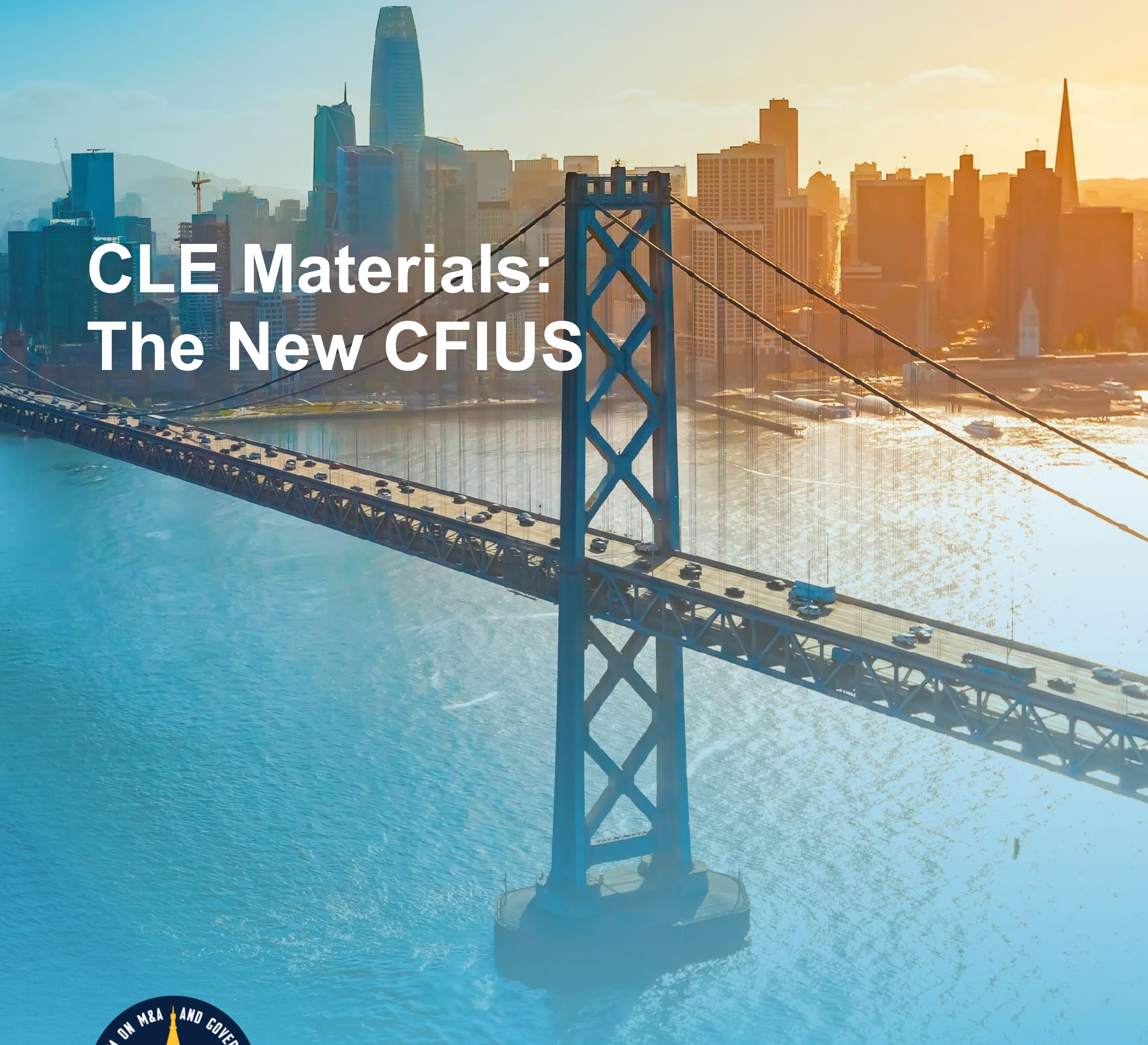

CLE Materials: The New CFIUS

FORUM ON M&A AND GOVERNANCE 2020 U.C. BERKELEY

FEB 6, 2020 | SAN FRANCISCO

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Navigating foreign investment rules

CFIUS and other international frameworks

Aimen Mir

Partner, Washington, DC

Christine Laciak

Special Counsel, Washington, DC

National security and commercial technology innovation – convergence and conflict

The race to lead in artificial intelligence, robotics, blockchain, gene-editing and other emerging technologies not only has potentially far-reaching economic implications, but also, from the US government's perspective, significant consequences for future national security. Artificial intelligence (AI), for example, may be the key to deriving value from the massive amounts of consumer data that many companies now collect, but it may also be vital to analyzing huge volumes of sensor data for intelligence purposes – by the US or its adversaries. The drama surrounding Huawei and 5G (which will get worse before it gets better) has drawn the tension between commercial and national security interests into stark relief. Some of the companies most impacted by the US government's decision to put Huawei on the Department of Commerce's (DOC) "Entity List" are US businesses with significant semiconductor sales to Huawei.

To manage these risks, the US government is working to establish a regulatory framework for sharing these technologies across borders, without stifling the development of new products and capabilities that may be key to ensuring the US's future national security advantage. This is a particularly challenging balance to strike, and it is not yet clear whether the government has the ability or the will to do so. Among the tools it is using to achieve this goal are export controls and foreign investment review. DOC, which administers the US dual-use export control system, is revising its regulations to impose additional controls on strategic emerging technologies. For example, it announced in January 2020 relatively narrow new controls on geospatial AI software, but it remains to be seen whether it will issue a more sweeping rule as well. Rules implementing the 2018 Foreign Investment Risk Review Modernization Act (FIRRMA), the most significant reform of the Committee on Foreign Investment in the United States (CFIUS) process in 30 years, take effect in February. FIRRMA subjects a wider breadth of foreign investment – particularly in strategic emerging technologies and companies – to CFIUS review. It will be imperative for boards to track these developments as they will have major consequences for how investments are made, where investments can be sourced, exit strategies, cross-border collaboration, who can license or acquire technology, who can be employed and a host of other functions that may be important to the development of future technologies.

China is not on the friends list, and that may not change despite "phase one" trade deal

The President’s rhetoric and tweets – and their timing – might understandably lead one to believe that the aggressive steps taken by CFIUS against Chinese investment in the US, and other pressure on China connected to technology issues like the Huawei designation, are really part of ongoing attempts to reduce the trade deficit with Beijing.

In reality, however, US government concerns around China’s acquisition of technology – whether through investments in US companies, forced joint ventures in China, or the theft of intellectual property – started in earnest in the last administration and have merely accelerated under the current presidency. Furthermore, even on Capitol Hill there is relative consensus among Democrats and Republicans that China poses a leading, if not the foremost, long-term threat to US national security. Thus, while President Trump may use national security issues as leverage in trade discussions, the successful inking of the "phase one" trade deal is not likely to make these security concerns go away. Against this backdrop it is important that boardroom discussions on the implications of China-US relations be nuanced and distinguish between actions that are tactical moves to gain advantage in trade talks from those that are likely to persist in the long term.

China, for its part, is also in this for the long-haul. The more the US exerts pressure on Beijing, the more China becomes motivated to develop its own capabilities to break its dependence on the United States for technology. And in response to moves like the Huawei listing that China views as punitive, it, too, has threatened to act against foreign companies that are deemed “unreliable entities.” As a key market and manufacturing outpost for many US businesses, these developments only add to long-term unpredictability.

These trends are global, and the tools do not always discriminate between friend and foe

The drive to consider how to control emerging technologies and to expand foreign investment review processes – and concern related to the challenge posed by Chinese overseas investment – is not limited to the United States. In the UK, legislation for a standalone foreign investment review regime has been proposed for this year. New EU rules will be applicable from October 2020 and provide for a cooperation mechanism between member states and the European Commission in screening direct investments from outside the EU on public security grounds. France and Germany, too, have recently revised their foreign investment laws, while Japan is in the process of doing so, and even Israel is considering a law. (Not surprisingly, this activity has prompted China to establish its own foreign investment review process.) Today, more than 100 jurisdictions now have laws that allow the review of foreign investment on security or public interest grounds. Typically, these regimes apply to all foreign investors – not just those from particular jurisdictions – although they may be more lenient with respect to some. There are a number of transactions involving European-based purchasers that have been caught up in extended US reviews and vice-versa, despite the historical security cooperation among these jurisdictions. As the proliferation of foreign investment regimes is resulting in longer lead times and greater execution uncertainty, those risks need to be factored into transactional decisions even among allied nations.

Practical guidance for boards

1

Directors and senior management should understand the company's national security profile (goods, services, and capabilities) and how government national security regulatory interests may limit future commercial opportunities.

2

Consider the national security profile of your primary customers and suppliers and how government action against any one of them would impact your operations.

3

Consider foreign investment review risk early on in any cross-border deal.

4

Think about this globally, not just in connection with operations in the United States. US investments even in "friendly" countries could get caught up in investment reviews. Meanwhile, US companies operating in China may bear the cost of the growing economic de-coupling of the US and China, driven in part by technology foreign policy.

10 key themes

Foreign investment

The impact of newly strengthened powers of political intervention in cross-border deals

Foreign investment control – the ‘new normal’ for cross-border deals

Foreign investment screening remains a key consideration for dealmakers in 2020. The ongoing trend is for governments to introduce new powers or strengthen existing powers to screen – and potentially impose restrictions on – foreign investments.

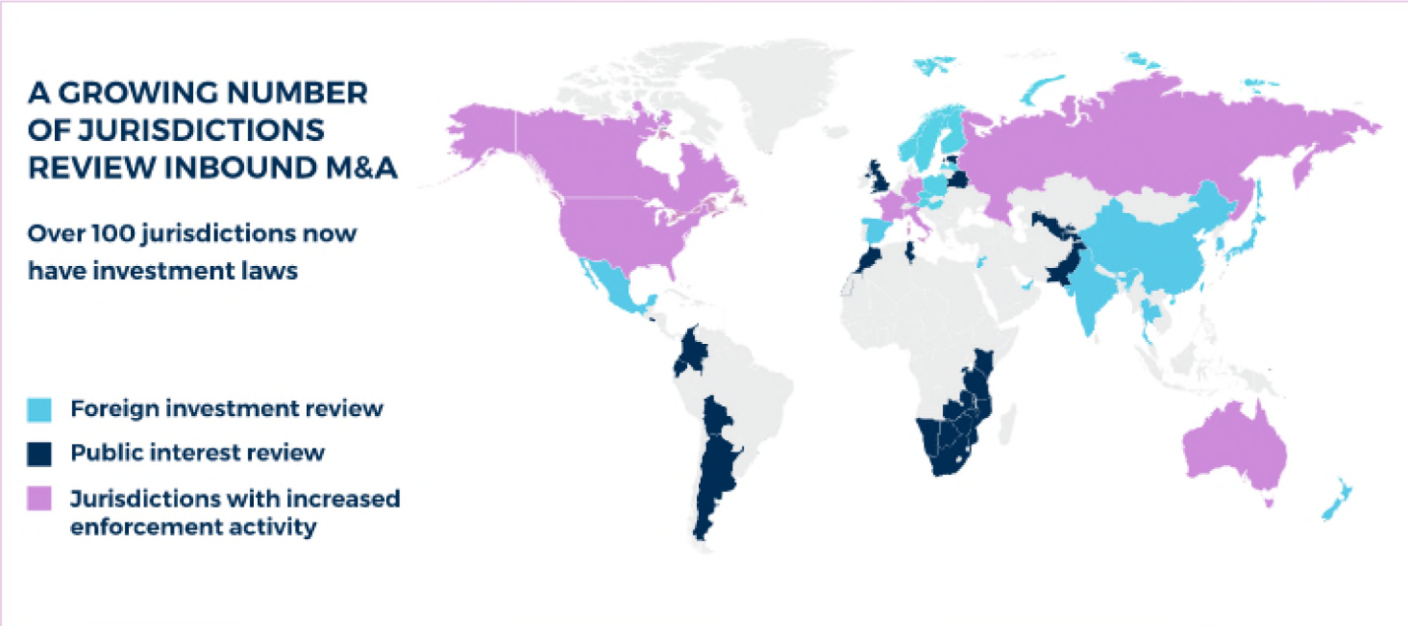
Against a backdrop of growing trade tensions, this is leading to heightened politicisation of deal-making and increased deal execution risk, or, at the minimum, delays to deal timetables. It is therefore more important than ever to incorporate effective strategies to identify and mitigate these risks into transaction planning from the outset.

“

CFIUS is now at version 3.0, with strengthened jurisdiction, enhanced enforcement powers, and millions of dollars of new resources to review transactions, monitor and enforce compliance, and co-ordinate with other countries, many of which are just advancing to versions 1.0 or 2.0 of their own foreign investment review regimes. This makes it critically important for dealmakers to develop a solid foreign investment review strategy early on.

Aimen Mir
CFIUS Partner,
Washington DC

Mandatory notification requirements are becoming more standard



Over 100 jurisdictions now have foreign investment or public interest laws – most notably in Europe, Asia, Australasia and North America. Of these, a growing number are introducing mandatory notification requirements with respect to some foreign investments.

> 2019 has seen a further increase of governmental powers to screen and potentially intervene in cross-border M&A. It is therefore critical to conduct a foreign investment filing risk assessment up front and factor this into deal structuring and planning.

Alastair Mordaunt
Antitrust Partner,
Hong Kong

Even jurisdictions that were traditionally voluntary are introducing mandatory notification requirements in some sectors. In the US, national security review by the Committee on Foreign Investment in the United States (CFIUS) used to be entirely voluntary, but a mandatory notification regime was introduced in October 2018 with respect to investments in US critical technology companies. By February 2020, investments by foreign persons in which a foreign government holds a 'substantial interest' (currently expected to be 49 per cent) will be subject to a mandatory filing requirement if the target US business is a critical technology company, is involved in critical infrastructure or holds certain sensitive personal data.

In the UK, legislation for a stand-alone national security review process has been proposed for 2020. Initial government analysis suggests a much greater level of review and intervention under the new rules than has historically been the case. While a voluntary system, those familiar with the UK's voluntary merger control regime will appreciate that the regime is likely to have real enforcement impact.

“

The UK is moving towards greater levels of intervention, with new rules on the horizon expected to increase the level of review significantly. In 2019, enforcement of national security issues under the existing rules was directed for the first time at acquisitions by private equity and pension funds – including the take-private of Inmarsat by a consortium of US, Canadian and UK funds – indicating that all types of buyer should expect scrutiny, irrespective of their country of origin.

Alex Potter
Antitrust Partner,
London

Co-operation and convergence of foreign investment regimes

Co-operation among competition authorities worldwide has been the norm for several years with established frameworks and networks. International consensus has been built around procedural and substantive issues. Historically, there has not been similar convergence or co-operation among foreign investment review authorities, but that is changing to some extent.

While national foreign investment regimes can differ materially in terms of the types of transactions captured, the key sectors at risk and the types of concerns identified, we are seeing increased co-operation and convergence be it through:

- formal frameworks as in the EU;
- increased informal exchange between relevant authorities; or
- cross-fertilisation of existing ideas across jurisdictions.

There are known examples in which CFIUS has reached out to its counterparts in other jurisdictions with respect to a particular transaction, and legislation to be implemented by February 2020 directs CFIUS to undertake greater international engagement in support of US national security interests. With the possibility of countries (and their investors) being ‘excepted’ from certain of CFIUS’ authorities – based, in part, on the robustness of the respective jurisdiction’s foreign investment regime – there will be greater incentives for convergence and co-operation.

The EU is also incentivising greater convergence and co-operation, at least between EU member states. The new EU rules, applicable from 11 October 2020, provide for a co-operation mechanism between member states and the European Commission in screening direct investments from outside the EU on public security grounds. While the ultimate decision over whether to permit a foreign investment will remain with member states, the mechanism allows for information to be requested from the national authorities, and for the European Commission to issue non-binding opinions to which member states must give ‘due consideration’.

The new rules are applicable retroactively in part, so opinions may be issued up to 15 months after the investment is completed. This means that foreign investments completing from 11 July 2019 onwards face possible intervention via the co-operation mechanism once the mechanism is established. Such transactions could, depending on available remedies under national law, be subject to enforcement action against the investment post-completion, so special care should be taken when assessing whether a foreign investment filing should be made.

> The new EU co-operation follows a series of increasingly protective foreign investment measures in European countries. Currently, more than half of the EU member states have some form of foreign investment screening mechanism: it will be interesting to see if others will now follow suit, and how proactive the Commission will be in issuing non-binding opinions to national governments.

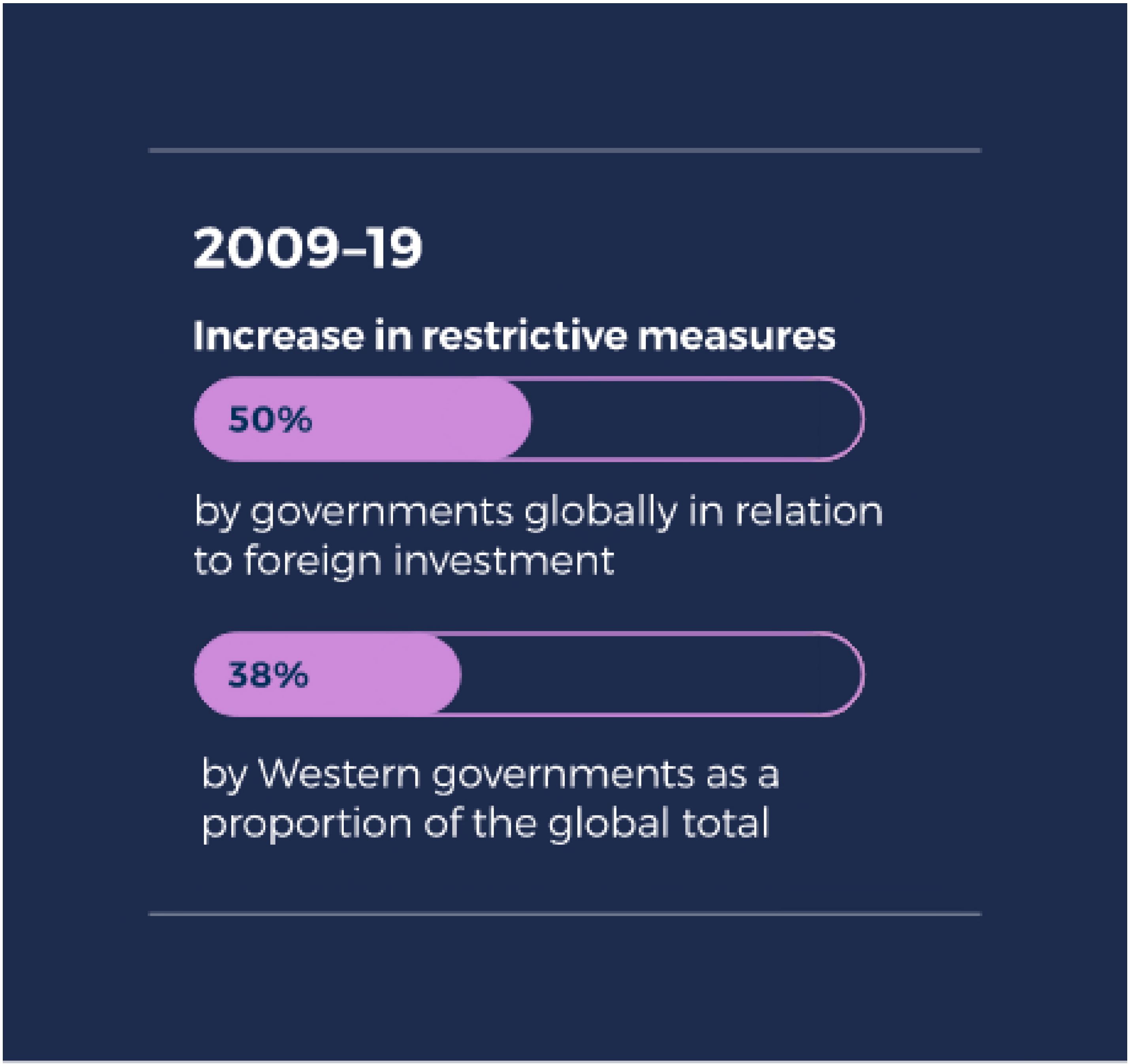
Juliane Hilf
Disputes and Regulatory Partner,
Düsseldorf

Growing intervention by governments worldwide

It is not just the number of regimes and their respective review mandates that is expanding: the longer-term trend is towards greater intervention by national authorities. In the US, for example, the number of transactions subject to mitigation, prohibited or abandoned in light of CFIUS opposition has been growing steadily.

This enforcement trend is likely to continue as national authorities acquire greater powers for intervention:

- in France, new powers in 2020 will allow the Minister of the Economy to unwind, amend or prescribe interim measures in relation to transactions that have been implemented without prior authorisation; and
- in China, against the backdrop of US–China trade tensions, it is possible we will see an increased number of cases reviewed under China's national security regime that until now has only been rarely used.



Broadening the scope of foreign investment control

Foreign investment review has extended far beyond what was traditionally considered to constitute ‘national security interests’ and now often captures a wide range of sectors. The focus is increasingly on infrastructure (communications, energy, transport, defence), advanced (largely commercial) technologies (AI, nanotechnologies, quantum computing, robotic systems) and big data.

The interpretation of what is included in these sectors can be surprisingly broad, with a particular customer contract or kind of data being enough to bring a transaction within the scope of review. The concept of ‘critical’ infrastructure or technology is increasingly used by regimes, without a clear definition of ‘critical’.

In Japan, the scope of review was recently widened:

- firstly, in terms of sectors subject to review, to include IT and telecommunication technology manufacturing, software development and infrastructure provision; and
- secondly, in terms of the extent of involvement in the target company, by lowering the filing threshold from shareholdings of 10 per cent to 1 per cent.

New rules in Italy have extended the scope of foreign investment review to 5G networks. A number of jurisdictions, such as Germany, have broader, non-sector-specific regimes. This will also be the case in the UK if the proposed new rules are enacted, after the existing rules were recently broadened to cover certain aspects of computing hardware and quantum technologies.

> The rapidly expanding scope of foreign investment controls is impacting deal risk in multiple sectors. Targeted due diligence informed by expertise in the types of acquisitions that may be caught is essential in order for foreign investment risk to be identified sufficiently early in deal planning.

Paul Tiger
Global Transactions Partner,
New York

Lower trigger conditions leading to more reviews

In the past, many foreign investment regimes only caught either controlled investments or investments above a certain shareholding and of a certain size. Now, there is a growing trend towards lowering the thresholds to capture smaller minority and non-controlling investments:

- Germany's foreign investment rules capture any transaction relating to critical infrastructure where as little as 10 per cent of shares is being acquired;
- in the US, CFIUS' expanded jurisdiction to review non-controlling, non-passive investments of any size in certain US businesses will be fully implemented by February 2020; and
- in the UK, while the proposed new rules will require a level of influence to be acquired, it will be a low level, and there will be no materiality-based threshold requiring the target to have a specified level of turnover in the UK (with the current turnover threshold having already been reduced to £1m in 2018 for intervention in certain industries).

The age of international tensions

Strategic acquisitions

Foreign investment

Antitrust for financial investors

Supply and distribution chains

Innovation

Antitrust in court

Antitrust and the consumer

Corporate compliance programmes

U.S. Department of the Treasury
Office of Public Affairs

Date: January 13, 2020
Contact: Treasury Public Affairs, (202) 622-2960

Fact Sheet: Final CFIUS Regulations Implementing FIRRMA

Background

The Committee on Foreign Investment in the United States (CFIUS) is an interagency committee chaired by the Secretary of the Treasury that is authorized to review certain transactions involving foreign investment in the United States to determine the effect of such transactions on the national security of the United States. On August 13, 2018, the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) was enacted after receiving broad bipartisan support in Congress. FIRRMA strengthens and modernizes CFIUS to address national security concerns more effectively, including by broadening the authorities of the President and CFIUS regarding national security concerns arising from certain foreign non-controlling investments and real estate transactions that previously fell outside CFIUS s jurisdiction.

Today, the Department of the Treasury issued final regulations, which will become effective on February 13, 2020, to comprehensively implement FIRRMA. Specifically, the regulations broaden the scope of transactions subject to CFIUS s review and make certain changes to enable a more effective and efficient process. The Department of the Treasury previously published proposed versions of the regulations, on which it received comments from the public. The final regulations address many of the public comments.

This fact sheet provides a summary of key aspects of the regulations issued today. Additionally, in response to public comments, the regulations include a new definition for the term principal place of business as an interim rule. The Department of the Treasury is providing the public 30 days to comment on this definition.

The CFIUS regulations and related resources including updated Frequently Asked Questions can be found on the Department of the Treasury s website: http://www.treasury.gov/cfius.

FIRRMA Provisions on Non-Controlling Investments

FIRRMA expands CFIUS s jurisdiction beyond transactions that could result in foreign control of a U.S. business to also include non-controlling investments, direct or indirect, by a foreign person in certain U.S. businesses that affords the foreign person:

- access to any material nonpublic technical information in the possession of the U.S. business;
- membership or observer rights on, or the right to nominate an individual to a position on, the board of directors or equivalent governing body of the U.S. business; or
- any involvement, other than through voting of shares, in substantive decisionmaking of the U.S. business regarding
  - the use, development, acquisition, safekeeping, or release of sensitive personal data of U.S. citizens maintained or collected by the U.S. business;
  - the use, development, acquisition, or release of critical technologies; or
  - the management, operation, manufacture, or supply of critical infrastructure.

This new authority applies only to non-controlling investments in U.S. businesses that:

- produce, design, test, manufacture, fabricate, or develop one or more ***critical technologies***;
- own, operate, manufacture, supply, or service ***critical infrastructure***; or
- maintain or collect ***sensitive personal data*** of U.S. citizens that may be exploited in a manner that threatens national security.

FIRRMA also requires that CFIUS prescribe regulations that further define the term foreign person in the context of non-controlling investments by specifying criteria to limit its applicability over certain categories of foreign persons.

Key Aspects of the Regulations Regarding Covered Investments

Types of investments covered: Non-controlling investments that afford a foreign person certain access, rights, or involvement in certain U.S. businesses (referred to as covered investments).

Largely a voluntary process: The process remains largely voluntary, where parties may file a notice or submit a short-form declaration notifying CFIUS of an investment in order to receive a potential safe harbor letter (which limits CFIUS from subsequently initiating a review of a transaction except in certain limited circumstances). In some circumstances, filing a declaration for a transaction is mandatory. In particular, the regulations implement FIRRMA s mandatory declarations for covered transactions where a foreign government is acquiring a substantial interest in certain U.S. businesses, as discussed below. Additionally, the regulations require declarations for covered transactions involving certain U.S. businesses that produce, design, test, manufacture, fabricate, or develop one or more critical technologies.

U.S. businesses covered: The new provisions on covered investments apply only to investments in U.S. businesses involved in specified ways with critical technologies, critical infrastructure, or sensitive personal data referred to as TID U.S. businesses for technology, infrastructure, and data.

Critical technologies: CFIUS may review certain transactions involving U.S. businesses that design, test, manufacture, fabricate, or develop one or more critical technologies. Critical technologies is defined to include certain items subject to export controls and other existing regulatory schemes, as well as emerging and foundational technologies controlled pursuant to the Export Control Reform Act of 2018.

Critical infrastructure: CFIUS may review certain transactions involving U.S. businesses that perform specified functions owning, operating, manufacturing, supplying, or servicing with respect to critical infrastructure across subsectors such as telecommunications, utilities, energy, and transportation, each as identified in an appendix to the regulations.

Sensitive personal data: CFIUS may review certain transactions involving U.S. businesses that maintain or collect sensitive personal data of U.S. citizens that may be exploited in a manner that threatens national security. Sensitive personal data is defined to include ten categories of data maintained or collected by U.S. businesses that (i) target or tailor products or services to certain populations, including U.S. military members and employees of federal agencies with national security responsibilities, (ii) collect or maintain such data on at least one million individuals, or (iii) have a demonstrated business objective to maintain or collect such data on greater than one million individuals and such data is an integrated part of the U.S. business s primary products or services. The categories of data include types of financial, geolocation, and health data, among others.

Foreign person and excepted investor: The regulations create an exception from covered investments for investments by certain foreign persons defined as excepted investors based on their ties to certain countries identified as excepted foreign states, and their compliance with certain laws, orders, and regulations. Importantly, investments from <u>all</u> foreign persons remain subject to CFIUS s jurisdiction over transactions that could result in foreign control of a U.S. business.

<u>**FIRRMA Provisions on Real Estate Transactions**</u>

In FIRRMA Congress authorized CFIUS to review the purchase or lease by, or a concession to, a foreign person of private or public real estate that

is, is located within, or will function as part of, an air or maritime port

is in close proximity to a United States military installation or another facility or property of the United States Government that is sensitive for reasons relating to national security;

could reasonably provide the foreign person the ability to collect intelligence on activities being conducted at such an installation, facility, or property; or

could otherwise expose national security activities at such an installation, facility, or property to the risk of foreign surveillance.

This authority does not extend to a single housing unit, and also does not apply to real estate in urbanized areas . . . *except as otherwise prescribed by [CFIUS] in regulations in consultation with the Secretary of Defense*. (emphasis added)

FIRRMA directs CFIUS to prescribe regulations to ensure that the term close proximity refers only to a distance or distances within which the purchase, lease, or concession of real estate could pose a national security risk.

FIRRMA also requires that CFIUS prescribe regulations that further define the term foreign person for real estate transactions by specifying criteria to limit its applicability over certain categories of foreign persons.

Key Aspects of the Regulations Regarding Real Estate Transactions

Types of transactions covered: The purchase or lease by, or a concession to, a foreign person of certain real estate in the United States, is covered if it affords the foreign person three or more of the following property rights: to physically access, to exclude others from physically accessing, to improve or develop, or, to affix structures or objects (referred to as covered real estate transactions).

Voluntary process: There is no mandatory filing requirement for covered real estate transactions. Parties may file a notice or submit a short-form declaration notifying CFIUS of a real estate transaction in order to potentially qualify for a safe harbor letter (which limits CFIUS from subsequently initiating a review of the transaction except in certain limited circumstances).

Covered sites: Coverage is focused on transactions in and/or around specific airports, maritime ports, and military installations. The relevant military installations are listed by name and location in an appendix to the regulations. The relevant airports and maritime ports are on lists published by the Department of Transportation and identified in the regulations.

Locations around covered sites: The regulations focus on:

- real estate that is, is within, or will function as part of an air or maritime port;
- real estate that is within close proximity (defined as one mile) of certain specified U.S. military installations;
- real estate that is within the extended range (defined as between one mile and 100 miles) of certain military installations; and
- real estate that is within certain geographic areas associated with missile fields and off-shore ranges.

Foreign person and excepted real estate investor: The regulations create an exception from covered real estate transactions for transactions by certain foreign persons defined as excepted real estate investors based on their ties to certain countries identified as excepted real estate foreign states, and their compliance with certain laws, orders, and regulations.

Urbanized areas and urban clusters: The regulations create exceptions for real estate transactions in an urbanized area or urban cluster, as defined by the Census Bureau, except those relating to relevant ports and those in close proximity to certain military installations.

Other excepted real estate transactions: The regulations create exceptions for the following, in addition to other transactions:

- the purchase, lease, or concession of a single housing unit, as defined by the Census Bureau;
- the lease or concession of real estate in airports and maritime ports only where for the purpose of retail sales; and
- the purchase, lease, or concession of certain commercial space in a multi-unit commercial building.

Interaction with other CFIUS regulations: Real estate transactions involving U.S. businesses and that are subject to CFIUS s regulations regarding control transactions and covered investments should be analyzed under those regulations (discussed above).

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HANDBOOK 2020

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2020

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For further information please contact Natalie.Clarke@lbresearch.com

PREFACE

Global Data Review is delighted to publish this inaugural edition of the *GDR Insight Handbook*.

The handbook delivers specialist intelligence and research to our readers – general counsel, government agencies and private practitioners – who must navigate the world's increasingly complex framework of legislation that affects how businesses handle their data.

The book's comprehensive format provides in-depth analysis of the global developments in key areas of data law and their implications for multinational businesses. Experts from across Europe, the Americas and Asia consider the latest trends in privacy and cybersecurity. Attention is also given to new legislation in the United States that regulates the use of artificial intelligence, and strict data localisation rules emerging in jurisdictions such as China. The handbook provides practical guidance on the implications for companies wishing to buy or sell data sets, and the intersection of privacy, data and antitrust. A chapter is dedicated to assessing how companies should respond to the GDPR enforcement regime.

In preparing this report, Global Data Review has worked with leading data lawyers and consultancy experts from around the world and we are grateful for all their cooperation and insight.

The information listed is correct as at October 2019. Although every effort has been made to ensure that all the matters of concern to readers are covered, data law is a complex and fast-changing field of practice, and therefore specific legal advice should always be sought. Subscribers to Global Data Review will receive regular updates on any changes to relevant laws over the coming year.

We would like to thank all those who have worked on the research and production of this publication.

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PART 3

Data in practice

DATA-DRIVEN M&A

Giles Pratt and Melonie Atraghji
Freshfields Bruckhaus Deringer LLP

Trends in data-driven deals

Businesses can entirely transform their offering by gaining access to valuable data sets. This has generated a rush for data assets, which in turn has led to a relatively new phenomenon: non-tech businesses having to think like tech companies. All businesses are now having to become familiar with how to answer complex legal questions like how to acquire rights in data and manage restrictions on data analytics. And this learning curve has coincided with new and stricter data laws – most notably the EU General Data Protection Regulation (GDPR).[1] Data-related fines are getting higher and high-profile data crises are damaging business reputations. All of this means that data issues are becoming front and centre in mergers and acquisitions (M&A) and other deals.

In this chapter, we will look at issues that businesses should consider when doing due diligence on a data-rich target; the level of warranty protection to seek on a deal; data integration issues; legal issues raised by the process of deals themselves; and specific issues relating to data collaborations.

Although we will focus on the issues arising on M&A, much of this chapter applies equally to data licensing, joint ventures and other data deals.

1 Breaches of the GDPR can result in enforcement action, fines of up to the higher of €20 million and 4 per cent of global group-wide turnover, and criminal liability for directors.

Data due diligence – assessing value and risks

A buyer of a data-heavy target needs to consider two broad themes.

First, what is the potential upside of acquiring the data? Its value will, of course, depend on its intrinsic content, but other factors will also be relevant, including the target's legal rights to use the data and its rights to stop others using it.[2]

Second, what are the potential risks of buying the data? With data regulation increasing all the time, it is possible that compliance costs might impair the value of the data. And if the data includes valuable know-how or personal information, then a data breach – whether past or future – could be disastrous.

We explore these issues further below.

What rights does the target have to the data?

A common misconception by businesses is that they legally 'own' data that they have collected or created. A buyer of a data-heavy target should always investigate what legal rights the target has over its data. There are two main ways that businesses can structure their operations to protect their rights in data: by getting intellectual property protection and by using contracts.

IP protection of data

One way of protecting data is the legal protection given to databases by the EU database right and copyright. These IP rights aim to harmonise the legal protection of databases across the European Union and protect the interests of businesses that invest in creating and maintaining databases.

The database right protects 'substantial investment' in collecting existing materials, and verifying and presenting them as a database. It prevents others from extracting or using large parts of a database. The difficult part in proving that database right exists is usually showing that there was investment in collecting the data, rather than creating it.[3] Copyright protects databases whose contents have been selected or arranged in an original way. It protects only the structure of the database – not the contents – and it is relatively rare that a database structure has been found to be original in a protectable sense.[4] So database right potentially offers better protection for data-driven businesses, provided the 'investment in collecting'

2 Putting a specific cash value on data is difficult. There have been several attempts to solve this but no definitive answer. It is possible to calculate enterprise value using revenue derived from products based on data, but there is no established methodology that can set a plausible monetary value on raw data itself. Investors in data-rich companies often need bank financing to pay for acquisitions, yet data is not included on the target's balance sheet. As the data economy grows, we are likely to see new valuation methodologies emerge.

3 The European Court of Justice confirmed that this was the key test in the case of *The British Horseracing Board Ltd and Others v William Hill Organization Ltd* (C-203/02).

4 See *Technomed v Bluecrest* [2017] EWHC 2142 for an example of one such case.

test is met, but only in the European Union. By contrast, in other jurisdictions (for example, in the United States) protection of databases tends to be more ad hoc, turning on the particular facts of a case (often under copyright law).

It is also sometimes possible to show that a data set amounts to a trade secret. Internationally, trade secrets are typically protected where the data is secret, has commercial value from being secret and reasonable steps have been taken to keep it secret.[5] Meeting these tests requires particular care in open, cloud-based data systems.

Data and contracts

As well as IP rights, the buyer will want to look at any contracts that affect the target's data. If the target licenses out its data, the buyer should check the key terms – for example, can the licensee merge the target's data with other data and, if so, who owns that derived data? Where a business is both licensing in and distributing data, it is important to diligence the flow of those rights, to ensure that there are no material gaps. Some licensors also require licensees to acknowledge in the licence that the licensor has made a 'substantial investment' in obtaining the data – to help assert database right. Certain industries – like the media, news and financial services – already have well-developed data-licensing practices, and this is likely to spread as other industries start to connect and share more data.

The target might also have outsourced the analytics of its data set. The buyer should check those contracts to see what they say about protecting IP rights, and complying with data privacy laws (assuming the data set contains personal data).

Has the target complied with data protection law?

If the target's data sets contain personal data, then data protection compliance is likely to be a key part of due diligence. A key issue will be whether individuals (including employees and customers) have been informed about, and (where required) consented to, how the target uses their data.

The first place to look for consent would be contracts, application forms and marketing literature used by the target. The GDPR, which is probably the high watermark for data privacy law internationally, states that consent must be freely given, specific, informed and unambiguous[6] for most processing; consent must be 'explicit' for processing sensitive data and for data exports from the European Economic Area (EEA).[7] Whether consent is valid will depend on the circumstances, but broadly: an opt-in, for example by ticking a box on

5 See article 39.2 of the TRIPS Agreement.
6 Article 4(11) GDPR.
7 Article 9(2)(a) and article 49(1)(a) GDPR.

an application form, is required.[8] Silence – or an opt-out – will not be valid consent. It is particularly hard to prove that employees have 'freely given' their consent, given the power imbalance between employers and employees.

If there is no consent, the buyer should assess whether the target's data use is permitted under any other conditions. The most commonly used conditions under the GDPR tend to be more specific (for example, data use necessary to perform a contract) – or they require a judgement as to whether they're satisfied (for example, do the target's 'legitimate interests' in using the data outweigh the data subject's interests).[9]

The target must also have given data subjects certain information about how it intended to process their personal data.[10] The buyer should check whether these notices have been given, and ask to see copies.[11]

Due diligence should also reveal whether the target has complied with other elements of data protection law. For example:

- paying the necessary fees to relevant regulators;[12]
- appointing a data protection officer (where relevant);
- keeping data secure;
- complying with the restrictions on exporting personal data;
- conducting direct marketing lawfully;
- complying with data subject individual rights requests;
- complying with notices received from regulators;
- appointing data processors in accordance with relevant laws, including the GDPR;
- conducting data protection impact assessments;[13] and
- conducting profiling and automated decision-making lawfully, including having analytics systems that can respond in a modular way to individuals who might object to processing.[14]

The buyer might also ask for details of the target's internal training programme and employee policies on data protection issues.

8 The EU guidance on consent is at http://ec.europa.eu/newsroom/article29/item-detail.cfm?item_id=623051. ICO's guidance on consent is at https://ico.org.uk/for-organisations/guide-to-the-general-data-protection-regulation-gdpr/consent.

9 See articles 5–9 GDPR.

10 Articles 13 and 14 GDPR.

11 The UK Information Commissioner's Office (ICO) has issued guidance on fair processing notices at https://ico.org.uk/for-organisations/guide-to-the-general-data-protection-regulation-gdpr/the-right-to-be-informed. The EU guidance is at http://ec.europa.eu/newsroom/just/document.cfm?doc_id=48850.

12 The GDPR reduced the amount of information that businesses had to register with data protection regulators, but there's still some information that a buyer can check via the regulator websites, including fees paid and notices issued.

13 ICO's guidance is at https://ico.org.uk/for-organisations/guide-to-the-general-data-protection-regulation-gdpr/data-protection-impact-assessments-dpias.

14 The EU's guidance on profiling is at http://ec.europa.eu/newsroom/article29/item-detail.cfm?item_id=612053.

The buyer should also review the data protection provisions in major third-party service-provider contracts. For example, in contracts with cloud providers, the buyer will want to check that they contain suitable data processing clauses and also review any liability caps; if those caps are very low, that might indicate that the target has failed to appoint its processors in a compliant way.

During due diligence, the buyer will also want to analyse whether existing consents are sufficient to cover the buyer's intended use of the target's personal data, for example, for cross-marketing its own products, or for developing new products. And if the target's products incorporate 'privacy by design' – a GDPR requirement – then the data assets are more likely to be attractive to a possible future buyer.[15]

If due diligence raises any major problems, the buyer might consider seeking a pre-closing covenant that those problems are fixed in the ordinary course before closing, such as requiring the seller or target to seek new consents or amend privacy notices. If breaches cannot be cured before closing, they might be relevant to the risk assessment or valuation of the deal, and the time it would take to integrate a target business.

Has the target addressed cybersecurity risks?

Cybersecurity due diligence is vital on any deal – but particularly where data is a key driver. Cyber issues can be deal-breakers, or at least affect deal value: during Verizon's 2017 acquisition of Yahoo!, US$350m was knocked off the price after data breaches were revealed.

And a buyer that fails to do full due diligence can store up problems for itself. The high-profile TalkTalk hack in 2015 was the result of a legacy IT system it had acquired from Tiscali in 2009. The ICO issued a record fine against TalkTalk, even though the vulnerability was part of an 'inherited infrastructure', because the ICO found that TalkTalk had failed to properly assess the infrastructure for possible threats.

So how should a buyer approach cyber due diligence? The answer is likely to depend on various factors, including:

- the buyer's negotiating stance: it might decide to carry out a detailed review of the target business's cybersecurity risk profile in exchange for receiving more limited or no warranties.[16] Alternatively, the buyer might want to carry out a more limited review and attempt to get full warranties;
- the nature of the target's IT systems, including the age and complexity of the target's IT systems, whether they are generic or bespoke, their 'fitness for purpose', and whether they are stand-alone or integrated with the seller's group; and

15 ICO's guidance on 'privacy by design' is at https://ico.org.uk/for-organisations/guide-to-the-general-data-protection-regulation-gdpr/accountability-and-governance/data-protection-by-design-and-default.

16 If cybersecurity is likely to be a big issue on a deal, the buyer might bring in specialist technical consultants, who work alongside the lawyers on the due diligence. Increasingly, a buyer might engage a third party to perform threat assessments on the target business, although that type of due diligence should itself be tested for whether it risks breaking any laws regarding hacking.

- the target's sector: more detailed due diligence will be needed for highly regulated, complex industry sectors (eg, financial services, energy, infrastructure or telecoms).[17]

Having said that, most buyers should consider seeking information on:
- any cyber breach – or attempted breach – suffered by the target during the last three to six years;
- any breach suffered by a third party engaged by the target that might have compromised the target's systems or data;[18]
- any notifications to regulators or individuals about cyber breaches;[19]
- any internal or third-party reports relating to cyber preparedness, vulnerabilities or particular breaches (the buyer should ask for copies, including details of any remediation steps);
- cybersecurity policies and procedures, and any steps the target takes to test them;
- those responsible for dealing with cyber risks and incidents;
- how the target minimises its exposure to cyber risks when entering third-party contracts;
- employee training programmes and IT policies;
- any cyber insurance policies;[20]
- anything the target has included in its annual reports and accounts on cyber risk management; and
- any recognised information security standards or best practices with which the target complies (including ISO27001, NIST and PCI DSS).

Other data issues to assess on due diligence

The buyer will also need to look at other legal issues that might affect data. In particular:
- Does the acquisition raise antitrust issues? This might be an issue where the parties' data pools – when combined – could create a monopoly.
- Could the buyer's access to the data raise foreign investment concerns where the data is regarded as sensitive? This might lead to the deal being reviewed by relevant government authorities (eg, the Committee on Foreign Investment in the United States).

17 See, for example, the EU's Network Information Security Directive, which imposes additional obligations on certain businesses in these sectors. Germany is currently revising its cybersecurity law to broaden its scope to cover IT product providers, among others, and to introduce GDPR-type fines.

18 The 2013 hack of US retail giant Target was reportedly caused by hackers accessing its systems via its third-party air conditioning supplier.

19 Many data privacy laws require businesses to notify regulators and individuals affected by serious cyber breaches.

20 The buyer should carefully assess the adequacy of the cyber insurance coverage. Many policies contain exclusions or limitations for third-party claims, damage to physical property, or loss of data – which are exactly the sorts of losses that might be caused by a cyber attack.

- Are there product liability issues? This might be a risk if the buyer is looking at creating interconnected products or services in circumstances where the control of the data is relevant to the allocation of risk.[21]
- What are the tax consequences of how the data set is structured (or will be structured after closing)? Historically, taxation has been linked to where a business is established, and that question has included looking at where a business's data is stored, but, to reflect the digital economy, regulators are now moving towards looking instead at where a business's customers are based. This leaves less room for businesses to structure their digital assets – including their data – so as to minimise tax exposure.
- Do sector-specific rules apply? Areas likely to attract sector-specific data laws include telecoms,[22] financial services[23] and healthcare.[24] There might also be special rules if the target provides products or services to children.[25]

Data and cybersecurity warranty protection

A buyer's approach to warranties and indemnities will depend on various issues, including its negotiating power and the extent of its due diligence. But most buyers will want to obtain warranties that the target:

- complies with data protection laws, regulator guidance and industry standards – and has done so for three to six years;
- has received no notices or allegations of non-compliance;
- has obtained all required consents from data subjects to the processing of their personal data;
- has rights to use all data collected and generated in its business;
- complies with best industry practice, or at least relevant standards, on cybersecurity;
- has experienced no cyber incidents, including in relation to its data processors or other key contract counterparties; and
- has procedures in place for responding to data crises.[26]

21 Historically, product liability laws have channelled liability towards the maker of a defective product. That makes sense in a world where manufacturers exercise control over the design and manufacture of their products; where they are better placed than others to judge any risks – and where they can insure against the risks. The law has also allowed them to limit the scope of their liability – a claim against a manufacturer might well fail if the customer didn't use it according to the manufacturer's instructions. But existing liability regimes struggle with interconnected products. These involve sophisticated interdependencies between hardware, software, networks and data. Where something goes wrong, this makes it hard to determine who is – and, as a matter of legal principle, should be – liable.

22 eg, the UK's Regulation of Investigatory Powers Act 2000 regulates surveillance and the interception of communications data.

23 eg, the US Gramm-Leach-Bliley Act contains provisions to protect consumer financial privacy.

24 eg, the US HIPAA law protect patients' health data.

25 eg, the US Children's Online Privacy Protection Act.

26 Warranties are often qualified by the seller's or target's 'knowledge' – a buyer should accept that qualification only if: the seller or target has sufficient measures in place to flag up risks; and 'knowledge' is properly defined (eg, referring to the DPO's knowledge).

On a data-heavy deal, a buyer will also want to get full warranties about the allocation of rights in data; and contractual issues (eg, breaches) that might affect data licences or data-sharing agreements.

A buyer will sometimes ask for a 'forward-looking' warranty that its processing of personal data post-closing will be lawful if the data is used in the same way as it was used before closing. A seller will rarely give this.

If due diligence has revealed that the target is not processing data fairly and lawfully, it might be necessary to approach data subjects for fresh consent to data processing. Subject to antitrust 'gun-jumping' rules, this sometimes takes place between signing the deal and closing it, and, in serious cases, is framed as a closing condition, usually based around a percentage of consents received. The number of consents received might also affect the final price.

And, if due diligence reveals a data breach, the buyer might require the seller or target to remedy inadequate security measures, and notify regulators and individuals affected.

Breaches of data laws could of course lead to fines or compensation claims: if there's a high risk of breach, a buyer might not want to accept financial caps on the data warranties.[27] In deals where data is key, the buyer will sometimes seek indemnities – most often where breaches of data laws or data licences are disclosed and loss is foreseeable.

Integration and post-closing issues

There will usually be data integration and post-closing issues for a buyer to consider. These will vary, depending on the structure of the sale and what the buyer intends to do with any data acquired. But most buyers will need to think about reviewing the data sets and deleting excess data; conducting IT and cybersecurity checks; analysing whether intended new data uses will require new data consent; notifying data protection regulators; and updating data processing arrangements.

Reviewing the data sets and deleting excess data

If the seller is transferring only part of a data set – for example, if the seller is retaining a product that is sold to certain customers only – there will be a logistical exercise in separating the relevant data. If excess data is transferred, there is a risk of breaching data protection law; for example, the GDPR permits data to be processed only if it is 'relevant and limited to what is necessary'. Provisions governing a data separation exercise are usually included in a transitional services agreement or migration plan.

The buyer will need to review the personal data it receives, to ensure compliance. In particular, it will need to delete irrelevant, excessive or out-of-date personal data, and if the seller is retaining data, it will need to ensure that it continues to process the data lawfully and delete any excess data.

27 On tech deals, IP ownership and non-infringement warranties are sometimes treated as 'fundamental warranties', with higher – or no – liability caps.

All parties should also delete data relating to the transaction itself, unless required to keep it by law or regulatory obligation.[28] Both parties might also need to think about securely disposing of IT equipment that contains personal data; it is important that no personal data is compromised during that process.

IT and cybersecurity checks

The buyer will need to check that the IT systems it has acquired are secure.[29] There is no 'one size fits all' for determining the appropriate level of security, but compliance with a security certification, for example the ISO 27001 series or NIST, and passing certain industry standard tests might be a good indicator of compliance. If a cyber breach occurs, any regulator will look at whether the business complied with industry standards – although that will not necessarily determine the level of any penalties, particularly if the standards in a particular sector are low or if there are indicators to suggest that compliance with a standard was not the whole IT security story.

The buyer might decide to appoint a cybersecurity consultant to review the new system. If so, it is worth remembering that any consultant reports might not attract privilege – so they might be disclosable to a court or regulator if a cyber breach occurs later on. This could be a problem if the report reveals multiple failings that are not fixed and are relevant to a later breach. Before commissioning a report, the buyer should clearly define the scope of work and consider how prepared it would be to implement any findings. Consultants will often give 'belt-and-braces' recommendations,[30] but the cost–benefit analysis for the buyer might not justify fixing all problems disclosed. All the more reason for lawyers and IT experts to work hand-in-hand to scope cybersecurity solutions.

New data uses: obtaining new consents and informing data subjects

Data protection law might require the buyer to notify data subjects and obtain new consents, including where:

- the deal is structured as an asset sale, and there is, therefore, a change of data controller. Under the GDPR, the buyer must give the data subjects notice of the change of data controller within a reasonable period, and no later than one month;[31]

28 In an auction sale, unsuccessful bidders should also delete or return to the seller any data received on due diligence.
29 Article 32 GDPR requires personal data to be processed securely.
30 Not least because they may view the exercise, in part, as a pitch.
31 Article 14(3).

- the buyer wishes to use the target's personal data for new uses, for example to cross-market its own products, or to conduct data analysis. Any new purpose that is incompatible with the original purposes for which the personal data was collected might require new notices or consents;[32] and
- the target intends to make new disclosures of personal data – either intra-group or to third parties – or new data exports.

Often, fair processing notices and requests for consents can be included in other employee or customer communications relating to the deal.

For new uses under the GDPR, the buyer might be able to rely on an exception to the rule requiring notices to be given where this would involve 'disproportionate effort'.

On an asset sale, the buyer will also need to consider rules on electronic marketing. For example, the ICO has issued guidance[33] on buying a marketing database where customers have consented to receiving marketing. The guidance says that the buyer can use it for e-marketing without a fresh consent from each individual only if the buyer was named in the original consent request. This is highly unlikely to be the case in an M&A situation, so fresh consent might be required.

Notifying regulators

Any change in the data controller might need to be notified to relevant national data protection regulators. There might also be increased fees to pay.

Data processing arrangements

The transaction might have involved transferring data processing agreements to the buyer (eg, agreements with cloud-providers). If the buyer already has agreements with the same processors, it might decide to consolidate those arrangements.

Data privacy issues arising from the deal process

The mechanics of most deals will raise data protection issues. These tend to involve disclosing or receiving personal data in due diligence, exporting personal data, and transitional arrangements.

32 In Germany, the Bavarian Data Protection Authority imposed a fine in 2015 relating to an asset deal where personal data was unlawfully transferred by the seller and used by the buyer. Email addresses were transferred and processed for marketing purposes without data subject consent and without data subjects being informed or given an opt-out. The case was decided under the pre-GDPR regime, but would very likely be decided the same way under the GDPR. Press release at https://www.lda.bayern.de/media/pm2015_10.pdf.

33 https://ico.org.uk/media/1555/direct-marketing-guidance.pdf.

Disclosing or receiving personal data in due diligence

Disclosing personal data to the buyer during the due diligence process raises data protection issues. There is no general exemption for M&A deals, although there are laws governing specific types of data that the parties might rely on.[34] To try to minimise the risk of a data protection breach, a seller or target should:

- ensure as far as possible that due diligence materials are made anonymous – this might include aggregating salary data so that individuals' salaries are not identifiable, using sample contracts rather than actual signed contracts,[35] and compiling summaries of any disputes;
- remove or anonymise all sensitive data;[36]
- sign a non-disclosure agreement (NDA) with each potential buyer;
- ensure that any agreement between the seller or target and a virtual data room provider contains GDPR-compliant processor clauses;[37]
- if appropriate, update privacy notices (including those in employment handbooks) to include data processing for M&A activity; and
- if it decides to disclose non-anonymised data to the buyer under the GDPR's 'legitimate interest' grounds (or similar), record its assessment of why it can rely on that ground and why it is not notifying the data subjects about the disclosure.[38]

The NDA should require the potential buyer to:

- only use the data it receives to help it evaluate the target's business;
- treat the data in confidence and not disclose it;

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34 eg, the UK's Transfer of Undertakings (Protection of Employment) Regulations 2006 require the seller to give the buyer certain information about transferring employees, including their identities (the 'employee liability information'). That information may legally be disclosed under the GDPR, as article 6(1)(c) GDPR permits any disclosure of non-sensitive data that is required by law. A seller must still take care to ensure that any employee information not caught by the regulations and any sensitive data is anonymised. The regulations will not apply on a share sale, so – pre-closing – sharing employee data will typically need to be anonymised (or consent obtained, if practical).

35 Names and signatures on contracts disclosed in due diligence are technically personal data, but these are not usually redacted in practice. This is mainly on grounds of pragmatism – although it is arguable that individuals who have signed contracts have consented to have their name and signature processed in this way.

36 Examples relating to employees might include information about their health conditions or trade union membership.

37 Article 28(3) GDPR.

38 The UK ICO's guidance on the legitimate interests provision states that it is good practice for the data controller to document its assessment as to why the provision is met. The guidance includes a template for documenting the assessment. German data protection authorities recently issued collective guidance on transferring customer data on asset deals. The guidance considers whether consent is required or whether it's possible to rely on the legitimate interests basis. It says that, for instance, customer data relating to ongoing claims may be transferred on the basis of legitimate interest, whereas sensitive data may be transferred only if consent is obtained. (Although the Berlin and Saxony regulators did not endorse the guidance.)

- comply with applicable data protection laws; and
- destroy or return the data if the deal does not proceed.

Sometimes, draft NDAs include GDPR-compliant data processor clauses,[39] on the basis that the buyer is deemed a data processor, acting on the instructions of the seller. However, a buyer will in fact usually be a data controller, so no data processor clauses are needed. A buyer will sometimes ask the seller to confirm in the NDA that the disclosure complies with data protection laws. The seller should resist this; instead, it might explain what it has done to reduce any risk, so that the buyer can make its own assessment.[40]

The buyer must ensure its own data protection compliance on due diligence. Under the GDPR, this means satisfying the lawful, fair and transparent requirements when using personal data to assess the target. To satisfy the lawful test, the buyer will usually rely on the 'legitimate interests' condition.[41] As regards transparency, the GDPR requires the buyer to inform data subjects of its identity and the purposes for which the data will be processed. This must be done within a month.[42] The buyer does not need to provide this information if it has already been provided. There's also an exception if informing would involve a disproportionate effort or would seriously impair the objectives of the processing.[43] The buyer can usually rely on this exception in a due diligence exercise. The risk to data subjects is low – personal data will be protected by an NDA and there will be strict limitations on use.

The parties will also need to consider any data localisation laws if personal data is being sent overseas to the buyer or its advisers. Under the GDPR, this means considering whether data is being exported from the EEA to countries without an 'adequate' level of protection.[44] If so, the parties might consider using EU model clauses (or relying on the buyer group's existing data transfer compliance steps). Remote access of a database in the EEA from a non-EEA location is an export – for example, if someone outside the EEA accesses a virtual data room hosted within the EEA. Storing or accessing data in the cloud may also result in an export.

39 Required under article 28 GDPR where there is a controller–processor relationship.

40 A buyer will sometimes also seek data protection compliance warranties in the sale agreement that relate to disclosures of information in the context of the transaction. A sensible seller response is to recommend that each side get its own data protection advice for the purposes of the transaction.

41 It should make a written record of its decision to rely on that condition: see footnote 38.

42 Article 14 GDPR.

43 Article 14(5)(b) GDPR.

44 The list of countries declared 'adequate' is at https://ec.europa.eu/info/law/law-topic/data-protection/data-transfers-outside-eu/adequacy-protection-personal-data-non-eu-countries_en.

Transitional arrangements

On many deals, the seller will provide services to the buyer on a transitional basis, until the buyer has set up its own systems. These services often include payroll or human resources administration, and the seller will therefore be processing personal data as a data processor on behalf of the target. The transitional services agreement will, therefore, need to contain relevant data processing clauses.[45] If the arrangements involve data export, the agreement will also typically need to include relevant data export clauses.[46]

Data collaborations – specific issues

Rather than acquiring a data-heavy target, a business might decide to create and use a data set in collaboration with another. Many of the issues raised above in relation to M&A will apply equally to data collaborations, but there are some additional traps to be aware of.

Most importantly, the parties will need to agree and specify ownership of and access to data that is contributed and generated by the collaboration. As we have seen above, 'ownership' of data is not straightforward, and the parties will need to think carefully about how they draft their contracts and structure their operations. And it is often not clear even what data will be produced by a particular digital collaboration. For example, for a retail digital offering, it is often necessary to work closely with the technical teams to analyse each step of a customer's journey to identify every data set that will be generated. Only then can the parties allocate ownership, access and use rights for each data set.

There is also a risk where one party contributes a data set containing personal data: this will, for example, restrict any profiling or analytics that can be conducted on the resulting data set. Before a party contributes any personal data, it will need to check that it has the relevant consent or other rights to use it. If not, the other party might seek a closing condition that the data be anonymised – and possibly vetted by a third-party anonymisation expert. The parties should also consider whether they need to have a data-sharing agreement or terms in place for data privacy purposes, including to allocate responsibilities where the parties are joint data controllers.

Antitrust issues can also arise in collaborations if the parties are pooling their data – carefully drafted data-sharing agreements can mitigate the risk.

45 eg, under article 28 GDPR.

46 Article 46 GDPR.

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Giles advises on the full range of legal issues relating to data, including IP protection and data privacy, particularly in the context of deals, crises, investigations and new data uses and analytics. He has been named as one of the 'top 40 under 40' for data law, and is on the editorial board of Global Data Review.

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No. 18-956

In The
Supreme Court of the United States

GOOGLE LLC,

Petitioner,

v.

ORACLE AMERICA, INC.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Federal Circuit

BRIEF OF 72 INTELLECTUAL PROPERTY SCHOLARS AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF *AMICI CURIAE*

Amici curiae (listed in Appendix A) are scholars of intellectual property law.[1] *Amici*'s sole interest in this case lies in our concern for the proper application of traditional principles of copyright law to computer programs. The Federal Circuit's copyrightability ruling in *Oracle* misconstrued the text of the Copyright Act, this Court's rulings as well as software copyright case law persuasively establishing that interfaces that enable compatibility among programs are unprotectable by copyright law, thereby disrupting settled expectations of this $845 billion industry.[2] *Amici* respectfully urge this Court to reverse the Federal Circuit's decision.

SUMMARY OF ARGUMENT

Until the Court of Appeals for the Federal Circuit's 2014 *Oracle* decision, software developers felt free to compete and innovate in the development of compatible software because major decisions from the Courts

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1. Pursuant to Supreme Court Rule 37, counsel for *amici* represent that they authored this brief in its entirety and that none of the parties or their counsel, nor any other person or entity other than *amici* or their counsel, made a monetary contribution intended to fund the preparation or submission of this brief. Counsel for petitioner gave blanket consent to the filing of *amicus* briefs, counsel for respondent has consented in writing to the filing of this brief, and both parties received timely notice of *amici*'s intent to file this brief.

2. S*ee* BSA Foundation, *Software: Growing US Jobs and the GDP*, https://software.org/wp-content/uploads/2019SoftwareJobs.pdf (based on 2018 data).

of Appeals for the Second and Ninth Circuits had established that copyright law does not protect software interfaces that enable the development of compatible programs. These cases and their progeny recognized that unlike conventional literary works, computer programs are highly utilitarian. They embody many copyright-unprotectable elements, such as compatibility-enabling interfaces, that must be filtered out before making infringement determinations. Programs consequently receive a relatively "thin" scope of copyright protection to ensure that subsequent programmers can freely reuse unprotectable elements in developing their own programs. As a matter of copyright law, the pro-compatibility decisions are sound as they facilitate fair competition by those who write new code while preserving copyright's role in protecting software from piracy and other wrongful appropriations.

The Federal Circuit's 2014 *Oracle* decision was a radical departure from these precedents and directly contradicts their rulings. It adopted an unduly narrow view of this Court's ruling in *Baker v. Selden*, 101 U.S. 99 (1880), which excluded methods, systems, and their constituent elements from copyright's scope. It ignored Congress' codification of the method/system exclusions. It misconstrued the case law properly interpreting those exclusions in relation to program interfaces.[3]

[3] The District Court relied on both the § 102(b) method/system exclusions and the merger doctrine in its analysis of the copyrightability issue. This practice is common. Once an author devises a particular method/system, there may be relatively few ways to express it. *See*, *e.g.*, *Ho v. Taflove*, 648 F.3d 489, 497-99 (7th Cir. 2011) (analyzing the copyrightability of a scientific

The Federal Circuit also misapplied the merger doctrine and case law persuasively holding that interfaces that enable compatibility are unprotectable by copyright law. Because of the Federal Circuit's numerous errors in analyzing Google's copyrightability defense, this Court should overturn its ruling. Programmers should have to write their own implementation code, as Google did, but interfaces that enable compatibility should be free from copyright restrictions.

ARGUMENT

I. This Court's Precedents, the Text of the Copyright Act, and Sound Copyright Policy Require the Exclusion of Program Interfaces From Copyright's Scope.

Freedom to compete and innovate in the development of compatible software was first recognized in the Second Circuit's landmark decision in *Computer Associates International, Inc. v. Altai, Inc.*, 982 F.2d 693 (2d Cir. 1992). It held that interfaces of computer

model and equation under § 102(b) and the merger doctrine); *Hutchins v. Zoll Med. Corp.*, 492 F.3d 1377, 1383-85 (Fed. Cir. 2007) (analyzing the copyrightability of the process of CPR and standard instructions for performing that process under § 102(b) and merger); *MiTek Holdings, Inc. v. Arce Eng'g Co., Inc.*, 89 F.3d 1548, 1556 n.19, 1557 n.20 (11th Cir. 1996) (analyzing application of copyright to a command tree structure under § 102(b) and merger); *Atari Games Corp. v. Nintendo of Am., Inc.*, 975 F.2d 832, 839-40 (Fed. Cir. 1992) (analyzing the copyrightability of a data stream for unlocking a console under both § 102(b) and merger).

programs that enable compatibility are unprotectable by copyright law, *id.* at 710, so Altai did not infringe by reimplementing the same interface as Computer Associates in its competing scheduling program. *Id.* at 715. Later that year the Ninth Circuit in *Sega Enterprises, Ltd. v. Accolade, Inc*., 977 F.2d 1510 (9th Cir. 1992), citing approvingly to *Altai*, decided that the functional requirements for achieving compatibility are unprotectable by copyright law. *Id.* at 1522. It characterized these requirements as "interface procedures" that were excluded from copyright protection under 17 U.S.C. § 102(b). *Id.* Accolade was thus free to adapt its videogames so that they could run on Sega's popular platform. Other courts followed these precedents. *See*, *e.g*., *Bateman v. Mnemonics, Inc*., 79 F.3d 1532, 1547 (11th Cir. 1996) (recognizing the need for compatibility between the defendant's application program and an operating system program). *Altai* and *Accolade* recognized that the essentially utilitarian nature of computer programs meant they embodied many copyright-unprotectable elements, including interfaces that enable compatibility, and hence, enjoy "a relatively weak barrier against public access" to those unprotected elements, thus ensuring that subsequent programmers can reuse those elements in developing their programs. *Altai*, 982 F.2d at 712. *See also Accolade*, 977 F.2d at 1527.

Relying on these precedents and the method/system exclusions of 17 U.S.C. § 102(b), Google believed that the declarations of the Java Application Program Interface (API) used in its Android software and the structure, sequence, and organization (SSO) embodied in the declarations are not within the scope of protection that copyright law provides to the work of authorship at issue,[4] namely, Java 2 SE (Java SE), whose contents include program code, specifications of the Java packages and their classes and methods, and related documentation.

The District Court made findings of fact from which it concluded that these declarations were not within the scope of protection that copyright law provided to Java SE. Pet. App. 215a-216a. It regarded the declarations as constituent elements of an interface system or method that should be excluded from the scope of copyright protection under 17 U.S.C. § 102(b). *Id.* This ruling is consistent with this Court's decision in *Baker v. Selden*, 101 U.S. 99, 106 (1880), which held that the selection and arrangement of columns and headings in Selden's bookkeeping forms were not within the scope of protection that copyright law provided to his book, with congressional codification of *Baker*'s exclusion of methods and systems, and with the Ninth Circuit's characterization of program interfaces as unprotectable procedures in *Accolade*, 977 F.2d at 1522. It was also consistent with the views of an information technology industry association known as the American Committee for Interoperable Systems

[4] According to the District Court, "all agree[] that Google had not literally copied the software but had instead come up with its own implementations of the 37 API packages," Pet. App. 213a, which is consistent with computer scientists' conception of the declarations as interfaces. 78 Computer Scientists Cert. Br. 6.

(ACIS), whose founding member, Sun Microsystems, created the Java API. In an *amicus* brief, ACIS advised this Court that "it can accurately be said that the interface specification is the 'system' or 'method of operation' that is 'expressed' by the program code." Brief Amici Curiae of American Committee for Interoperable Systems and Computer & Communications Association in Support of Respondent at 19, Lotus Dev. Corp. v. Borland Int'l, Inc., 516 U.S. 233 (1996) (No. 94-2003).[5]

A. This Court Originated the Exclusion of Systems, Methods, and Their Constituent Elements from the Scope of Copyright Protection.

The first of this Court's decisions to rule that copyright protection did not extend to a system and its constituent parts embodied in a copyrighted work was *Perris v. Hexamer*, 99 U.S. 674 (1879). Perris sued Hexamer for using the same symbol system in a map of Philadelphia as Perris had used in a map of certain wards of New York City. *Id.* at 675. Both maps depicted the layout of lots and buildings using a set of symbols and color-coding to identify different types of buildings to aid in risk assessment for fire insurance purposes. *Id.* The Court concluded that Perris had "no more an exclusive right to use the form of the characters they employ to express their ideas upon the face of the map, than they have to use the form of type they select to print the key." *Id*. at 676. After all, Hexamer had not

[5] ACIS membership was listed, *id.* at 1, n.1.

copied Perris' map, but only "use[d] to some extent their system of arbitrary signs and their key." *Id.* The Court considered this system to be a "useful contrivance[] for the despatch of business." *Id.* at 675. It did not matter how original that system might have been or how many other symbol systems could have been devised. That system was simply not protectable by copyright law.

Soon thereafter, this Court reviewed a similar infringement claim in *Baker*. Because *Baker* is such a foundational case and its proper interpretation is disputed by the litigants, we provide some details about the case. Prior to Charles Selden's claimed invention of a novel bookkeeping system, the standard process by which officials kept account books was slow and inefficient. Bookkeepers had to record information about each transaction in a journal for accounts of that kind and then record details again in a ledger where all transactions were recorded in sequential fashion. Supreme Court Record at 92, 106, Baker v. Selden, 101 U.S. 99 (1880) [Record].[6] Because the relevant information was spread out over multiple volumes, it was difficult to prepare a balance sheet for each period and to detect errors or fraud.

[6] For further details about the *Baker* litigation, see Pamela Samuelson, *The Story of* Baker v. Selden: *Sharpening the Distinction Between Authorship and Invention* 160, *in* Intellectual Property Stories (Rochelle Cooper Dreyfuss & Jane C. Ginsburg eds., 2005). To view simulations of the relevant forms, see *id.* at 170-71.

Selden's key innovation was figuring out a way (as the book's title, "Selden's Condensed Ledger, or Bookkeeping Simplified," suggested) to condense the journals and ledger, so that users could record pertinent information about transactions and accounts on one page or two adjoining pages. It enabled a much more efficient accounting process, making the preparation of trial balances and detection of errors and fraud much easier.

Selden's sense of the magnitude of his achievement was expressed in the preface of his book: "To greatly simplify the accounts of extensive establishments doing credit business would be a masterly achievement, worthy to be classed among the greatest benefactions of the age." Record at 21. The preface revealed that Selden had sought a patent on his system "to prevent the indiscriminate use [of his system] by the public." *Id.*

Although Selden knew about Baker's competing book and similar forms during his lifetime, it was his widow who charged Baker with infringement, claiming that "the ruled lines and headings, given to illustrate the system, are a part of the book, and, as such, are secured by the copyright; and that no one can make or use similar ruled lines and headings . . . without violating the copyright." *Baker*, 101 U.S. at 101.

The Court had no doubt that a work on bookkeeping could be copyrighted, or that it would be "a very valuable acquisition to the practical knowledge of the community." *Id.* at 102. But the Court perceived "a clear distinction between the book, as such, and the [useful] art which it is intended to illustrate." *Id.* Copyright law could protect the author's explanation of a useful art, but not the useful art itself, no matter how creative it was. "To give to the author of the book an exclusive property in the [useful] art described therein," the Court said, "would be a surprise and a fraud upon the public. That is the province of letters-patent, not of copyright." *Id.* That Mrs. Selden intended to assert patent-like rights through copyright is evident from her announcement to Baker's customers that they too were infringers. Record at 79-80. Had Selden obtained the patent he sought, it would have given him and his heirs exclusive rights to control uses of the system, as well as making and selling the forms that embodied the system. But no such patent had issued.

The Court recognized that Selden's claim seemed plausible because of the "peculiar nature of the [useful] art described in [his] books" in which "the illustrations and diagrams employed happen to correspond more closely than usual with the actual work performed by the operator who uses the art." *Baker*, 101 U.S. at 104. Someone who kept books using Selden's method would necessarily use forms with the same or substantially similar headings and columns. Usually, the Court observed, useful arts are "represented in concrete forms of wood, metal, stone, or some other physical embodiment." *Id*. at 105. But "the principle is the same in all" regardless of whether the useful art was embodied in a writing or in metal. *Id.* The Court concluded that Selden's system was unprotectable by copyright law, as were the ruled lines and headings that instantiated the system. *Id.* at 106.

Baker illustrates why copyright law should allow second comers to build upon methods and systems embodied in a first author's works and why authors of writings on methods and systems should not have too much control over subsequent adaptations of these creations. Selden's forms may have been a substantial improvement over the old-fashioned bookkeeping methods previously in use, but they were only one stage in an evolving art of bookkeeping. Selden's death meant that any further innovation in this field would have to come from others. Baker advanced the state of the art by redesigning the forms so that entries could be made as transactions occurred rather than having to wait until the end of the week or month as Selden's forms required. Samuelson, *Baker Story*, *supra*, at 162. Baker went on to write other books and he, not Selden, is credited with having advanced the state of the art of bookkeeping in the nineteenth century. *Id.* at 169, n.76. Had Mrs. Selden prevailed, further improvements in the bookkeeping field might well have been retarded until the copyrights expired. This outcome would have disserved both patent and copyright goals as it would have slowed progress in the science and useful art of bookkeeping.

B. Congress Codified the Well-Established Exclusion of Systems and Methods in § 102(b).

Dozens of cases followed *Baker*'s conclusion that methods, systems, and their constituent elements are beyond the scope of copyright protection in writings that embody useful arts. Two courts, for example, rejected claims of infringement against authors who wrote books about the plaintiffs' original shorthand systems: *Brief English Systems, Inc. v. Owen*, 48 F.2d 555 (2d Cir. 1931); *Griggs v. Perrin*, 49 F. 15 (C.C.N.D.N.Y. 1892). Another court in *Aldrich v. Remington Rand, Inc*., 52 F. Supp. 732, 733 (N.D. Tex. 1942) dismissed a claim of infringement for copying the plaintiff's tax record system, which Aldrich claimed to be "the most modern and efficient system of property revaluation for tax purposes." Numerous other *Baker*-inspired cases ruled that original methods and systems for contests, games, rules, and strategies for playing games were beyond the scope of copyright protection. *See* Pamela Samuelson, *Why Copyright Law Excludes Systems and Processes from the Scope of Its Protection*, 85 Tex. L. Rev. 1921, 1936-44 (2007) (reviewing post-*Baker* method/system copyright cases).

The *Baker*-inspired exclusions of methods and systems from copyright's scope was so well-established that Congress decided to codify these exclusions in the Copyright Act of 1976. 17 U.S.C. § 102(b) provides: "In no case does copyright protection for an original work of authorship extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied in such work."

C. The Federal Circuit's *Oracle* Decision Ignored the § 102(b) System/Method Exclusions.

Amici agree with the Federal Circuit that § 102(b) should not be interpreted so literally that it would deprive authors of machine-executable programs of the exclusive rights that Congress intended them to have just because programs are machine processes. Pet. App. 163a.

The Federal Circuit's *Oracle* decision properly quoted the text of § 102(b), Pet. App. 137a, but it treated ideas as the only unprotectable elements of software, giving the other seven terms of exclusion no substantive meaning. Pet. App 163a. This is, as Justice Scalia once stated, "a stark violation of the elementary principle that requires an interpreter 'to give effect, if possible, to every clause and word of a statute,'" to which he added:

> Lawmakers sometimes repeat themselves . . . . [They] do not, however, tend to use terms that "have no operation at all." So while the rule against treating a term as a redundancy is far from categorical, the rule against treating it as a nullity is as close to absolute as interpretive principles get.

King v. Burwell, 135 S. Ct. 2480, 2498 (2015) (Scalia, J., dissenting) (citations omitted). When a statute such as § 102(b) specifically identifies several categories of uncopyrightable elements and says "[i]n no case" should any of these be within the scope of copyright's protection, reading all but one of the terms out of the statute, as the Federal Circuit did in *Oracle*, violates this rule. It failed to be "deferential to the judgment of Congress in the realm of copyright." *Eldred v. Ashcroft*, 537 U.S. 186, 198 (2003).

Although the text of § 102(b) and holdings in *Baker* and its progeny are unambiguous, it is worth noting that Congress added the method/system exclusions to the statute in part to allay concerns about the risk of excessive copyright protection for software:

> Some concern has been expressed lest copyright in computer programs should extend protection to the methodology or processes adopted by the programmer, rather than merely to the "writing" expressing his ideas. Section 102(b) is intended, among other things, to make clear that the expression adopted by the programmer is the copyrightable element in a computer program, and that the actual processes or methods embodied in the program are not within the scope of the copyright law.

H.R. Rep. No. 94-1476 at 57 (1976); S. Rep. No. 94-473 at 54 (1975).[7] The Federal Circuit tellingly recited only

[7] During hearings on copyright revision bills, several witnesses recommended adoption of a specific provision to limit the

that part of the legislative history stating that § 102(b) codified the idea/expression distinction, Pet. App. 141a, and omitted congressional expressions of concern about excessive copyright protection for software. It overlooked this Court's directive not to "alter the delicate balance Congress has labored to achieve." *Stewart v. Abend*, 495 U.S. 207, 230 (1990).

1. The Method and System Exclusions of § 102(b) Avert Patent/Copyright Overlaps.

Consistent with the *Baker* tradition, codification of the system/method exclusions in § 102(b) aims, in part, to ensure that domains of copyright and patent protection for programs should be kept separate. The Federal Circuit recognized this purpose in *Atari Games Corp. v. Nintendo of America, Inc.*, 975 F.2d 832 (Fed. Cir. 1992). After quoting § 102(b)'s exclusion of procedures, processes, systems, and methods of operation, it stated

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scope of copyright protection in computer programs. *See Copyright Law Revision: Hearings on S. 597 before the Subcomm. on Patents, Trademarks, & Copyrights of the S. Comm. on the Judiciary*, 90th Cong. 196-97 (1967) (statement of Arthur R. Miller). Miller foresaw a risk that courts would interpret copyright to extend to computer processes "that the program uses to achieve a functional goal," which would confer "patentlike protection under the guise of copyright." *Id.* at 197. He recommended that Congress should affirm that copyright would extend "solely to duplication or replication of the program" and not to "the art, process or scheme that is fixed in the program" because only patent law could protect "systems, schemes, and processes." *Id.* at 197, 199. For a fuller discussion of the genesis of § 102(b) exclusions, see Samuelson, *Why Copyright Excludes Systems*, *supra*, at 1944-61.

that patent and copyright laws protect "distinct aspects" of programs. *Id.* at 839. The role of copyright, said the court, was to protect program expression, not any methods or processes that might be eligible for patenting under the Patent Act. *Id.*

The Federal Circuit's *Oracle* decision, however, instead seemingly endorsed the view that computer program innovations such as interfaces were eligible for both copyright and patent protection. Pet. App. 190a (erroneously quoting *Mazer v. Stein*, 347 U.S. 201, 217 (1954), which considered only potential design patent and copyright overlaps). This was pertinent because both Sun and Oracle had obtained utility patents on program interfaces. Pet. App. 260a.

2. Unprotectable Elements in Computer Programs Must Be Filtered Out Before Assessing Infringement.

The Federal Circuit's *Oracle* decision also failed to recognize that the utilitarian nature of computer programs differentiates them from conventional literary works because programs contain many functional design elements, including methods and systems, that are beyond the scope of copyright under § 102(b) and other doctrines. *See*, *e.g.*, *Accolade*, 977 F.2d at 1524. The higher quantum of unprotectable elements in programs as compared with novels explains why courts such as the Second Circuit in *Altai* have directed that numerous types of unprotectable elements of programs be "filtered out" before deciding infringement claims in software copyright cases. *Altai*, 977 F.2d at 706-11. Although the Federal Circuit criticized the lower court for not following *Altai*, Pet. App. 145a, the appellate court itself performed no filtration whatsoever.

3. Methods and Systems Are Part of Program Structure, Sequence, and Organization, So SSO Obscures Rather Than Clarifies Expressive Aspects of Software.

The Federal Circuit accepted without question Oracle's claim that the SSO of computer programs is protectable expression. Pet. App. 159a-160a. By contrast, the Second Circuit wisely recognized in *Altai* that SSO is not a useful term with which to distinguish nonliteral elements of programs that may be expressive enough to be copyright-protectable from nonliteral elements that are excluded from copyright protection. *Altai*, 982 F.2d at 706.

By their very nature, methods and systems, when embodied in computer programs, are parts of SSO. Under the Federal Circuit's *Oracle* decision, it would be trivially easy for software developers to claim SSO copyright protection in methods or processes for which they failed to seek patent protection, or even to claim SSO copyright protection for processes for which patent protection is now unavailable in the aftermath of *Alice Corp. v. CLS Bank International*, 573 U.S. 208 (2014). The Federal Circuit's ruling thus undermines this Court's holding in *Alice*.

D. Key Post-1976 Act Decisions Follow *Baker* in Excluding Methods, Systems, and Their Constituent Elements from Copyright's Scope.

An exemplary decision applying *Baker* and § 102(b) to exclude systems and their constituent parts from the scope of copyright is *Bikram's Yoga College of India, L.P. v. Evolation Yoga, LLC*, 803 F.3d 1032 (9th Cir. 2015). Bikram Choudhury claimed copyright in a sequence of twenty-six yoga poses and two breathing exercises described and illustrated in books and videos. *Id.* at 1035-36. After Evolation Yoga began teaching the same sequence, Bikram's Yoga College sued for infringement. Relying on *Baker* and its codification in § 102(b), the Ninth Circuit held that the Bikram Yoga Sequence was "not a proper subject of copyright protection." *Id.* at 1034.

It did not matter whether Choudhury's arrangement of poses and breathing exercises was beautiful or graceful. *Id.* at 1040. Nor did it matter that "the Sequence may possess many constituent parts," for "[v]irtually any process or system could be dissected in a similar fashion." *Id.* at 1041. Also irrelevant was "that similar results could be achieved through a different organization of yoga poses and breathing exercises." *Id.* at 1042. What mattered was that "[a]n essential element of this 'system' is the order in which the yoga poses and breathing exercises are arranged." *Id.* at 1039. Choudhury's books directed his pupils to perform the yoga moves "in the strict order given in this book."

Id. Choudhury had, moreover, repeatedly characterized his sequence as a method or system for improving health and well-being, which rendered the system and its constituent parts too functional for copyright protection. *Id.* at 1038-39.

As in *Baker*, the Ninth Circuit in *Bikram* opined that to get exclusive rights in a functional system, such as the Yoga Sequence, it would be necessary to obtain a patent. *Id.* at 1039-40. As in *Baker*, copyright protected Choudhury's explanation of his method or system, not the system itself or downstream uses of it. His books invited readers to practice the method the books taught. Echoing *Baker*, the Ninth Circuit said that this objective "would be frustrated if the knowledge could not be used without incurring the guilt of piracy of the book." *Id.* at 1041 (quoting *Baker*, 101 U.S. at 103). "Consumers would have little reason to buy Choudhury's book if Choudhury held a monopoly on the practice of the very activity he sought to popularize." *Id*. *See also Ho v. Taflove*, 648 F.3d 489, 498-99 (7th Cir. 2011) (scientific model and constituent elements held unprotectable by copyright law); *Palmer v. Braun*, 287 F.3d 1325, 1334 (11th Cir. 2002) (meditation exercises held uncopyrightable process).

Consistent with *Bikram* was the Ninth Circuit's *Accolade* decision, which stated that program "interface procedures" that constituted "the functional requirements for [achieving] compatibility" were unprotectable by copyright law under 17 U.S.C. § 102(b). *Accolade*, 977 F.2d at 1522. While these statements appeared in a ruling that Accolade's reverse-engineering of Sega program code was fair use, they were not mere dicta or of only slight importance to the outcome of the fair use ruling, as the Federal Circuit asserted. Pet. App. 166a. The statements were the very linchpin of the *Accolade* ruling. Accolade's reverse-engineering of Sega programs was legitimate because of its need to make copies to get access to and extract interface information to enable it to reimplement the procedures and make its games compatible with the Sega platform. *Accolade*, 977 F.2d at 1525-26.

The Ninth Circuit explained that "[i]f disassembly of copyrighted object code is *per se* an unfair use, the owner of the copyright gains a *de facto* monopoly over the functional aspects of his work—aspects that were expressly denied copyright protection by Congress." *Id.* at 1526 (citing § 102(b)). Channeling *Baker*, the Ninth Circuit said that if Sega wanted to enjoy a legal monopoly over the interface procedures, it would have to "satisfy the more stringent standards imposed by the patent laws." *Id.* Allowing reverse-engineering would enable new entrants such as Accolade to make compatible products available in the market. *Id.* at 1523-24. *Accord Sony Computer Entm't, Inc. v. Connectix Corp.*, 203 F.3d 596, 605, 608 (9th Cir. 2000) (reverse-engineering to achieve partial compatibility was fair use); Pet. App. 269a ("Contrary to Oracle, 'full compatibility' is not relevant to the Section 102(b) analysis.").

Compatibility considerations were also important in *Lotus Development Corp. v. Borland International, Inc.*, 49 F.3d 807 (1st Cir. 1995), *aff'd by an equally divided Court*, 516 U.S. 233 (1996) (per curiam). Lotus charged Borland with infringement for reusing the Lotus 1-2-3 menu command hierarchy for the emulation mode of its competing spreadsheet program. The District Court held that this hierarchy was protectable SSO because there were other ways to organize commands for spreadsheet program functions. *Id.* at 810-11.

The First Circuit recognized that "Borland had to copy the Lotus menu command hierarchy" if it wanted to enable users "to operate its programs in substantially the same way" as Lotus 1-2-3. *Id.* at 816. Borland's emulation mode enabled users of the Lotus program who had constructed macros for common sequences of functions to "port" those macros to Borland's program. *Id.* at 811-12. For those macros to be executable, Borland had to employ the same command terms arranged in exactly the same order. As the First Circuit explained:

> Under the district court's holding, if the user wrote a macro to shorten the time needed to perform a certain operation in Lotus 1-2-3, the user would be unable to use that macro . . . . Rather, the user would have to rewrite his or her macro using that other program's menu command hierarchy. This is despite the fact that the macro is clearly the user's own work product.

Id. at 818. The First Circuit concluded that this hierarchy was an unprotectable method of operating a spreadsheet program under § 102(b). *Id.* at 817-18.

Judge Boudin, concurring, observed: "If Lotus is granted a monopoly on this pattern, users who have learned the command structure of Lotus 1-2-3 or devised their own macros are locked into Lotus, just as a typist who has learned the QWERTY keyboard would be the captive of anyone who had a monopoly on the production of such a keyboard." *Id.* at 821 (Boudin, J., concurring). Lotus' command hierarchy "look[s] hauntingly like the familiar stuff of copyright; but the 'substance' probably has more to do with problems presented in patent law." *Id.* at 820.

E. Consistent with *Baker* and § 102(b), Program Interfaces Should Be Considered Unprotectable Procedures, Methods, or Systems.

This Court articulated a clean distinction in *Baker* between the copyrightable expression in Selden's book and the uncopyrightable bookkeeping system, constituent elements of which were embodied in the forms. A clean distinction is also possible here. Google and Java programmers around the world should be free to use the Java SE declarations to develop compatible programs, subject only to the norm that they must instantiate those interfaces in independently written code that copyright law protects from misappropriation.

Characterizing program interfaces as unprotectable procedures under § 102(b) is consistent with *Baker*, the text of § 102(b), and the case law properly interpreting it. The District Court's characterization of the declarations as methods or systems is similarly consistent, as was the ACIS *amicus* brief in *Borland*, *supra*. Interfaces are methods insofar as they enable one program to function effectively with other software or with hardware. Some program interfaces are relatively simple, as in *Accolade*, while others are more complex, as in *Oracle*. But as this Court so aptly said, "the principle is the same in all." *Baker*, 101 U.S. at 105. Allowing programmers to reuse interfaces that enable compatibility promotes the ongoing progress in the field of computer programming as well as advancing the science of computing, in keeping with the constitutional purpose of copyright law. U.S. Const. art. I, § 8, cl. 8.

II. The Federal Circuit's Merger Analysis Is Irreconcilable with *Baker* and Other Persuasive Decisions.

The merger doctrine is often traced to this Court's decision in *Baker*.[8] *See*, *e.g.*, *Arica Inst., Inc. v. Palmer*, 970 F.2d 1067, 1076 (2d Cir. 1992). In *Baker*, this Court concluded that the forms embodying Selden's bookkeeping system were unprotected by copyright law because using these or similar arrangements of columns and headings was necessary to implement the

[8] *See* Pamela Samuelson, *Reconceptualizing Copyright's Merger Doctrine*, 63 J. Copyright Soc'y U.S.A. 417, 419-20 (2016). While *Baker* did not originate the term "merger," it nonetheless articulated principles congruent with what came to be known as the merger doctrine and that guide the outcome here.

underlying system. 101 U.S. at 103. As the Court explained:

> [W]here the [useful] art [a work] teaches cannot be used without employing the methods and diagrams used to illustrate the book, or such as are similar to them, such methods and diagrams are to be considered as *necessary incidents* to the art, and given therewith to the public; not given for the purpose of publication in other works explanatory of the art, but for the purpose of practical application.

Id. (emphasis added). This "necessary incidents" language serves to prevent copyright from extending to unprotectable systems when the reuse of some expression is inseparable from the systems.

The Federal Circuit's analysis of the merger doctrine cannot be reconciled with *Baker*. It is, moreover, contrary to persuasive authorities recognizing the merger doctrine as a shield against infringement for software interfaces that enable the development of compatible programs. Consistent with these authorities, the District Court found that the declarations had to be identical for the functionality they enable to be available in Android, leading it to conclude correctly that the merger doctrine barred Oracle's infringement claim. Pet. App. 215a.

A. The Federal Circuit's Analysis of the Merger Doctrine Is at Odds with *Baker* in Three Key Respects.

When Charles Selden devised his novel bookkeeping system, he could have designed it in a number of ways. This Court recognized that anyone who wanted to implement the Selden system would have little choice but to select and arrange columns and headings in a substantially similar way. *Baker*, 101 U.S. at 101. Since copyright does not protect useful arts such as bookkeeping systems, but only authorial expression, *id.* at 101-02, Baker was free to publish similar forms to instantiate the Selden system. The Court ruled that the forms were uncopyrightable. *Id.* at 105. *Baker* importantly distinguished between authorship (the original expression that copyright protects) and invention (the functional creativity, which only utility patent law can protect). *Id.*

With regard to merger, the Federal Circuit conflicts with *Baker* in three significant ways.

First, the Federal Circuit incorrectly concluded that merger can only be found if a first author had no or only extremely limited alternative ways to express an idea when creating his work.[9] For example, it pointed to the existence of alternative names for Java

[9] The Federal Circuit construed the merger doctrine inconsistently. It correctly describes the merger doctrine as applying "when there are a limited number of ways to express an idea," Pet. App. 147a, but elsewhere it incorrectly characterizes the doctrine as applying exclusively when an idea "can be expressed in only one way," Pet. App. 148a.

functions, such as "Arith.larger" instead of "Math.max," in finding that the merger doctrine did not apply to the Java SE declarations. Pet. App. 150a. In *Baker*, it did not matter whether column headers such as "Brought forw'd." or "Aggregates of Accounts" could have been worded differently when implementing Selden's accounting system.

Thus, merger is a viable argument against copyrightability when the range of available alternatives for functions is limited, as the District Court concluded, Pet. App. 261a, and as was true in *Baker*.[10]

[10] Courts since *Baker* have also concluded that merger is an available defense when there is a limited number of alternatives (and not just one choice). For example, in *Morrissey v. Procter & Gamble Co.*, the court concluded that a set of sweepstakes rules Morrissey authored was original, and that there were different ways to express the rules. 379 F.2d 675, 678 (1st Cir. 1967). However, the court observed that the range of possible expressions of sweepstakes rules admitted of little variation "so that 'the topic necessarily requires' if not only one form of expression, at best only a limited number, [so] to permit copyrighting would mean that a party or parties, by copyrighting a mere handful of forms, could exhaust all possibilities of future use of the substance." *Id.* (citations omitted). The court rejected this outcome, writing that "[w]e cannot recognize copyright as a game of chess in which the public can be checkmated." *Id.* at 679 (citing *Baker*). *Cf. TrafFix Devices, Inc. v. Mktg. Displays, Inc.*, 532 U.S. 23, 33-34 (2001) (rejecting test for functionality of trade dress based solely on the existence of alternative designs).

Second, the Federal Circuit's opinion conflicts with *Baker* in concluding that courts in merger cases can consider only constraints on the plaintiff's creation and never constraints on the defendant's expressive choices. Pet. App. 151a. The Court in *Baker* did not consider whether Selden's own choices in designing a bookkeeping system were constrained. Nor is there anything in *Baker* suggesting that the Court rejected Selden's copyright claim because Selden had no choice about how to select and arrange columns and headings for his bookkeeping forms. Indeed, Baker's forms were somewhat different. *See Baker*, 101 U.S. at 101. Instead, the Court decided that once Selden designed his bookkeeping system, Baker's design choices for arranging columns and headings to implement the same system were constrained by the choices that Selden had made.[11] *Id.*

Third, the Federal Circuit's decision conflicts with *Baker* in holding that merger can be a defense to

[11] More recent appellate decisions also support the idea that a first comer's choices can limit the options of those who come after. In *Veeck v. Southern Building Code Congress International, Inc.*, 293 F.3d 791 (5th Cir. 2002) (en banc), merger precluded enforcement of SBCCI's claim against Veeck for his online posting of a privately written code that had been adopted as law in Anna and Savoy, Texas. *Id.* at 800-02. It did not matter how many possible alternative expressions existed when the codes were initially created. What mattered was that once enacted, there was no other way to express what the law was. *Id.* at 802.

infringement claims, but not a basis for denying copyrightability. Pet. App. 144a-145a. The Court in *Baker* held that Selden's forms were uncopyrightable because the selection and arrangement of columns and headings were embodiments of the bookkeeping system. *Baker*, 101 U.S. at 107. Thus, the merger doctrine can be part of the copyrightability analysis, and is not solely a defense to infringement.

There is a consensus among major authorities in copyright law that merger can present a copyrightability issue, not just a defense to infringement. Two major treatises now recognize that merger can serve as a bar to copyrightability. 1 Paul Goldstein, *Goldstein on Copyright*, §§ 2.3.2, 2:38.1 (2015); 1 Melville B. Nimmer & David Nimmer, *Nimmer on Copyright*, § 2A.05[A][2][b] (2019). The U.S. Copyright Office's *Compendium of U.S. Copyright Office Practices* also identifies merger as one of the bases on which the Office may refuse registration applications. U.S. Copyright Off., *Compendium of U.S. Copyright Office Practices* § 313.3(B) (3d ed. 2015).

B. The Merger Doctrine Provides a Sound Basis for Holding That Program Interfaces That Enable Compatibility Are Uncopyrightable.

Since the Second Circuit's *Altai* decision, there has been broad-based consensus that computer program interfaces that enable the development of compatible software programs are not within the scope of copyright protection. Computer Associates claimed that

Altai infringed by copying the structure of the compatibility component of its scheduling software designed to run on IBM operating systems. *Altai*, 982 F.2d at 701. The *Altai* court invoked *Baker* as the "doctrinal starting point" of its analysis. *Id.* at 704.

Altai articulated a three-step "abstraction, filtration, and comparison" test for judging nonliteral infringement of software copyrights. The first step involves creation of a hierarchy of abstractions of the plaintiff's program; the second step filters out unprotectable elements; and the third step compares the remaining expressive elements of the plaintiff's program with the defendant's program to determine if the defendant's program is substantially similar to expressive elements copied from the plaintiff's program. *Id.* at 706-11. Among the unprotectable elements to be filtered out are those dictated by efficiency, those constrained by external factors—such as the need to be compatible with hardware or software—and those in the public domain. *Id.* at 707-10. The court concluded that the similarities between Altai's and Computer Associates' programs were constrained by external factors, namely, the need to be compatible with IBM programs. *Id.* at 714-15.

Courts have invoked the merger doctrine in concluding that even literal copying may be excused from infringement when needed to achieve compatibility.[12]

[12] The only decision—other than the Federal Circuit ruling in *Oracle*—to cast doubt on the lack of copyright protection for computer program elements required for interface compatibility was the Third Circuit's in *Apple Computer, Inc. v. Franklin*

The Federal Circuit once recognized this principle in *Atari Games*, 975 F.2d at 840. Atari Games claimed its copying of Nintendo's data stream was necessary to enable videogames to run on its platform. *Id.* at 836-37. Had Atari Games copied only as much of the Nintendo data stream as was actually necessary to achieve compatibility with the then-current version of the Nintendo platform, the Federal Circuit said it would have ruled in Atari's favor on merger grounds. *Id.* at 839-40. Because it copied more than was necessary, its merger defense failed. *Id.* at 840.

Drawing in part on *Atari Games*, the Sixth Circuit concluded that literal copying of program code to enable compatibility was justifiable under the merger doctrine. *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 387 F.3d 522 (6th Cir. 2004). Lexmark challenged Static's copying of a program installed in Lexmark printer cartridges. Static defended by saying this copying was necessary for its chip customers to manufacture printer cartridges that interoperated with Lexmark printers. *Id.* at 529-30. There was no other way for unlicensed cartridges to perform the digital

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Computer Corp., 714 F.2d 1240 (3d Cir. 1983). Its anti-compatibility dicta should be given little weight for two reasons. First, Franklin made no effort to reimplement the interface procedures embedded in the Apple OS in independently written code. It made exact copies of the Apple programs. *Id.* at 1245. Second, these statements were made at an early stage in the evolution of software copyright law, well before *Altai* and other cases described above provided more thorough analyses of the copyright implications of a second comer's reimplementation of interface procedures necessary for interoperability.

handshake with Lexmark's printer software to authenticate the cartridge so it would work in Lexmark printers. *Id.* The court decided that "[t]o the extent compatibility requires that a particular code sequence be included in the component device to permit its use, the merger and scenes a faire doctrines generally preclude the code sequence from obtaining copyright protection." *Id.* at 536.

The Eleventh Circuit rendered a similar ruling in *Bateman*, 79 F.3d at 1547. After Bateman stopped licensing its operating system on which Mnemonics had run its automated parking garage program, Mnemonics developed its own compatible operating system that reimplemented Bateman's interface. *Id.* at 1538-39. The Eleventh Circuit concluded that even literal code may be filtered out under the abstraction, filtration, and comparison test pioneered in *Altai*. *Id.* at 1545. It faulted the District Court for failing to instruct the jury "that compatibility . . . is a consideration that applies at the literal level." *Id.* at 1546. While the court declined to hold that interface specifications are wholly outside the scope of copyright, *id.* at 1547, it nonetheless concluded that "external considerations such as compatibility may negate a finding of infringement" *Id.* Where literal copying is "dictated by compatibility requirements," *id.*, copyright does not apply.

These decisions affirm the conclusions of the National Commission on New Technological Uses of Copyrighted Works, whose report Congress commissioned and relied upon when regulating software copyrights. Nat'l Comm'n on New Tech. Uses of Copyrighted

Works, *Final Report* (1979). The report explained that "[w]hen specific instructions, *even though previously copyrighted*, are the only and essential means of accomplishing a given task, their later use by another will not amount to infringement." *Id.* at 20 (emphasis added).

C. The Federal Circuit Ignored the District Court's Fact Findings That Supported Its Holding That the Interfaces at Issue Were Unprotectable Under the Merger Doctrine.

As these authorities demonstrate, merger is a viable argument against copyrightability when the range of available alternatives for expressing a particular idea or method is very limited. The District Court made a finding that there *was*, in fact, only one way to write the name of each function: "Under the rules of Java, [declarations] *must be identical* to declare a method specifying the *same* functionality—even when the implementation is different." Pet. App. 215a. Thus, any programmer wishing to invoke the functionality of "Math.max" would have to use the exact phrase "Math.max."

Its conclusion that there was only one way to write the declarations is bolstered by the *amicus* brief submitted by 78 computer scientists. 78 Computer Scientists Cert. Br. They explain that, with a very limited exception addressed below, the Java programming language requires that declarations be written in a precise form; that reuse of software interfaces such as the Java SE declarations is a foundational practice in computer science that allows programmers to write software that performs on multiple platforms at once; and, that this reimplementation requires exact duplication of an interface's declarations and organizational scheme. *Id.* at 3.

D. The District Court Properly Held That Names and Short Phrases Are Not Protectable by Copyright.

The only part of the declarations not precisely dictated by the Java language are names given to specific functions. *Id.* at 8-9. But this does not bring the interface within the scope of copyright. As the District Court concluded, Pet. App. 202a, names are not protected by copyright law.[13]

Among the circuit courts concluding that identifiers of functional items are unprotectable by copyright law is *Southco, Inc. v. Kanebridge Corp.*, 390 F.3d 276 (3d Cir. 2004) (en banc) (Alito, J.), in which the Third Circuit considered whether the serial numbers used to uniquely identify hardware parts were copyrightable; it decided that they were not. *Id.* at 277-78. The court explained that part numbers are "excluded from

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[13] Declaration names are constrained by efficiency and other functional considerations. 78 Computer Scientists Cert. Br. 7-9. Changing the names would also undermine compatibility.

copyright protection because they are analogous to short phrases or the titles of works."[14] *Id.* at 285.

The Sixth Circuit has rendered similar rulings. In *ATC Distribution Group v. Whatever It Takes Transmissions & Parts, Inc.*, 402 F.3d 700 (6th Cir. 2005), the court held that a taxonomy for assigning unique identifiers to auto transmission parts by sorting them into categories and sub-categories was not copyrightable. *Id.* at 706. The taxonomy for assigning numbers was itself an uncopyrightable idea, *id.* at 707, and the numbers generated through application of the taxonomy were unprotected because they were unoriginal or else merger had occurred. *Id.* Beyond this, the court concluded that there were additional reasons not to grant copyright protection "to short 'works,' such as part numbers." *Id.* at 709. It recognized that allowing copyright in such short works would substantially raise the risk of litigation for those who use such works legitimately and would not meaningfully advance the progress of science and useful arts. *Id.* at 710. *Accord Lexmark*, 387 F.3d at 542 (invoking names and short phrases doctrine to reject Lexmark's claim that inserting stock ticker symbols into code was creative expression).[15] *See also* 37 C.F.R. § 202.1(a) ("[w]ords and short

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[14] The Court also held that the serial numbers were not original expressions. *Id.* at 282.

[15] Other circuits have denied copyright protection to names on other grounds. *See*, *e.g.*, *Mitel, Inc. v. Iqtel, Inc.*, 124 F.3d 1366, 1373 (10th Cir. 1997) (four-digit numeric codes used to access features of telecommunications hardware not copyrightable due to unoriginality and scenes a faire).

phrases such as *names*, titles, and slogans" are not copy-right-protectable) (emphasis added).[16]

Thus, because names are unprotectable, no aspect of the declarations is protectable by copyright law.

CONCLUSION

For the foregoing reasons, the Federal Circuit's judgment should be reversed.

Respectfully submitted,

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[16] Circular 34, *Copyright Protection Not Available for Names, Titles, or Short Phrases*, was updated to become Circular 33, *Works Not Protected by Copyright* (2017), available at https://www.copyright.gov/circs/circ33.pdf. The update is noted in the Office's Circular Update Guide, https://www.copyright.gov/circs/circular-update-guide.pdf.