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ALJ Orders Complete Divestiture in Challenge to Consummated Chicago Bridge & Iron Acquisition of Pitt-DesMoines, Inc.

In our April 2003 K&L *Antitrust and Trade Regulation Update* ("Recent FTC Challenges to Consummated Mergers: the FTC Orders Unscrambled Eggs"), we discussed three recent cases in which the Federal Trade Commission ("FTC" or "Commission") has challenged consummated mergers. One of these challenges — to the acquisition by Chicago Bridge & Iron Company, N.V. ("CB&I") of two divisions of Pitt-DesMoines, Inc. ("PDM") — is especially significant because it marks the first time the FTC has challenged a consummated merger or acquisition that had been subjected to the Hart-Scott-Rodino Act ("HSR Act" or the "Act") pre-merger review without also contending that the disclosure requirements of the Act had not been met. On June 27th, the FTC made public the Administrative Law Judge's ("ALJ") June 12th decision in the *CB&I* challenge, including ordering CB&I to divest all of the assets acquired in its February 2001 acquisition (the "Acquisition") of the Water Division and the Engineered Construction Division of PDM. CB&I has promised an appeal to the full five-member Commission and, if necessary, through the federal appeals courts.

The *CB&I* decision is not the first time that a consummated transaction was challenged and full divestiture ordered. In 2001, the FTC challenged an acquisition by Hearst Corporation of J.B. Laughery, Inc. and ordered divestiture of assets purchased in the acquisition, as well as disgorgement of unlawful profits. In addition to alleging that the acquisition unlawfully impaired competition, the FTC alleged that Hearst failed to submit various high-level corporate documents prepared to evaluate the acquisition and its competitive effects as required in its pre-merger HSR Act filing. In contrast, the *CB&I* decision is noteworthy because the violations alleged did not include, and the remedy ordered was not based on, a failure to comply with the reporting and waiting requirements of the HSR Act, but instead were based solely on the alleged anticompetitive effects of the acquisition that had been subject to the HSR Act review and not challenged at the time of such review.

The FTC filed its administrative complaint in *CB&I* on October 25, 2001 (the "Complaint"). The Complaint alleged that the Acquisition violated section 7 of the Clayton Act (Count I) and section 5 of the FTC Act (Count II) by threatening to substantially lessen competition in four specific markets in which both CB&I and PDM had competed in the United States: (1) liquefied nitrogen, liquefied oxygen and liquefied argon storage tanks; (2) liquefied petroleum gas storage tanks; (3) liquefied natural gas storage tanks; and (4) the associated facilities and field-erected thermal vacuum chambers. The divestiture of all of the assets acquired in the Acquisition, as ordered by the

ALJ, is designed to restore competition as it existed prior to the Acquisition. Specifically, the ALJ held that the FTC "ha[d] established by reliable and probative evidence that the effect of the [a]cquisition…may be to substantially lessen competition in the relevant markets… [The FTC] has met its burden of proof on Count I and Count II of the Complaint. The appropriate remedy is divestiture."

After determining the relevant products and geographic markets, the ALJ evaluated the effects of the Acquisition on competition. In order to establish a violation under section 7 of the Clayton Act, the FTC first had to establish that the Acquisition produced a firm controlling "an undue percentage share in each of the four relevant product markets." In the majority of cases, the government seeks to fulfill this requirement by calculating the Herfindahl-Hirshman Index ("HHI," an index used to measure market concentration) based on annual sales. In contrast, the FTC's expert examined market share data for eleven years. In addition, while the *Merger Guidelines* suggest that in certain cases market shares may be measured over a longer time period than a year, they do not state that using a period longer than a decade is appropriate. Due to the unusual nature of the four relevant markets, where sales are often sporadic and a single sale can represent a large percent of market share in any given year, the ALJ suggested that both a mechanical application of the HHI to yearly sales and a decade-long analysis may provide misleading results. Despite the fact that the ALJ noted that the FTC's HHI statistics alone did not establish its *prima facie* case, he concluded that the FTC did present reliable and probative evidence proving that CB&I and PDM were the top two competitors in all four product markets, and that no other company provided or was likely to provide effective competition. Having emphasized that, in this particular case, market shares may not be used alone to measure market dominance, the ALJ stated that it is the ability to *maintain* market share that is more significant than market share itself, and a more accurate way to measure competition is to examine the pressure that each manufacturer in the market exerts by bidding on various tank projects. The ALJ went on to evaluate the market power of CB&I and PDM in the four relevant markets through bids on recent projects and found that, in most instances, CB&I and PDM competed against each other and often were the *only* two bidders on a given project.

Further, the FTC was able to demonstrate that CB&I acquired its only real competitor in the relevant markets and that it was not likely that another equally cost-effective and qualified competitor would replace PDM in any of the four relevant markets. Prior to the Acquisition, no company other than PDM challenged CB&I's market power by bidding against CB&I in various customer projects. The ALJ held that one could not ignore the positive competitive effects created by CB&I and PDM, prior to the Acquisition, by bidding against each other. The ALJ found that such pre-Acquisition competition resulted in lower prices for customers. Once the Acquisition was consummated, CB&I was no longer under pressure to maintain low prices.

CB&I apparently attempted to rebut the FTC's *prima facie* case by demonstrating PDM's financial weakness. This defense may only be credited in those rare cases where an acquired firm's financial position is so weak that the firm's assets will exit the market absent the proposed acquisition and that the proposed acquisition does not adversely alter competitive conditions. In the present case, however, the evidence established that, prior to the Acquisition, PDM was profitable and was winning tank projects. As a result, the ALJ held that considerations of financial weakness did not rebut the FTC's *prima facie* case.

Once the FTC established the presumption of illegality of the Acquisition in all four relevant markets, the burden shifted to CB&I to show that the FTC had not presented an accurate account of the Acquisition's probable effects on competition. The ALJ found that CB&I was not able to demonstrate that the FTC had overstated CB&I's ability to

compete in the relevant markets. Thus, the ALJ determined that the evidence presented by CB&I did not establish that other firms were likely to enter the market and thus undercut any of the anticompetitive effects of the Acquisition. The ALJ first considered the likelihood and timing of entry of potential competitors and found that, based on the fact that CB&I's and PDM's success was based on their long experience and track record, rather than any major changes in the industry, it was unlikely that other firms would enter the four relevant markets following the Acquisition if the prices rose. In light of the fact that CB&I and PDM were not the only two firms in the world competing against each other in the four relevant markets, the ALJ concluded that the potential and actual entry of other competitors into the four relevant markets in the United States was slow and ineffective. As a result, such entry could not keep these markets competitive.

Further, to serve as a defense to an otherwise anticompetitive acquisition, the potential entry of competitors must be such as to offset any loss of competition due to the Acquisition. New entrants must be in a position to increase the output to a level where it would prevent CB&I from raising prices. Thus, CB&I presented evidence demonstrating that a number of manufacturers had expressed an interest in entering the market and that customers would consider turning to these alternative sources. The ALJ held, however, that simply the existence of interest on the part of other firms in making sales was not sufficient to prevent CB&I from exercising market power. The ALJ further examined the evidence and concluded that the bids offered by smaller competitors were at higher prices than those of CB&I and, therefore, did not represent a constraint on pricing.

The ALJ analyzed various barriers to entry into the four relevant markets because if such barriers were low, the threat of outside entry could deter CB&I from exercising market power. Expertise in the industry, a fair amount of capital, a positive reputation, the need to have specialized equipment, as well as the reluctance of existing customers to switch to new entrants were all found to be barriers that exist in the present case and make it highly unlikely that any potential competitor (or an existing smaller competitor in the United States), would be in a position to exert competitive force equal to that of PDM.

CB&I also attempted to demonstrate that the bargaining power of customers would overcome the presumption of anti-competitiveness. The ALJ found, however, that in three of the four relevant markets, there were few products purchased and there were confidentiality provisions that precluded the customers from knowing past pricing. Therefore, because the customers had no pricing information, they did not possess significant bargaining power.

Based on the totality of the evidence presented by the FTC and CB&I, the ALJ concluded that the Acquisition would threaten to substantially lessen competition. Prior to the Acquisition, there were two primary competitors, and, as a result of the Acquisition, there now exists one dominant firm that can increase prices without any real competitors to discipline it. The ALJ specifically pointed out that the FTC was not required to "prove that anticompetitive effects have in fact occurred." It only needed to establish a probability, which, according to the ALJ, it did.

After concluding that the Acquisition was in violation of section 7 of the Clayton Act and section 5 of the FTC Act, the ALJ mandated that divestiture include not only all of the assets acquired from PDM but others as well in order to restore competition to the state in which it existed prior to, and would have continued to exist but for, the Acquisition. Thus, the ALJ ordered that CB&I divest not only those assets acquired in the Acquisition, but also those assets that had been purchased by CB&I in order to replace or maintain the assets purchased in the Acquisition. In addition, among the assets to be divested are all the intellectual property or all the rights to intellectual property acquired by CB&I in the Acquisition, as well as a worldwide, royalty-free, perpetual

irrevocable license to any intellectual property owned by CB&I that would block the use by a new acquirer of the intellectual property that is required to be licensed to the acquirer. Further, CB&I must divest all contracts formerly held by PDM and obtained by CB&I in the Acquisition that have not been fully performed. The ALJ's order also precludes CB&I from granting incentives to its employees or enforcing any non-compete clauses in its employees' contracts in order to prevent the employees from transferring to a new acquirer.

The ALJ's decision is subject to review by the full Commission, either on its own motion or at the request of either party.

In August 2001, the FTC announced its intent to challenge acquisitions and mergers that, in its view, raised "substantial competitive issues," even if the acquisition or merger had already been consummated. *CB&I* represents the Commission's first administrative victory in pursuit of this policy, and perhaps not its last.

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