ECONOMISTS INCORPORATED

A brief analysis of policy and litigation

ECONOMISTS INK

Winter 1993

ANTITRUST ANALYSIS OF DEFENSE INDUSTRY MERGERS

The collapse of the Soviet Union has led to a sharp decline in defense spending and precipitated consolidation through merger in the defense industry. As a result, both the Department of Justice (DOJ) and the Federal Trade Commission (FTC) have recently been very active in reviewing defense industry mergers.

As with other mergers, the antitrust authorities focus on the effect of a defense industry merger on the price and quality of the products manufactured by the merging parties and their competitors. If, because of sole sourcing, no direct competition exists between the merging parties for current programs, then the agencies focus on the extent to which the firms compete in developing new weapons.

Merging parties face the greatest risk of an antitrust challenge when they compete for one or more current production programs. In *FTC v. Alliant and Olin*, the only two manufacturers of 120 millimeter tank ammunition agreed to merge prior to a winner-take-all competitive bid. The FTC mounted a successful challenge on the grounds that if the firms merged prior to bidding, the Army would be denied the benefits of the competition to become the sole source.

From the viewpoint of the merging parties, it is essential that the Department of Defense (DoD) and the affected military services support the transaction and, if they do, their opinion must be consistent with a procompetitive justification of the merger. In *Alliant*, Army witnesses testified in support of the merger, but the Army as an institution did not take a position. The court cited the lack of institutional support as a "critical fact." The court was not convinced by the testimony of Army witnesses that the Army could protect itself from monopoly pricing. Similarly, both agencies appear to be skeptical about whether regulatory oversight can prevent noncompetitive pricing.

Mergers permit firms to downsize to a cost-effective base by consolidating the remaining production and development programs of the firms at a smaller number of sites. In many cases, mergers will be the only effective way to quickly reduce redundant overhead and achieve other program and development efficiencies. For cost-plus contracts, reductions in overhead costs result in direct savings to DoD. In addition, as the defense industrial base shrinks, it is important to reduce the work force and number of plants in ways that preserve the most valuable know-how and production resources. Arguably, mergers will preserve these resources more effectively than reduction of excess capacity through the eventual exit of the financially weakest firms. In *Alliant*, however, the court appears to have concluded that the benefits from preserving know-how were too speculative to outweigh the likely anticompetitive effects of merger to monopoly.

Defense industry mergers are more likely to pass antitrust review if the merging parties can demonstrate a lack of anticompetitive effects on current production programs. If the parties are actual or potential competitors for future development programs, the presence of several other such competitors and the uncertain funding of the programs can reduce the likelihood of an antitrust concern, especially if there is evidence of substantial efficiency gains. Despite the *Alliant* decision, strong support from DoD, the only U.S. customer, will be very helpful in convincing the agencies and the courts that the efficiencies resulting from the merger are significant.

EI Senior Vice President Philip B. Nelson and Senior Economist John H. Preston provided economic analysis and antitrust advice to the parties involved in General Dynamics' sale of its missile division to Hughes Aircraft and the sale of its jet fighter division to Lockheed.

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EXAGGERATED DAMAGES IN SECURITIES FRAUD LITIGATION

Securities and Exchange Commission Rule 10b-5 enables shareholders to sue corporate agents who disseminate fraudulent information about the firm's business prospects. Insofar as the fraudulent information leads investors to pay too much for the stock, and the stock price falls when the fraud is revealed, shareholders who are left holding the stock are damaged. Typically, damage calculations for this type of securities fraud litigation have been based on the assumption that all shares are equally likely to trade in a given period. This assumption is likely to be wrong in most cases, resulting in exaggerated damage estimates.

Determining total damages in securities fraud cases requires estimating both the damage to each share (the price aspect) and the total number of such shares (the quantity aspect). The damage theories that have arisen in the context of Rule 10b-5 have focused on the price aspect and involve determining the difference between the security's "true" value and its fraud-inflated value at the time of the transaction.

Courts have found that the presence of out-of-pocket damages (the difference between what investors paid for a security and its fraud-free value) depends on two key elements. The first element, known as "reliance," concerns the plaintiffs' reliance on either direct or price-manifested fraudulent information in entering the transaction. The second is that a causal relation must exist between the fraud and the damage. The latter concept has led to extensive use of financial economics to distinguish fraud-related price movements from those unrelated to the fraud.

New standards were set for meeting the "reliance" test following the Supreme Court's 1988 *Basic v. Levinson* decision. It is enormously cumbersome to prove that each of the many shareholders who might make up a shareholder class relied directly on fraudulent information in deciding to buy a security. *Basic* eased the standard of establishing individual reliance by adopting a standard whereby individuals in an efficient market need only prove that they relied on market prices which had themselves incorporated the fraudulent information. By adopting this "fraud-on-the-market" theory of reliance, *Basic* vastly expanded the potential for 10b-5 class action suits.

Unlike individual litigation in which the precise number of damaged shares can be determined from the plaintiff's records, complete trading records for each shareholder are not typically available for large shareholder classes. Consequently, class action litigation requires estimation of the number of affected shares. Stock trading models that provide these estimates use trading volume to infer the number of shares purchased during the fraud interval. In the most common model, the estimates are based on the assumption that all shares are equally likely to trade in any given period. This assumption, however, is highly suspect. If all shares are not equally likely to trade at any time, the model overestimates the number of damaged shares. The degree of error varies depending on several variables including the ratio of volume to tradeable shares and the length of the fraud interval being considered.

Damages can be calculated more accurately by using the limited available trading records to draw inferences regarding the trading frequency of shares for which information is unavailable. In addition, new models can accommodate assumptions other than that of equal share trading probability. These methods have been used successfully and are likely to become increasingly important in securities fraud litigation.

EI Senior Economist Dean Furbush has testified in securities fraud litigation. He and Senior Economist Jeffrey W. Smith have developed new models as part of their research on securities fraud damages.

NEW COMPETITION POLICY IN ARGENTINA

Argentina, like many second- and third-world nations, has recently adopted free market economic policies. Enterprises owned by the state are rapidly being privatized and barriers to trade which had protected domestic industry have been lowered. When the state recedes from direct ownership and control of the microeconomy, as it has in Argentina, demand for competition policy arises.

Argentina entered the 1980s with both an antitrust law and an enforcement agency, neither of which was much utilized. Heavy industry and utilities were largely nationalized, trade barriers were high, and the government printed money at an extraordinary rate, while attempting to control the resulting hyperinflation with a system of price controls. In these circumstances, price competition was rare.

In 1991, President Carlos Menem selected Domingo Cavallo as his economy minister. Cavallo initiated a series of macroeconomic reforms that drastically reduced inflation. With the backing of international lending institutions, Cavallo also embarked on an ambitious series of privatizations and a dramatic program of deregulation. The competition policy concerns accompanying the government's reforms were not addressed by Argentina's current antitrust statute, which is silent with respect to mergers and acquisitions. Accordingly, without revisions in the statute, antitrust concerns could be addressed only on an ad hoc basis within the context of each privatization project.

To deal with this and other problems, the government retained an international advisory team of economists and lawyers to study its competition and consumer protection policies and make recommendations for reforms. The scope of this project, which was funded by the World Bank, included among other topics the regulation of mergers and acquisitions. The team reported with a draft law in August 1992 which is now progressing through Argentina's Congress.

In making recommendations for an Argentine merger law, the team adhered to certain principles. First, the team judged that the relatively small size of the Argentine economy could not justify the luxury of a merger law aimed at deterring incipient threats to price competition, as in the United States. Instead, it suggested that the merger law be aimed at preventing the formation of dominant firms and monopolies. Second, the team recognized the importance of relying on open international trade to ensure that domestic producers felt the force of competitive market discipline. It suggested that competition enforcement authorities be given a voice in trade policy, that they be given a consumer advocate role in anti-dumping proceedings, and that the anti-dumping law itself be amended to require a balancing of the interests of Argentine consumers with that of domestic producers. Third, the team recommended that, while there should be a pre-merger notification procedure, the authorities should be under strict time limitations in reviewing filings, and that the value threshold for reportable transactions should be relatively high.

In addition to a competition law, Argentina needs an enforcement agency that commands public respect if competition is to take root as the primary focus of economic life. Because this could be difficult to accomplish within the traditional Argentine legal system, the team recommended the creation of a new enforcement agency of substantial scope, resources and political independence. The agency, which would be modeled on the highly respected and effective Argentine tax court, would be composed of lawyers and economists, appointed for life.

The Argentine government has taken the critical first steps in liberating the economy from large-scale public ownership. These recommendations provide a solid foundation on which competition can be established in the Argentine economy.

EI President Bruce M. Owen headed a six-man international team of advisors to the Government of Argentina on competition policy. EI Senior Economist David D. Smith was also a member of the team.

IMPACT OF ENERGY POLICY ACT ON ELECTRIC UTILITY MERGERS

The Energy Policy Act of 1992, which promotes competition in wholesale electric power markets, is likely to figure prominently in antitrust analyses of electric utility mergers. While the new law reduces the potential for the exercise of market power in transmission, it does not eliminate competitive concerns that arise from overlaps in transmission between merging utilities. Furthermore, it could increase antitrust problems arising from vertical mergers between regulated monopoly distribution systems and generators that operate in competitive markets.

The principal horizontal competitive issue that has arisen in recent electric utility mergers involves market power in transmission service for wholesale power. The Act allows any electric generator to apply to the Federal Energy Regulatory Commission (FERC) for an order requiring a utility to provide transmission services for wholesale power, including enlargement of transmission capacity to provide such services. By giving FERC this power, the Act imposes limits on the exercise of market power in transmission. However, there is some risk that FERC will assume that its new authority to order transmission service eliminates the need for concern over market power in transmission in the context of mergers.

The Act is also designed to increase competition

SELECTED EI CASES IN 1992

McNeil v. National Football League: EI President Bruce M. Owen testified regarding damages on behalf of the NFL. The case, which was litigated for the NFL by Covington & Burling and Skadden, Arps, Slate, Meagher & Flom, concerned whether the NFL's Plan B rules were too strict in limiting movement of players among teams. Trebled damages of $1.6 million were awarded, substantially less than the $12 million claimed.

Light Bulb Merger: EI Principal Peter R. Greenhalgh and economists Paul E. Godek and Kent W Mikkelsen analyzed the competitive effects of Osram's proposed acquisition of GTE's Sylvania Division. DOJ ultimately approved the transaction. Sylvania was represented by O'Melveny & Myers, Osram by Shearman & Sterling.

New York v. Anheuser-Busch: Testimony by EI Principal William C. Myslinski, who worked with EI economist John H. Preston and Howrey & Simon, persuaded the court that Anheuser-Busch's exclusive distribution territories in New York state were not anticompetitive.

U.S. v. Charles H. Keating, Jr. and Charles H. Keating III: EI economist Dean Furbush was a trial consultant to the government in this S&L case. He analyzed several fraudulent transactions and critiqued defendants' use of option pricing theory. The defendants were convicted on all counts.

Missile and Jet Fighter Mergers: EI economists Philip B. Nelson and John H. Preston analyzed General Dynamics' proposed sale of its missile division to Hughes Aircraft and its jet fighter division to Lockheed. Following written and oral submissions, the antitrust agencies closed their investigations. General Dynamics was represented by Hogan & Hartson, Hughes by Weil, Gotshal & Manges, and Lockheed by O'Melveny & Myers.

Banking Merger: EI economist Bruce R. Snapp worked with Jones, Day, Reavis & Pogue on behalf of Ameritrust in its acquisition by Society. DOJ approved the merger contingent on the divestiture of enough bank branches, deposits, and loans to enable the buyer to have an effective network to reach small business borrowers.

in the generation and supply of wholesale power. It facilitates entry by non-rate-base generators by defining a new category of "exempt wholesale generators," which generally must be exclusively in the business of generating electric power for sale at wholesale. Presumably, this will reduce the cost of long-term bulk power, and thus be procompetitive. However, antitrust analyses have seldom found that concentration in generation is an important competitive problem.

The principal vertical competitive issues that have arisen in recent electric utility mergers relate to evasion of retail rate regulation and foreclosure of competition in generation. The Act increases the potential for evasion of cost-based retail rate regulation, and thus the exercise of market power, by providing an opportunity for utilities with regulated monopoly distribution systems to increase their ownership of unregulated, competitive generation. A utility could raise its retail rates because paying an inflated price to its affiliates increases its costs. Furthermore, the utility could foreclose competition by purchasing power from unregulated generating affiliates instead of lower-cost independent suppliers.

A utility can purchase power from an affiliated exempt wholesale generator if each state public utility commission with jurisdiction over the utility's retail rates determines that it has the authority and resources to prevent foreclosure of competition and that the transaction would benefit consumers. This opens the way for more attempted evasion of regulation through affiliate transactions, as well as foreclosure of competition from non-affiliated generating facilities with lower costs.

Just how successful the Act will be in reducing the exercise of market power in transmission and otherwise increasing the efficiency of generation and transmission will depend on how FERC implements the new law. The central issues include how FERC will regulate transmission pricing, how expansions of transmission systems will be made to accommodate service for others, and the extent to which FERC is concerned about utility mergers increasing the evasion of retail rate regulation.

EI Senior Economist Mark W. Frankena testified on the merger of Northeast Utilities and Public Service of New Hampshire, and on the pending merger of Entergy and Gulf States Utilities. EI President Bruce M. Owen testified on the proposed merger of Southern California Edison and San Diego Gas & Electric. A more detailed discussion of this topic appears in International Merger Law, *February 1993.*