Can Purchasing Efficiencies Save Mega-Mergers? The D.C. Circuit Says “No”

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Efficiencies, economies of scale, and the general desire to improve the customer experience are the lifeblood of all mergers. And one of the most common efficiencies in any deal comes from enhanced purchasing power, or the ability to lower costs through increased volume. Long before a deal is announced, merging parties will create clean teams focused on comparing costs, hoping to leverage the better rates that one firm or the other has negotiated with key vendors. This low hanging fruit – simply moving volume from high-cost vendors to lower cost ones – is among the most basic, least speculative efficiencies and can often provide a powerful rationale for doing the deal. But can they save a mega-merger?

Perhaps not, at least according to the D.C. Circuit's recent decision in *United States v. Anthem, Inc.*, which blocked a proposed merger between two of the nation's three largest healthcare insurers by a 2-1 party-line vote. The parties claimed that the combined firm's increased purchasing power would, at a minimum, allow them to obtain the best healthcare provider rates that either one had negotiated on its own. Just extending Anthem's lower rates – reflecting its larger size and scale – to Cigna customers would produce over $2 billion in annual synergies, a fact that was not contested. What was contested was whether such efficiencies were legally cognizable, whether practical realities would prevent them from being realized, and whether they would be passed on to consumers.

The majority, concurrence, and dissent (penned by Judge Kavanaugh – the sole Republican on the panel) answered these questions differently and, in so doing, cast doubt on whether such quintessential purchasing efficiencies can save a merger that substantially increases market concentration. Though efficiencies were given no credence in merger litigation for most of the nation's history, the 2010 revisions to the *FTC and DOJ Merger Guidelines* offered a ray of hope. Those Guidelines explicitly recognized an "efficiencies defense" for the first time, though it articulated a difficult standard that arguably stripped it of any real significance. The majority's decision in *Anthem* follows this mold, continuing to express doubt about the existence of an efficiencies defense, embracing the Guidelines' difficult test, and casting aspersions on the parties' proof. In doing so, the decision suggests that efficiencies defenses will remain within the realm of prosecutorial discretion, once again confirming the conventional wisdom that, for efficiencies arguments to do any good, they must win over the hearts and minds of the regulators.

The Courts Reject a Radical Restructuring of the Healthcare Insurance Market

The problem for Anthem began at inception. This was no ordinary merger. It arose in the context of a major industry shake-up, in which all four of the nation's major health insurers felt the urge to merge in two separate transactions announced at roughly the same time: one between Anthem and Cigna, and the other between Aetna and Humana. There have been other instances where the four largest seek to consolidate down to two. And in most cases, the federal agencies intervene to prevent the duopoly from forming. So it was here.

The DOJ filed two separate suits before two different federal judges, each of whom enjoined the transaction before them. But while Aetna and Humana promptly walked away – and Cigna wanted to – Anthem pressed on, appealing the decision and dragging Cigna along as a "reluctant supporter of the merger." Indeed, at trial, Cigna, which had second thoughts about the merger, had rejected many of Anthem's claims and refused to sign its proposed findings of fact. So, not only did Anthem fail to win over the regulators' hearts, it could not even convince Cigna of its idyllic world vision. The majority on appeal felt the same way.

The Majority Casts Doubt on the Existence of an Efficiencies Defense Based on Discredited but Not Overruled 1960's Era Case Law

The court first addressed the threshold issue of what role efficiencies should play in merger analysis. The majority said none. Quoting from the Supreme Court's 1967 holding in *FTC v. Proctor & Gamble Co*., the court explained that, "despite widespread acceptance of the potential benefits of [merger] efficiencies," they "cannot be used as a defense to illegality" because Congress "struck the balance in favor of protecting competition." Because *P&G* has never been formally overruled, the court said it was bound by its letter and spirit. Indeed, presaging a return to when Antitrust laws focused on competitor welfare, over consumer benefits, the court even cited commentators who noted that, when passing the Clayton Act in 1952, "Congress may not have wanted anything to do with an efficiencies defense" because it would give large firms an "even greater advantage over rivals."

But the world has changed since then. Over the last three decades, the Supreme Court took case-after-case to overrule outdated precedents that protected competitors from competition more than they protected consumers from the absence of it. This case too would likely be headed to the Supreme Court for reversal had the court actually *held* that there was no efficiencies defense. The *Merger Guidelines*, two sister circuits, and an earlier panel from the D.C. Circuit itself recognized the defense. And, in *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, the Supreme Court expressly rejected the view that rival-impairing efficiencies are an "anticompetitive effect" of a merger, a ruling that conflicts with the commentators the majority cited to support its decision.

Seeking to insulate itself from reversal, the majority chose not to stand behind its own discussion of the defense's viability, instead relegating it to mere dicta. "Prudence," it said, "counsels that the court should leave [the issue] for another day" and "simply assume the availability of an efficiencies defense." Whether the panel's avoidance strategy will work remains to be seen – Anthem has already filed its petition for cert. – but as the dissent points out, the majority's "drive-by-dicta" means that no other court should feel bound by it.

Consultant and Economist Analysis Must Bow to Practical Reality as the Majority Rejects "Bargaining-Power-Inspired" Cost Savings

This brings us to the heart of case: whether synergies arising from the merging firm's increased bargaining power can save an otherwise anticompetitive merger. All sides – the parties, the DOJ, and the courts – agreed on the applicable standard, pulled from the 2010 Merger Guidelines. Efficiencies, they say, must be "verifiable," "merger-specific," and – in the case of high market shares – "extraordinarily" great so that they "offset" any presumed anticompetitive effects. But they could not agree on whether the parties' claimed $2 billion in bargaining-power-inspired efficiencies met this standard.

Each of the three panel judges had a different view. In her concurring opinion, Judge Millet said that such efficiencies are not cognizable as a matter of law because "securing a product at a lower cost due to increased bargaining power is not a procompetitive efficiency when doing so simply transfers income from supplier to purchaser without any resource savings." Were this the rule, many parties' core efficiencies analysis – the ones supposedly given the most weight because they are the least speculative – would be rendered useless, as the parties would also need to prove, not just the existence of cost savings, but that it stems from an actual shedding of costs from the *entire* supply chain.

The dissent rejected this view. The ultimate question, the dissent said, was whether insurance rates would go up; if not, the merger would not substantially lessen competition in the *insurance* market. As to that question, the dissent believed that the parties' two experts – a litigation economist and an integration consultant – presented "overwhelming" *proof* of efficiencies, and their reports exceeded the requirement that, to be "verifiable," the efficiencies must be "more than mere speculation and promises about post-merger behavior."

Judge Rogers, writing for the panel majority, took the Goldilocks approach. She did not reject the notion that bargaining power inspired efficiencies were cognizable. Nor did she agree with the dissent that parties could justify an otherwise anticompetitive merger "merely by offering expert testimony of fantastical cost savings." Instead, believing that there is no such thing as a free lunch, she held that Anthem's bargaining power inspired efficiencies either "floundered in the face of business reality or was achievable without the merger, or both."

The problem with the parties' bargaining power inspired savings, Judge Rogers said, was that providers would not offer additional discounts for nothing. The parties had already conceded that, as the nation's second largest insurer, it "has already achieved whatever economies of scale are available." Thus, the merger did not promise significantly lower rates for Anthem's existing customers. Rather, Anthem claimed that its own customers would receive better service, commensurate with Cigna's "high-touch" offerings that focused on preventative care in addition to post-illness treatment. But the court rejected this argument. Such an efficiency was not "merger specific," the court said, because nothing prevented Anthem from offering its customers Cigna-like service levels on its own if it wanted to. As for Cigna's customers, the court questioned whether Anthem could extract greater discounts without "degrading" service levels. More likely, the court said, providers who are forced "to accept less money … will simply respond by offering customers less in the way of Cigna high-touch service." Believing that "pulling at any one loose thread quickly unravels Anthem's narrative," the majority held that the parties' projected cost savings "fall to pieces in a stiff wind."

Structural Arguments Fail to Persuade in the Absence of Competition Forcing The Merging Parties to Pass On the Discounts to Consumers

The majority and the dissent also disagreed when it came to the issue of pass-through. Both sides agreed that efficiencies are only relevant where they "improve consumer welfare," which requires that they "are actually passed through to consumers, rather than simply bolstering [the merging parties'] profit margin." But they disagreed as to whether the estimated savings would, in fact, be passed on. In part, this was because the parties presented a novel pass-on argument grounded on "industry structure," not on "competition." The dissent bought into this argument; the majority did not.

Ordinarily, merging parties claim that ongoing competition will force them to pass on a substantial portion of any cost savings. The problem here was that Anthem did not rely on competition as the mechanism for pass-through; it relied on industry structure. All healthcare insurers, it explained, provide employer-customers with a provider network that employees may use when they get sick. But not all employers actually buy "insurance" from the insurer; some self-insure. Those employers access the network rates negotiated by the insurer on a cost-plus basis, effectively ensuring that 98% of any discount the insurer negotiates with a provider is passed on directly to the employer. For the dissent, this meant that, because the merger would certainly reduce provider rates to some extent, self-insured employer-customers would pay lower rates post-merger, defeating any finding of lessened competition.

The majority rejected this static, industry-structure-based theory of pass-through. That theory was undone, the majority said, by Anthem's own internal documents suggesting that "total pass-through" was not the "optimal solution." But the majority had a problem. If the structural theory was even somewhat correct, self-insured employers would still benefit, even if pass-through was less than total; indeed, even if it was *de minimis*. To overcome this problem, the majority offered two legal rulings – one procedural, one substantive – to justify its result.

Procedurally, the majority threw out the entirety of the parties' efficiency analysis because it could not credit every aspect of it. Rejecting Anthem's argument that the court should conduct a "dollar-for-dollar comparison after discounting whatever claimed efficiencies were properly rejected," the majority noted that "Anthem, not the district court, has the burden" of proving efficiencies. As such, the court did not need to "calculate … a more realistic pass-through rate" once it rejected the 98% rate Anthem's expert proffered. This all-or-nothing approach – untethered to *Daubert* or any other standard – has grave consequences for future cases since it arguably gives courts free reign to reject projected cost savings just by taking some pot shots at it.

Substantively, the court held that static, structure-based arguments cannot take the place of more traditional competition-based pass-through arguments. As the court explained, "in highly concentrated markets, already-large insurers are less constrained by competition and thus tend to find it more profitable to capture medical savings and increase premiums." This fact, the court held, "corroborates rather than remediates anticompetitive concerns," notwithstanding Anthem's industry-structure pass-through arguments.

Teachings from the Anthem Decision

So what does the *Anthem* decision mean for antitrust practitioners and clients interested in M&A transactions? *First*, it means that courts will remain skeptical of efficiencies defenses, and will – if they even recognize the defense – rigorously apply the Guidelines' requirement that they be verifiable, merger-specific, and extraordinary.

Second, *Anthem* teaches that these three requirements present many opportunities for results-oriented outcomes, in which courts or regulators cast aside the parties' efficiencies claims. To combat this, it is not enough to have top notch experts. If their analysis is superficial at its core – based on simple comparisons of parties' costs coupled with assumptions about how the merged parties will get the best of both worlds – the projections may not carry the day. Rather, the parties and their experts must also explain *why* those savings can be practically achieved without any degradation in product quality.

This means that, for purchasing synergies, the parties may need to show how *vendors* would realize benefits that offset the greater discounts they are being asked to provide. How, for example, does the increased volume allow *them* to lower *their* costs, achieve *their* own economies of scale, or reduce *their* risk? Explaining how the merger removes costs from the entire supply chain, rather than simply shifting it from one link to another, addresses both the concurrence's legal concerns about bargaining-power-inspired efficiencies and the majority's factual concerns about the rarity of a free lunch. For other kinds of synergies – like reduced head-count or changes in product offerings – the parties will need to show that the contemplated changes would not reduce product quality or customer choice -- "withdraw[ing] a product that a significant number of customers strongly prefer … can constitute a harm to customer."

Third, *Anthem* suggests that parties will need to show that competition – not industry structure – will force the merging parties to pass on the savings and reduce prices. While this makes efficiencies arguments difficult in deals resulting in merger to monopoly, this view of the efficiencies defense dovetails nicely with the overall competitive effects analysis in deals involving lesser degrees of concentrations. Rather than sidestep the question of competition, as Anthem tried to do, merging parties must show that competition is so great post-merger that the incentive to further increase market share by passing along the cost savings will dominate any *presumed* incentive to raise prices.

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