

Chapter 2

The Regulatory Environment

Answers to End of Chapter Discussion Questions

2.1 What factors do U.S. antitrust regulators consider before challenging a merger or acquisition?

Answer: Regulators attempt to measure the likelihood of increased market power, i.e., the ability to raise prices resulting from a business combination. Initially, regulators examine the size of the market and the increase in industry concentration that might ensue. Other factors that are considered include the potential for coordinated interaction among current competitors, the extent to which products are differentiated in the minds of consumers, and the similarity of substitute products. Frequently, M&As can be approved if it can be demonstrated that the combination of certain businesses will result in enhanced efficiency and eventually lower prices. Finally, regulators consider the likelihood that a firm would fail if it were not merged with a more viable business.

2.2 What are the obligations of the acquirer and target firms according to Section 14(d) of the Williams Act?

Answer: The acquirer must disclose its intentions and business plans as well as any agreements between the acquirer and the target firm in a Schedule 14D-1. The disclosure must also include the types of securities involved, the identities of the person, partnership, syndicate, or corporation that is filing, and any source of funds used to finance the tender offer. The target firm cannot advise its shareholders on how to respond to the tender offer until it has filed a Schedule 14D-9 with the SEC inside 10 days after the tender offer's commencement date.

2.3 Discuss the pros and cons of federal antitrust laws.

Answer: Such laws are intended to prevent individual corporations from assuming too much market power such they can limit their output and raise prices without concern for any significant competitive reaction. Antitrust laws such as the Hart-Scott-Rodino Act require that the firms involved in the pending transaction notify the regulatory authorities before completing the transaction. The regulators thus have time to assess the potential anticompetitive effects of the transaction before hand to avoid the disruption involved in dismembering the combination once it has been completed. Using consent decrees, regulators are able to reduce potential concentration by requiring the parties to the transaction to divest substantially overlapping portions of their businesses (so-called structural decrees) or to pursue policies minimizing anticompetitive practices (so-called behavioral decrees).

The ability of regulators to assess accurately potential anticompetitive effects is often questionable. Defining concentration is heavily dependent on their ability to define the market, ease of entry for new competitors, current competitors (including foreign), the availability of substitute products, and the extent to which products are differentiated. Inappropriate challenges to M&As may thwart potential improvements in efficiency and innovation. Antitrust policy sometimes ignores market dynamics such as the accelerating change in technology, which may result in the introduction of new substitute products, thereby undermining the dominant firm's competitive position.

2.4 When is a person or firm required to submit a Schedule 13D to the SEC? What is the purpose of such a filing?

Answer: Any person or firm acquiring 5% or more of the stock of a public corporation must file a Schedule 13D with the SEC within 10 days of reaching that percentage ownership threshold. The disclosure is necessary even if the accumulation is not followed by a tender offer. The filing is intended to give target shareholders access to sufficient information and an adequate amount of time to evaluate properly a tender offer.

2.5 Give examples of the types of actions that may be required by the parties to a proposed merger subject

to a FTC consent decree?

Answer: A typical consent decree requires the merging parties to divest overlapping businesses (structural decrees) or take actions (behavioral decrees) that minimize activities that are perceived by the regulators as anticompetitive.

- 2.6 Having received approval from the Justice Department and the Federal Trade Commission, Ameritech and SBC Communications received permission from the Federal Communications Commission to form the nation's largest local telephone company. The FCC gave its approval of the \$74 billion transaction, subject to conditions requiring that the companies open their markets to rivals and enter new markets to compete with established local phone companies. SBC had considerable difficulty in complying with its agreement with the FCC. Between December 2000 and July 2001, SBC paid the U.S. government \$38.5 million for failing to provide adequately rivals with access to its network. The government noted that SBC failed repeatedly to make available its network in a timely manner, to meet installation deadlines, and to notify competitors when their orders were filled. Comment on the fairness and effectiveness of using the imposition of heavy fines to promote government-imposed outcomes, rather than free market outcomes..

Answer: The use of fines to achieve social objectives assumes that the government can provide a better solution than the free market. In general, the imposed solution will be less efficient than what the free market would have determined. It requires the government to determine what constitutes a fair solution. Such definitions are often arbitrary, politically motivated, and result in less innovation and less product variety offered to customers and, in some cases, higher prices. The usual justification for the use of fines in a regulated industry is that industries such as utilities are "natural monopolies" not subject to competitive market conditions. While this may have been a compelling argument in the past, it is less relevant today due to the emergence of a variety of competing technologies such as voice over internet and wireless telephony.

- 2.7 In an effort to gain approval of their proposed merger from the FTC, top executives from Exxon Corporation and Mobil Corporation argued that they needed to merge because of the increasingly competitive world oil market. Falling oil prices during much of the late 1990s put a squeeze on oil industry profits. Moreover, giant state-owned oil companies are posing a competitive threat because of their access to huge amounts of capital. To offset these factors, Exxon and Mobil argued that they had to combine to achieve substantial cost savings. Why were the Exxon and Mobil executives emphasizing efficiencies as a justification for this merger?

Answer: Current antitrust guidelines recognize that the efficiencies associated with a business combination may offset the potential anti-competitive effects of increased concentration. The guidelines call for an examination of the net effects of the proposed combination. Proving that the presumed efficiencies justify the merger is difficult, since most synergies will not be realized for a number of years. It is therefore difficult to measure their true impact and often even more difficult to unravel the anticompetitive impacts that might ensue from the merger.

- 2.8 Assume that you are an antitrust regulator. How important is properly defining the market segment in which the acquirer and target companies compete in determining the potential increase in market power if the two firms are permitted to combine? Explain your answer.

Answer: Whether a company is able to engage in anticompetitive practices is heavily dependent on how the market is defined. The presumption is that the degree of pricing power is directly related to the degree of market concentration. If the market is defined narrowly, the Herfindahl index will show a much higher level of concentration than if the market is more broadly defined to include regional, national, or foreign sources of supply..

- 2.9 Comment on whether antitrust policy can be used as an effective means of encouraging innovation. Explain your answer.

Answer: Regulation almost always is reactive rather than proactive. Efforts to promote innovation through regulation may be particularly inappropriate in that the conditions that give rise to innovation are not well understood. For example, efforts to establish product standards may promote innovation by enabling software developers to focus on developing new products for the Windows standard. Without a standard, the risk of developing new applications is higher due to the potential for developing products for operating systems that achieve a relatively low market share in the future. However, the existence of standards may also make it possible for companies such as Microsoft to stifle innovation by embedding innovative ideas developed by others in their operating system as they have done in the past.

- 2.10 The Sarbanes-Oxley Act has been very controversial. Discuss the arguments for and against the Act. Which side do you find more convincing and why?

Answer: Detractors argue the Act is overkill in that it imposes costly and unnecessary burdens on firms. They argue that many firms have de-listed from the major exchanges in recent years because of these added reporting costs. There is evidence that the Act has been disproportionately burdensome on small firms. However, changes in the law may alleviate this problem. Proponents argue that, while hard to quantify, the Act has increased public confidence in the equity markets and at least reduced the perception of fraud. While some firms have de-listed, this does not mean that they will be able to avoid the reporting requirements of the Act if they issue high yield debt to finance their LBO. To the extent the Act promotes better governance, it is likely to be worth the additional expense. However, the inability of the Act to mitigate the collapse in U.S. financial markets in 2008 raises serious questions about its effectiveness in promoting greater financial transparency.

Solutions to End of Chapter Case Study Questions

Regulators Approve Merger of American and US Airways to Create Largest Global Airline

Discussion Questions

1. Whose interests do you believe antitrust regulators represent? What trade-offs do antitrust regulators face in making decisions that impact the groups whose interests they represent? Be specific.

Answer: Antitrust legislation was passed with the objective of ensuring that firms could not engage in what were viewed as anticompetitive practices. These included gaining excessive market share such that they could effectively set prices or collude with competitors to restrain competition to achieve the same objective. Ostensibly, the regulatory authorities set up to enforce legislation are intended to represent the interests of consumers, for example airline travelers. In practice, regulators often consider the impact on firm viability, employment, suppliers, creditors, and communities.

In effect, to carry out their mandate to protect consumers, the regulators often look at the firms they regulate as stakeholders. In making decisions, regulators consider the trade-off between lower consumer prices and possibly less innovation and safety due to lower reinvestment in the airlines. That is, lower prices often mean lower profitability and financial returns providing less incentive for the airline to reinvest and a reduced ability to attract capital. Less reinvestment also limits expansion and employment opportunities. Moribund profitability also adversely affects creditors, suppliers, and communities in which the airlines operate.

2. Speculate as to why the share prices of American and US Airways increased sharply on the day that the agreement with the Justice Department had been reached? Why did the share prices of other major airlines also increase?

Answer: Investors approved of the merger and other airline share prices rose due to the expectation that their profits would rise as a result of less competitive fare discounting. Not only would American and US Airways profitability be positively affected but also other airlines as well causing investors to bid up their share prices in anticipation of higher future profits.

3. Why do you believe the regulators approved the deal despite the large increase in industry concentration and their awareness that historically increases in concentration would likely result in a further reduction in industry capacity?

Answer: The airline industry is among the most capital intensive and cyclical industries in existence. Preserving the ability of airlines to raise capital to maintain and modernize their fleets of airplanes is critical to the long-term viability of the industry. High air plane occupancy rates tend to drive airline profitability due to the exceeding small incremental costs of adding an additional passenger. To achieve better equipment utilization rates, excess capacity measured by airplane seat availability must be reduced over time. Regulators recognizing this strategic imperative try to reduce capacity in such a way that it minimizes excessive fare increases. This may be achieved by focusing on airline concentration at specific airports.

4. How does the approval of a merger involving a firm in Chapter 11 complicate decision making for regulators?

Answer: Presumably, the firm was in Chapter 11 because it was failing. The objective of Chapter 11 is to give the debtor firm a respite from its creditors to remake itself into a viable concern. Acquirers often view firms in Chapter 11 as attractive target firms because of their reduced debt burden and more favorable supplier and labor contracts renegotiated while in bankruptcy. Allowing the debtor firm to be acquired may give it the scale necessary to achieve sustained profitability. Therefore, regulators may feel the greater good is served if the merger is allowed even though the end result could be increased industry consolidation.

5. How did the delay in filing the Justice Department lawsuit impact the economic viability of American Airlines?

Answer: The delay created an unnecessary amount of uncertainty for all stakeholders to the process including investors, creditors, workers, suppliers, and communities. The uncertainty disrupted the ability of these stakeholders to plan for the eventual exit of American from Chapter 11. By threatening the merger, it disrupted the ability of American and US Airways to develop plans for the eventual integration of the two airlines. History shows that the complexity of airline integration makes such planning critical to the successful combination of the businesses. Ineffective post-closing integration creates passenger angst, reduces employee morale, and disrupts supply and creditor agreements.