Leveling the Playing Field in Antitrust Merger Litigation: The *Sungard* Decision

By **J. Mark Gidley** and **David A. Balto**

Merger enforcement is unlike many other aspects of government enforcement. Very few cases are litigated, and the vast majority of mergers are resolved either through consent decrees or when the parties "throw in the towel" in face of government opposition. The reality is that mergers are fragile agreements and the time and cost of government investigations can often derail a well-planned merger. Many mergers collapse based on the mere threat that the Department of Justice ("DOJ") or the Federal Trade Commission may sue to enjoin the merger. Few parties possess the will or resources to fully litigate and defend a merger in the face of government opposition.

A notable recent exception was the acquisition of Comdisco by SunGard Data Systems ("SunGard"), two firms in the computer disaster recovery market, in which SunGard successfully defeated the DOJ's attempt to enjoin the merger. SunGard's victory reversed an 8-year unbroken record of success by the government in the Federal Court in D.C.—the agencies' "home court." The challenge to SunGard was more daunting than most government enforcement actions because Comdisco was in bankruptcy court and there was a competing bid from Hewlett-Packard. By prevailing, SunGard demonstrated that mergers can be effectively defended and resolved within a short period. Ultimately, the substantive and procedural precedents of the litigation will level the playing field and enable more effective defense of mergers.

Procedurally, the case posed an Olympic obstacle course. SunGard had to fight a two-front battle—in bankruptcy court (in Chicago) and district court (in Washington, DC)—to overcome bankruptcy and antitrust challenges. Due to the timing of the bankruptcy process, both challenges had to be resolved in less than a month. The merger case went from complaint to trial in just over two weeks, by far the shortest trial period in U.S. merger litigation history. The parties were under a terrific burden to provide evidence and focus the litigation. As Magistrate Facciola stated in ruling on a protective order issue in the merger case: "This lawsuit is on a track to trial which can only be described as heroic. Next to it the renowned 'rocket docket' is a slow moving train."[1]

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Substantively, the litigation posed significant hurdles to SunGard. There were some consumers that believed they had relatively few choices in disaster recovery services and the DOJ amassed an impressive set of customer complaints about the acquisition. Some customers suggested that they played SunGard and Comdisco off each other in order to secure lower prices. By demonstrating the ability of consumers to perform disaster recovery internally and focusing on the dynamic nature of the market, SunGard was able to convince the court that the merger was unlikely to harm consumers. The court's decision provides important guidance about merger analysis in high tech markets, especially the need to carefully gauge the alternatives that consumers possess in a dynamic fast-changing marketplace.

The Case

Computers are the lifeblood of the business world and all firms have some form of planning for the possibility that a disaster might destroy or disable their computer systems. There are numerous forms of disaster recovery, which vary in terms of cost and speed of recovery. One form of disaster recovery is shared hotsite services—a single remote facility where several firms perform disaster recovery. DOJ alleged that SunGard and Comdisco were the two largest providers of shared hotsite services with a combined market share exceeding 70%.

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Although its shared hotsite service business was profitable, Comdisco filed for Chapter 11 bankruptcy protection in July 2001. The bankruptcy court ordered Comdisco's assets sold at auction. Comdisco's first suitor was Hewlett-Packard, which agreed to purchase substantially all the assets of Comdisco's disaster recovery business for about $610 million. SunGard responded with a bid of $825 million and HP returned with a bid of $700 million. HP argued that its lower bid was preferable because of the antitrust concerns raised by a SunGard acquisition (and DOJ had not raised any concerns over an acquisition by HP). On October 22, just before the bankruptcy court could have approved the SunGard bid, the DOJ weighed in, suing in Washington to block SunGard's acquisition.

Due to significant operational deadlines, the defendants had to secure a decision by mid-November. SunGard succeeded in convincing the court to agree to an expedited discovery and briefing schedule and a unified permanent injunction trial—a crucial victory. After less than two weeks of discovery, the court held a 10-hour evidentiary hearing on November 8, oral argument on November 9, and issued its decision on November 14. Although the discovery period was unusually brief, the court was presented with thousands of pages of documents, hundreds of trial exhibits, scores of affidavits, and the live testimony of three expert witnesses. The court issued a detailed 36-page decision that contained a comprehensive analysis of merger law and the competitive dynamics of the disaster recovery marketplace.[2]

Among numerous disputes in the litigation,[3] the decision hinged on two central issues: (1) whether shared hotsite services for mid-range and mainframe computers was a relevant product market and (2) whether the merger would adversely affect a substantial portion of consumers.

The Relevant Product Market Includes More than Shared Hotsite Services

There are numerous types of services that businesses use to deal with the risk that their computer systems might become unavailable due to disaster. They include: (1) shared hotsite services—large remote facilities with sophisticated computer and communication facilities; (2) internal hotsites—off-site locations owned by the company itself; (3) quick-ship services, in which computer equipment is sent to locations designated by the customer within a specified period; (3) coldsites, or computer-ready facilities that lack computer hardware; (4) work area recovery—mobile or fixed-location facilities that allow employees to continue basic business operations in the event of disaster; and (5) mobile hotsite recovery—trailers configured for use as small data centers. Each of these services varies in cost and the time necessary to recover the computer system.

The DOJ alleged that the relevant market was "the provision of shared hotsite services for customers with mainframe and midrange computer processing centers." Shared hotsite services are provided at remote facilities that have a wide variety of computer mainframes and servers and communication facilities needed for a company to recover business applications when its own data center becomes unavailable. Recovery times range from 24 hours to 96 hours after a customer produces a back-up tape, which is kept at a third location. Since multiple clients share hotsites, they enable customers to share the costs of disaster recovery.

Ultimately, the relevant market question turned on where to appropriately limit the market and what other forms of disaster recovery were effectively in that market. The court ultimately found that the DOJ did not meet its burden of establishing that the relevant product market was limited to shared hotsite services for mainframe and mid-range computer processing centers.

The two critical factors in this finding were the dynamic nature of the market and diversity of customers. The court observed that the market included an

> extremely heterogeneous group of customers, particularly in terms of their needs and computer equipment. Given the rapid changes in computer capabilities and the reduced cost of both hardware and communications, the evidence does not permit the exclusion of either internal hotsites or quick-ship services from any market that includes shared hotsites.[4]

Simply, it was difficult for the court, based on the evidence before it, to determine that there was a clear group of customers for whom internal or quick-ship services were not a viable alternative in response to a price increase for shared hotsite services.

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The court's analysis about relevant product market follows the typical Merger Guidelines analysis. "Defining a relevant product market is primarily a process of describing those groups of producers which, because of the similarity of their products, have the ability — actual or potential — to take significant amounts of business away from each other."[5] SunGard suggested that the market included a wide range of potential products, including coldsites, work area recovery, mobile recovery, high availability and quick-ship services and internal use. Each of these services provided a different set of costs and benefits, both in terms of the time of recovery and the cost of the product. The court applied the traditional Guidelines analysis and excluded coldsites, work area recovery, mobile recovery and high availability, because they did not offer the necessary recovery time needed by most consumers.

The critical linchpin to the case was whether enough customers could switch to internal hotsites in response to a price increase in shared hotsite services.

However, when it came to quick-ship services and internal solutions, the DOJ was unable to exclude these products from the relevant market. "Quick-ship services" provide that in case of a disaster, a provider would overnight-ship some type of mainframe or midrange system. There was evidence that this was a realistic option for some consumers and accounted for a significant amount of business for both firms. In addition, "the record demonstrates that quick-ship service is a viable substitute for a shared hotsite for at least some customers with midrange systems, and as noted, midrange systems compose a substantial segment of the DOJ's proposed product market, both in terms of revenue and numbers of customers."[6]

The critical linchpin to the case was whether enough customers could switch to internal hotsites in response to a price increase in shared hotsite services. SunGard faced a tough challenge on this issue: although "internal use" or "captive consumption" is often raised as a defense in merger cases, it had never been used successfully to derail a merger challenge. Most recently, in enjoining a merger of drug wholesalers, the same court rejected internal use as a competitive constraint even though most pharmacy chains performed their own wholesaling services.[7]

Ultimately, DOJ's legal and factual arguments were insufficient to exclude internal use. In terms of the law, the DOJ argued that internal hotsites should be included only to the extent that such internal use was a potential competitor in the commercial shared hotsite service market. In other words, internal use would be in the market only if a firm actually sold disaster recovery services. The DOJ's argument, however, was inconsistent with the law and the Merger Guidelines, which state that captive production can be considered, to the extent that "such an inclusion reflects [its] competitive significance in the relevant market prior to merger." Merger Guidelines § 1.31.[8] As the court observed: "[W]hat is significant is not whether the companies that currently use internal solutions have the capability to enter the market as vendors for others, but whether the customers that currently use shared hotsites would switch to an internal hotsite in response to a [small but significant increase in price]."[9]

For factual support, the DOJ relied on the testimony of Comdisco executives, declarations from Comdisco customers and a SunGard document that suggested that "high availablity" internal use was 5-15 times more expensive than shared hotsite services. Moreover, only a small handful of customers (perhaps 1% a year) were lost to internal use each year. The court found the evidence inconclusive because of the wide ranging needs of consumers. The court recognized that "any generalizations about consumer behavior cannot be arrived at with any certainty."[10] Moreover, the evidence here was equivocal and there was scant data about the relative costs between using a shared hotsite and going internal.

SunGard responded with an even more impressive and ultimately persuasive set of facts to demonstrate that internal use was a "practical alternative." First, both SunGard and Comdisco's internal documents indicated that their "primary competitor" across all product lines was the internal data recovery solution. SunGard used both a government exhibit and an HP document to demonstrate that internal use was the dominant competitive threat from the view of disaster recovery rivals. Second, industry studies showed

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that internal use was a significant part of the market. Third, and perhaps most importantly, SunGard's and Comdisco's lost sales reports demonstrated that they lost more customers to internal solutions each year than to all other competitors combined. Thus, the court concluded that although the DOJ attempted to "classify the product market as an oligopoly that the proposed acquisition would shrink to a duopoly, the record leaves little doubt that SunGard and Comdisco consider internal solutions, including internal hotsites as their main competitive threat. There is increasing evidence that their perception is fully justified in view of the decreasing cost and changing nature of the technology."[11]

With internal use in the market, the market shares of the competitors dropped dramatically. The defendants' documents estimated that internal use accounted for 50% to 70% of the entire market for disaster recovery services, so that post-merger, SunGard's market share would be far smaller.

Substantial Adverse Harm Was Not Shown

The second central dispute was whether there was a significant group of customers who would be adversely affected by the merger: whether "a hypothetical monopolist could ***profitably*** raise price."[12] Such an inquiry centers on whether there were a significant number of customers that will not switch to an alternative product in response to a price increase. Courts often struggle with whether there are a substantial number of customers adversely affected by a merger, even though there is no clear guidance on what constitutes a "substantial group" of consumers.

In ***Cardinal Health***, which involved two mergers of the four largest drug wholesalers, for example, there were a large number of pharmaceutical chains that could turn to internal use as an alternative, but the majority of the drug wholesalers' customers relied extensively on wholesaling services.[13] This group of inelastic customers was sufficiently large to lead the court to enjoin the merger. Similarly, in ***Owens-Illinois***, which involved the merger of two glass manufacturers, the court found that only 25% of the potential customers of glass jars who could be adversely affected by the merger had relatively few alternatives.[14] However, such a set of potentially harmed customers was too small to enjoin the merger. As the court observed: "those few end-use segments [that] proved to be inelastic are not significant enough, in and of themselves, to constitute a relevant product market and are not representative of the glass container market as a whole."[15]

In ***SunGard***, the court received a significant number of affidavits from both the DOJ and the Defendants about internal use as an alternative to shared hotsite services. Frequently, customer testimony is the linchpin to the government's challenge and in this case the DOJ produced statements from customers suggesting they could not switch to an internal alternative in response to a price increase. In return, SunGard produced over 90 customer statements suggesting they could use internal recovery as an alternative. The court found this battle of customer statements inconclusive.[16]

Although the DOJ's evidence allowed the court to surmise that there are some customers that could not switch to an internal solution in response to a significant price increase, it did not "show [that] this captive group is substantial enough that a hypothetical monopolist would find it profitable to impose such an increase in price."[17] The court noted that the sampling of customer statements was minuscule when compared to the entire universe of shared hotsite customers, nor did the record indicate whether the customers cited by the DOJ were "representative of the entire universe of shared hotsite customers, especially given the differences among customers in terms of their size, the equipment that they use, and their business needs . . . instead of fine-tuning its presentation to account for significant differences among Defendant's customers, the DOJ lumped all customers together."[18] Thus, the court was unable to determine "with any degree of certainty" that the customers who claimed they had no alternatives were "representative of shared hotsite customers in terms of their business structure."[19]

Lessons Learned

Process and Bankruptcy

Numerous merger investigations involve bankrupt firms, which is not surprising because the likely acquirer of bankrupt assets is often a competitor in the same market. On rare occasions these mergers can be approved under the "failing firm" doctrine where there is no likelihood that the firm can be successfully reorganized and

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there is no less anticompetitive bidder.[20] The failing firm doctrine can be used only in extraordinary cases where it is unambiguous the firm will fail and there is no less anticompetitive bidder. The failing firm doctrine arguably was not applicable in this case, because of the presence of the HP bid.

Typically, due to the short time period of bankruptcy, once the government raises competitive concerns about an acquisition by a rival, the parties reject the bid. Often the government can handicap or derail such a bid simply by voicing "concerns." For example, in 1991, the DOJ derailed a bid by United Airlines to acquire assets of Eastern Airlines by merely threatening to sue to enjoin the acquisition. In other cases, less concrete government concerns have effectively killed acquisitions. Prior to ***SunGard***, no acquirer ever fought the government's opposition because time was the government's greatest ally: the parties assumed it was impossible to resolve the case in a timely fashion (merger cases typically take 4-6 months to litigate). Simply, the government typically can prevail simply by suggesting there could be competitive concerns.

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The ***SunGard*** case is the first time that a competitor-bidder has been willing to litigate in this setting where the government holds almost all the cards. By convincing the court to expedite the discovery and trial, SunGard effectively began to level the playing field with the government. The trial demonstrated that even sophisticated substantive issues can be litigated and tried within a very short period. This should be an important precedent for competitors seeking to acquire assets in bankruptcy. Hence, when competitive concerns are raised by the antitrust agencies, competitors can attempt to litigate the merits in federal court, using the ***SunGard*** decision to secure an expedited schedule. In addition, the government will recognize that a challenge to an acquisition in bankruptcy will require an exceedingly short litigation schedule, complicating the government's efforts to enjoin a merger.

This is a welcome development from the perspective of the bankrupt company (and its employees), creditors and consumers. Under the current environment competitor buyers are put at a significant disadvantage. That may be unfortunate since a competitor often has the expertise, knowledge and resources to put the bankrupt firm's resources to its greatest use and value. It may be able to restore the competitive vigor of the bankrupt firm and achieve important efficiencies in the market. Moreover, a competitor may be able to offer the highest bid for the bankrupt estate.

Dynamic Nature of the Market

In high-tech cases, market definition can be a particularly daunting task due to rapidly evolving technology. As the D.C. Circuit observed in Microsoft, "Rapid technological change leads to markets in which firms compete through innovation for temporary market dominance, from which they may be displaced by the next wave of product advancements."[21] The antitrust agencies must not only determine the alternatives that consumers have, but how those alternatives will change as technology evolves within the market.

The changing dynamic character of the market was a key issue in the SunGard case. SunGard succeeded in demonstrating that the traditional hotsite market was under assault from a variety of new technological alternatives. In particular, improvements in technology and decreases in hardware costs made internal hotsites an increasingly viable alternative.[22] The DOJ, however, took a relatively static view of the market. It focused on a single niche in the market, and failed to give sufficient consideration to the nature of the evolving market. Although shared hotsite solutions were an important part of the market, this market was changing dramatically given the changes in telecommunications costs and the increasing need for almost instant disaster recovery. Both Comdisco and SunGard had lost increasing segments of their business to these more immediate forms of recovery, a marketplace in which SunGard in particular was only a minor participant. The court recognized the importance of the DOJ's failure to take a more dynamic view noting that: "in light of the decreasing costs of equipment in telecommunications and the rapidly evolving computer technology, the court cannot accept the DOJ's overly narrow and static definition of the product market."[23]

This is an important precedent for future high-tech mergers. The SunGard case involved a relatively stable technology that was well-recog-

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nized and used by thousands of consumers. Nevertheless, the potential for new technological alternatives to transform the market was a critical factor. Such a finding will likely be a hotly litigated issue in future high-tech mergers.

The Law on Internal Use

In many markets, consumers face make or buy decisions. The antitrust agencies tend to be skeptical about whether these "internal" alternatives can serve as a competitive constraint, especially since "going internal" can often be far more expensive than simply purchasing a service. In ***SunGard***, the price difference between purchasing hotsite services, and establishing an internal hotsite, seemed to be the critical factor from the perception of DOJ.

The court critically examined went beyond this cost difference and provided important guidance on the analysis of internal use in competitive markets. The DOJ strayed from the law and from the Merger Guidelines in suggesting that internal disaster recovery was only a factor if it was in the merchant market. The court properly followed the legal precedent by taking a broader view of the potential impact of internal use. The price difference was not dispositive since many customers already did some disaster recovery on their own and the large number of used computers available in the aftermarket. Moreover, even if only a small percentage of customers actually switched to internal use, SunGard was able to persuade the court it was a potent weapon since customers could use the threat of going internal as a competitive restraint.

Conclusion

Ultimately, the ***SunGard*** litigation may dispel some firmly rooted notions about merger litigation: that it is impossible to secure a timely decision, that government-generated customer affidavits are dispositive, or that bad internal documents will be fatal. Each of these obstacles was present in this case, along with an alternative bidder supporting the government's case. Yet by focusing on the dynamic aspects of the market, supported by actual lost sales data, SunGard was able to demonstrate that the merger would not harm consumers. The most critical precedent of the case, however, may be that a complex merger trial was effectively litigated within a remarkably short period. This precedent should begin to give defendants a greater opportunity to effectively defend and resolve mergers through litigation and ultimately begin to level the playing field in merger litigation.

Notes

1 *United States v. SunGard Data Systems, Inc.*, (Civ. No. 01-2196 (ESH)) 2001 WL 1335090, at *1 (D.D.C. Oct. 30, 2001).

2 *United States v. SunGard Data Systems, Inc.*, (Civ. No. 01-02196 (ESH)) 2001 WL 1474734 (D.D.C. Nov. 14, 2001), also available at http://www.dcd.uscourts.gov/01-2196a.pdf.

3 Besides the relevant market and competitive effects arguments described in this article SunGard raised several other defenses, including the arguments that: 1) entry barriers were not substantial and 2) buyers were sophisticated and could protect themselves against any price increases. The court did not address these issues.

4 *Id.* at 17.

5 *United States v. Engelhard Corporation*, 126 F. 3d. 1302, 1305 (11th Cir. 1997).

6 *SunGard*, slip op. at 22.

7 *FTC v. Cardinal Health, Inc.*, 12 F.Supp.2d 34 (D.D.C. 1998)(the Court rejected internal use because it was not a viable alternative for two sets of customers: independent pharmacies and health care buying groups).

8 For cases approving inclusion of captive or internal solutions in the market, see, for example, *United States v. ALCOA*, 148 F.2d 416, 424 (2d Cir. 1945); *Reazin v. Blue Cross & Blue Shield*, 899 F.2d 951, 959 n.10 (10th Cir.) (private health care financing market included "self-insurance"), *cert. denied*, 497 U.S. 1005 (1990); *Spectrofuge Corp. v. Beckman Instruments, Inc.*, 575 F.2d 256, 278 (5th Cir. 1978) ("independent service organizations compete for contract and call-by-call emergency work within a market where in-house service personnel provide the consumer with a reasonably interchangeable substitute"); *see also* IIA Areeda *Antitrust Law* § 535e, at 193 (1995) (discussing captive output).

9 *SunGard*, slip op. at 25.

10 *Id.* at 29.

11 *Id.* at 27-28.

12 Merger Guidelines § 1.11.

13 *FTC v. Cardinal Health, Inc.*, 12 F.Supp.2d 34, 48-49 (D.D.C. 1998).

14 *FTC v. Owens-Illinois*, 681 F. Supp. 27, 37-38 (D.D.C. 1988).

15 *Id.*

16 "[A]lthough both Parties have submitted numerous declarations and letters to bolster their respective positions, these exhibits do not allow any reasonable conclusion as to whether a substantial number of shared hotsite customers would switch to a substitute disaster recovery service in response to a [significant price increase]." Slip Op. at 32.

17 *Id.* at 33.

18 *Id.* at 34.

19 *Id.*

20 Merger Guidelines § 5.0.

21 *See United States v. Microsoft Corp.*, 253 F.3d 34, 49 (D.C. Cir. 2001)(internal quotations omitted).

22 *SunGard*, slip op. at 28.

23 *Id.* at 35.

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