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The "Bleak House" of Merger Enforcement: Obstacles to Future DOJ Oversight of Mergers After *Oracle/ PeopleSoft*

By **David Balto**

The landmark decision of *United States v. Oracle* rejected the Antitrust Division of the Department of Justice's (DOJ) efforts to regulate the merger of two major competitors in the enterprise resource planning software market: Oracle and PeopleSoft. The Court's carefully reasoned 160-page opinion followed the most extensively litigated merger case in recent history. The ultimate result of the decision will make it far more difficult for the government to prevail in cases involving narrow markets, even when supported by substantial customer testimony. Simply, for many cases, especially in high tech markets, although merger enforcement may be supported by great expectations, the ultimate results will be unsatisfying.[1]

Merger enforcement is typically a regulatory process. The vast majority of mergers receive little or no scrutiny by the antitrust enforcement agencies (the Antitrust Division of the Department of Justice and the Federal Trade Commission). In some small percentage of cases, the agencies conduct extensive investigations; the majority of those investigations end with the parties entering into a settlement with the agencies and restructuring the transaction to resolve competitive concerns.

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For years, the courts have played a modest role in the enforcement of the merger antitrust laws. In part, the substantial costs of litigating a merger case promoted settlement prior to trial. Litigated merger cases typically take at least three to six months to resolve and often cost defendants as much as $20 million in legal and expert fees, including those expenses incurred in both the merger investigation and those through trial. Most important, merger litigation puts the business of the merging companies on hold, diminishing their ability to conduct normal operations during the course of the litigation. Thus, companies traditionally have been willing to litigate only when the merger is essential to the success of the acquiring firm.

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Enforcement agencies also have been reluctant to litigate. Prior to the enactment of the Hart-Scott-Rodino Act, the agencies could only win relief in merger cases through litigation. The HSR Act created a regulatory system in which the government could achieve a great deal of relief through the consent order process rather than through litigation. Not surprisingly, as a result of the enactment of the HSR Act and the increasing costs of litigation, the agencies and merging parties go to court and actually litigate merger cases less than once a year. In most cases, the ability to obtain relief through the regulatory process is sufficient to meet the agencies' competitive objectives.

That certainly was the case for almost all software mergers. Since the enactment of the 1992 Horizontal Merger Guidelines, the Antitrust Division of the Department of Justice and the Federal Trade Commission had brought more than 10 cases challenging software mergers and all of these matters were resolved without litigation. In fact, the only "precedents" that existed for analyzing software mergers were a series of complaints and consent decrees. From this blank slate of regulatory actions, it appeared that the agencies had a wide degree of discretion to challenge mergers under a variety of theories not necessarily wholly consistent in the eyes of some.[2] If there was a unifying theme of these cases, it was that the Agencies tended to define very narrow markets, based on unique competition between the merging parties (i.e., in antitrust parlance, known as the "unilateral effects theory"), supported by complaints from some customers who thought the merger would lead to higher prices. This regulatory blank slate gave the agencies almost unbridled discretion to bring cases.

The Oracle decision sends a loud signal that the DOJ will have to sharpen its collective saw before litigating to enjoin a proposed merger in the future.

Then along comes a case like the Justice Department's challenge to Oracle's hostile bid to acquire PeopleSoft.[3] This situation turns this staid regulatory framework on its head. The DOJ had great expectations for success based on significant evidence of each of the traditional elements in its regulatory approach. The DOJ presented scores of customer witnesses with substantial experience in the markets in which Oracle and PeopleSoft competed, introduced volumes of exhibits, and put forth very distinguished experts. Even though the Department appeared to have a "full house," the defendants and Judge Vaughn Walker of the Federal District Court in San Francisco found the DOJ's poker hand far less than compelling.

Background

Oracle and PeopleSoft developed, produced, marketed and serviced a variety of software products. At issue in this case was Enterprise Resource Planning ("ERP") software, which integrates most entities' data across a wide range of activities. The Justice Department suit focused on two segments of these ERP products: Human Relationship Management ("HRM") and Financial Management Systems ("FMS").

The DOJ's fundamental claim was that PeopleSoft and Oracle were two of just three significant competitors (the other is SAP, A.G.) in these two segments, and the merger would raise the risk of significantly diminishing competition by eliminating head-to-head competition between PeopleSoft and Oracle.

In addition to Oracle and PeopleSoft, other actual or potential vendors in the two market segments asserted by the DOJ included SAP; Lawson Software, headquartered in St. Paul, Minnesota; AMS, headquartered in Montreal; and most prominently, Redmond, Wash.-based Microsoft and its Microsoft Business Solutions ("MBS"). Other, smaller entities, known as best-of-breed vendors, specialize solely in providing

As to a determination of SAP's strength in the market, once again, customer testimony was the linchpin of the DOJ's case. When five customers testified that they had eliminated SAP from final consideration in the bid process, the Court dismissed their "self-interested" testimony.[12] First, the Court observed that "[d]rawing generalized conclusions about an extremely heterogeneous customer testimony based upon testimony from a small sample is not only unreliable, it is nearly impossible."[13] Second, the Court felt the testimony was inconsistent with what was actually happening in the market as demonstrated by SAP's significant market share.

Customer complaints are almost invariably the linchpin of challenges by the antitrust agencies to mergers.

The Justice Department's economic testimony was no more persuasive to the Court. The government economists analyzed discount forms and performed a merger simulation to suggest significant competition between PeopleSoft and Oracle. But this evidence also suggested that SAP was actually a competitive restraint. The Court observed: "Simply because Oracle and PeopleSoft often meet in the battlefield and fight aggressively does not lead to the conclusion that they do so in the absence of SAP."[14] Moreover, the Court found that "the plaintiffs evidence was devoid of any thorough econometrics analysis"[15] that would typically be found in a unilateral effects case.

Four Observations About the Decision

1. *The rejection of customer complaints.* Customer complaints are almost invariably the linchpin of challenges by the antitrust agencies to mergers. In fact, FTC and DOJ studies have found that the existence of customer complaints is the most significant factor leading to challenges to proposed mergers. The Court's rejection of customer complaints was quite striking because of the significant number of complaining customers, the breadth of customers involved, and their technical sophistication. Not only did the Court call their opinions speculative and unsubstantiated, it also stated that the customers exhibited preferences, rather than a hardcore, demonstrable ability to switch to lower-tier vendors. This rejection of customer testimony likely will have a profound impact on future antitrust cases. First, it will be substantially more difficult for the enforcement agencies to challenge and successfully litigate against a wide variety of mergers; second, since each of the customers involved in this litigation expended substantial resources in order to join the Department of Justice's battle, similarly situated customers may be reluctant to engage in this type of endeavor in the future. Customer objections must be based on the strongest possible empirical foundation.
2. *The importance of internal documents.* Other successful merger challenges brought by the enforcement agencies relied in strong part on the company's internal documents, which projected their ability to increase prices or engage in other types of anticompetitive, post-merger activity. In this case, there were no such documents. Instead, the Court pointed to conflicting PeopleSoft documents relating to market definition, for example, that defined the markets in different terminology than that used by the government in making its *prima facie* case. In addition, the Court suggested that the parties would need to demonstrate the econometric significance of documents. Thus, according to the court, discount documents showing that PeopleSoft and Oracle competed closely against each other, were only significant if other documents tended to prove, for example, that PeopleSoft and other competitors, most notably SAP, were not such close competitors.
3. *The dubious future of unilateral effects analysis.* Twelve years ago, the antitrust agencies revised their Horizontal Merger Guidelines. The revisions were seen as a landmark event, attempting to infuse a great deal more analytical rigor into the evaluation of mergers. One of the Merger Guidelines' innovations was the articulation of a unilateral effects analysis—a description of the situations in which the merged firm might unilaterally act anticompetitively. The theory became the subject of dozens of legal and economic articles and several consent decrees. But the theory had rarely been litigated. The Court was clearly concerned that unilateral effects analysis had not been tested through the crucible of antitrust litigation, and that the analytical underpinnings to the doctrine had not been significantly analyzed in the rigorous environment of a real world case. The Court certainly gave the parties sufficient opportunity to argue their points on the unilateral effects doctrine and the decision pointed out the very narrow basis for that limited doctrine. Whether the unilateral effects doctrine will continue to exist as a vibrant foundation for future merger enforcement is yet to be seen. Perhaps the two failings in the Justice Department's case were the lack of

McDonald's, and Johnson & Johnson. According to the Court, the Justice Department's case failed to explain why Lawson's ability to capture the business of large enterprises did not make them a competitive alternative to SAP, Oracle and PeopleSoft. The Court concluded that evidence presented by Oracle demonstrated that Lawson should not be dismissed so quickly as a non-factor in the market, incapable of competing with the likes of the Big Three firms.

The Court's rejection of customer complaints was quite striking because of the significant number of complaining customers, the breadth of customers involved, and their technical sophistication.

To buttress the testimony of its customers, the DOJ used the testimony of a Harvard business school professor to identify the metes and bounds of the relevant market. Professor Marco Iansiti testified that only the products of Oracle, PeopleSoft and SAP could meet the needs of large and complex enterprises. Judge Walker declined to follow this analysis, concluding that the expert had failed to identify a "clear line of demarcation" to distinguish between high-level and mid-market needs.[9] The DOJ's economist, the well-regarded Professor Kenneth Elzinga, also testified that the relevant product market consisted solely of high-function HRM and FMS software.[10] The Court was not persuaded by Professor Elzinga's testimony because he did not quantify how the high-level HRM and FMS software differed from the mid-market alternatives.

Probably the most dramatic part of the decision was the treatment of the testimony of Microsoft executives. Oracle sought to use Microsoft as the 800-pound gorilla ready to discipline any anticompetitive conduct in the market. Microsoft and its business plans became central to the case after the software giant's secret merger talks with SAP came to light. Oracle argued that the talks proved Microsoft intended to compete more aggressively in the enterprise applications market. Microsoft Senior Vice President, Doug Burgum, a key government witness, testified about the company's diminished aspirations in the wake of abandoned SAP negotiations. Judge Walker did not find Mr. Burgum's testimony to be credible. "The court accords little weight to Burgum's testimony attempting to prove Microsoft's absence from the so-called high-function (business applications) business market. Burgum's Uriah Heep-like humility about Microsoft's intentions regarding the failed SAP alliance," according to Judge Walker, was unconvincing. The Court noted that "[i]t strains credulity to believe that Microsoft would offer millions of dollars to acquire SAP merely to make data processing easier for customers who use both Microsoft office and SAP."[11]

The Justice Department, through its expert, Professor Elzinga, defined the geographic market as being limited to the United States. In another ironic moment, the DOJ did not rely on the well-regarded Elzinga-Hogarty Test, co-developed by Professor Elzinga, which evaluates exports and imports to determine the geographic scope of the relevant market. The Court concluded that the geographic market proposed by Professor Elzinga was too limited because there was substantial potential competition from other worldwide sources, including the German-based competitor, SAP, the worldwide ERP market leader.

The Court then focused its decision on the issue of competitive effects. The DOJ based its case on a unilateral effects theory, much like any other previous DOJ high-tech and software case. Judge Walker was clearly perplexed about the unilateral effects theory throughout the trial. In a separate order to the parties after the trial, Judge Walker asked the parties to provide information about the unilateral effects test, noting that it had not been tested by the "crucible" of litigation. In response, the Department of Justice simply reiterated cases they had already cited to the Court. Their efforts did not assuage the Court's concerns. In approximately 30 pages of the decision (which often resembled a law and economics dissertation), the Court reviewed at length the law and economics of unilateral effects to provide some type of foundation to the unilateral effects analysis.

The centerpiece to the DOJ's unilateral effects theory was that Oracle and PeopleSoft competed in a localized competition sphere (a "node") within the high-function FMS and HRM market. The Department suggested that this node only included the merged firms, but the Court thought the relevant market was defined too narrowly. One critical piece of evidence for the DOJ was an analysis of companies that captured business from Oracle. The Justice Department referred to this analysis to argue that PeopleSoft was the most significant competitive constraint on Oracle. The Court found that—in some quarters—SAP was almost as significant a competitive constraint as Oracle. Second, the DOJ tried to suggest that SAP was an expensive and less agile rival, but Oracle demonstrated that SAP had a market share as significant or higher than its rivals (in FMS, SAP was the largest firm with a 39% market share; and in HRM, it was second with a 29% market share).

HRM or FMS products normally included in bundled software. Companies also can outsource HRM or FMS functions by hiring another company to perform them.

Merger analysis primarily focuses on three issues. First, what is the relevant product and geographic market affected by the merger ("market definition")? Second, will the merger enable the remaining firms to act in an anticompetitive way ("the competitive effects story")? Third, will the anticompetitive effects be offset either by easy entry of other companies into this sphere or significant efficiencies from the transaction?

In numerous respects the decision will make future antitrust enforcement in the software market and other high-tech markets more difficult, as well as make it substantially more difficult for the government to litigate merger cases effectively.

The antitrust laws seek to protect consumers from unwarranted price increases so the relevant market question focuses on the alternatives open to various groups of consumers. The agencies look for groups of consumers and ask each group what alternatives to the merging parties it would have if prices were to increase significantly (typically 5% to 10%.) over an indefinite period of time. If there are close alternatives, those products are included in the relevant market. If consumers have relatively few close substitutes and would have to accept a price increase, economists consider those customers to be inelastic. The ultimate inquiry in determining the contours of a product market and whether customers in such a product market would be harmed by a merger is whether there is a sufficiently large group of inelastic customers to make a post-merger price increase profitable to the merging parties.

All of agency's recent software merger cases have been similar in their approach to market definition and harm to consumers. They almost invariably involved narrowly defined relevant markets; there was a heavy emphasis on the limited choices available to customers; and they relied on a competitive effects theory known as "unilateral effects."[4] A unilateral effects case raises the concern that the merging firms are each other's closest competitor and that the merger will enable the merged firm to act in an anticompetitive way unilaterally, usually by raising prices that are sustainable in the market because there is insufficient competition to the merging parties to offset such a price increase. These cases shared one other important characteristic—they were settled by a consent decree and not actually litigated.

The DOJ had reason to be fairly optimistic about its likelihood of success in opposing this merger. Most significantly, there were nearly universal and very articulate objections by customers about the impact of the merger. These customers testified that only the Big Three firms (Oracle, PeopleSoft and SAP) could meet their needs for high-function ERP software that is scaleable, highly configurable and able to adapt to rapid growth, acquisitions, reorganizations, and industry-specific requirements. Other mid-market vendors or other alternatives (including best-of-breed vendors, outsourcers and companies like Lawson Software and Microsoft) would not be a viable option if the merged PeopleSoft/Oracle attempted to raise prices by 10%. These other vendors either were too expensive or their solutions insufficiently robust to meet customer needs. At great length, the Court described and ultimately rejected the customer testimony, reasoning that evidence of customer preferences, standing alone, could not substantiate the differences in the relevant product market. The Court made clear that these preferences were not based on hard evidence such as cost benefit analyses of switching to other suppliers. The Court characterized the testimony of the government's customer witnesses as "largely unhelpful to plaintiff's effort to define a narrow [product] market"[5] and noted "unsubstantiated customer apprehensions do not substitute for hard evidence."[6] The Court gave more credit to Oracle's customer witness testimony, which included "concrete and specific actions they had taken."[7]

As the Court noted:

> The issue is not what solution the customer would like or prefer for their data processing needs; the issue is what they could do in the event of an anticompetitive price increase by a post-merger Oracle. Although these witnesses speculated on the subject, their speculation was not backed up by serious analysis that their sales had performed or evidence they presented . . .. Each testified with the kind of rote, that they would have no choice but to accept a 10% price increase by a merged Oracle/PeopleSoft.[8]

The Court held that the Justice Department failed to account for other market participants such as outsourcing solutions provided by firms such as Accenture, Fidelity, and ADP or mid-market ERP vendors including Lawson Software and AMS. Lawson, for example, had ERP software contracts with large enterprises including HCA, Safeway, Target, econometric evidence demonstrating a post-merger Oracle's dominance, and evidence that SAP was almost as significant a competitor as the merged firm would be. But econometric evidence will be frequently unavailable in markets such as software where products are customized and in markets where there is significant price discrimination. One might posit that the unilateral effects doctrine will be limited only to cases where the merged firm was clearly dominant, *e.g.*, where it had a post-merger market share of over 50%. But requiring that type of dominance would mean that the unilateral effects doctrine would add little to merger analysis.

4. *Antitrust enforcement in the software market*. The decision once again highlights the significant difficulty parties may face in bringing antitrust actions in software markets. The Court openly wondered whether blocking the merger ultimately would result in the retardation of innovation and competition in the market. It seems that in cases like *Oracle* and *Microsoft*, the courts appeared to take a more hands-off approach to enforcement. It is a powerful weapon of parties in high-tech markets to argue that any market power gained from concentration is only transient because the rapidly changing nature of software markets makes the specter of market power only fleeting in the face of significant innovative forces.

Learning From Your Parents

One final observation: Was the Justice Department wrong in deciding not to appeal the decision? The efforts of the Government and the complaining customers in this case were Herculean and certainly the merger involved a tremendously important market. Yet the Court's decision was uniquely thorough. And history presented an important lesson for the DOJ. In the Bush I Administration, the Justice Department lost a challenge to a merger it believed would create a monopoly in the Las Vegas movie theatre market.[16] The District Court opinion posed some analytical problems and the DOJ appealed in order to clarify the law. But the results squarely conflicted with the Justice Department's goals in that case. The Ninth Circuit, in a case called *United States v. Syufy Enterprises*, clarified the law in a decision that significantly expanded the definition of "entry" and lessened the burden that merging parties would need to shoulder in defending mergers. Following the loss in *Syufy,* the DOJ only brought a few other merger cases in the Bush I Administration, not wanting to repeat that error.

The Justice Department in the Bush II Administration, in its decision not to appeal, apparently did not want to repeat the same mistake.

Conclusion

The *Oracle* decision sends a loud signal that the DOJ will have to sharpen its collective saw before litigating to enjoin a proposed merger in the future. First, future courts may afford less weight to customer complaints, which according to the Court are more self-serving than indicative of likely anticompetitive effects of a merger. Second, the DOJ will need to plead and puere relevant markets with greater care. Third, the "unilateral effects" theory, the mainstay of enforcement actions for the past decade, suffered a severe blow, particularly in markets where the products are highly customized. Finally, the *Oracle* decision reinforces the courts' reluctance to find entry barriers in a rapidly evolving high tech market.

Ultimately, the decision will force the agencies to reexamine their regulatory approach. The decision will make future antitrust enforcement in the software market and other high-tech markets more difficult, as well as make it substantially more difficult for the government to litigate merger cases effectively. In turn, the *Oracle* decision may enable a far broader range of mergers to survive antitrust scrutiny. M&A

1 The title refers to one of Charles Dicken's favorite novels on the legal system, *Bleak House*. Judge Walker is obviously a fan of Dickens. As explained *infra,* the Court, reflecting on the irony of Microsoft testifying on behalf of the government and against an alleged monopolist, quipped that Microsoft's Senior Vice President Doug Burgum's, "Uriah Heep-like humility" about Microsoft's modest plans to enter the market stretched the limits of credulity. This is a reference to a character in *David Copperfield*.

2 For a discussion of these cases see David A. Balto, *Antitrust Analysis of Computer Software Mergers*, Antitrust Report 82 (Winter 2003).

3 *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

4 *Id.*

5 *Id.* at 1130.

6 *Id.* at 1131.

7 *Id.* at 1133.

8 *Id.* at 1131.

9 *Id.* at 1134.

10 *Id.* at 1145.

11 *Id.* at 1144.

12 *Id.* at 1167.

13 *Id.*at 1169.

14 *Id.*

15 *Id.* at 1172.

16 *United States v. Syufy Enters*, 903 F.2d 659 (9th Cir. 1990).