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A BRIEF ANALYSIS OF POLICY AND LITIGATION

Market Definition in the Sabre-Farelogix Ruling

Robert A. Arons

Senior Economist Robert A. Arons has worked on matters involving market definition, including mergers in the digital and telecom industries.

Judge Stark of the U.S. District Court for the District of Delaware recently denied the Department of Justice's ("DOJ") challenge to the acquisition of Farelogix Inc. ("Farelogix") by Sabre Corp. ("Sabre"). DOJ argued that significant head-to-head competition in an alleged relevant market for "booking services" would be eliminated. However, Judge Stark ruled against DOJ's alleged relevant market. Judge Stark also noted that Sabre operates a two-sided transactions platform, while Farelogix only sells to airlines (one side of the platform). These findings may provide lessons for digital firms operating two-side platforms, such as Apple and Google, that face antitrust scrutiny.

Judge Stark considered DOJ's alleged "booking services" relevant product market. Judge Stark highlighted several reasons why he was not convinced that this was a relevant product market. Judge Stark noted that he had not heard the term "booking services" used by any industry witness, and, more importantly, Sabre and Farelogix have never offered a standalone "booking services" product for sale in the United States. Further, DOJ's economic expert was unable to determine the price of booking services and did not attempt to measure the value of the functionality associated with booking services. Critically, DOJ did not provide an expert opinion on whether airlines' direct sales (referred to as "airline.com") constituted a bigger competitive constraint on Sabre's GDS than FLX OC. Airline.com constitutes about half of all tickets booked. Including airline.com in the DOJ's alleged "booking service" market would make Farelogix's share *de minimis*.

Judge Stark also determined that Farelogix and Sabre competed in different markets. Sabre operates a global distribution system ("GDS") that connects airlines to travel agencies. Farelogix is an innovative airline technology solutions company. Farelogix created Farelogix Offer Creation ("FLX OC"). FLX OC is a solution sold only to airlines that allows airlines to sell services on their own websites and to push those offers onto GDS systems. FLX OC offers only one airline per connection, and thus is not a content aggregator like a GDS. Judge Stark noted that the relevant market is one of providing "transactions" and ruled that two-sided transaction platforms only compete with other two-sided transaction platforms. In other words, Sabre does not compete with Farelogix, because Sabre provides transactions between airlines and travel agencies while Farelogix supplies transaction software solely to airlines.

Despite this ruling, Sabre terminated the acquisition following the UK Competition and Markets Authority's announcement that it would block the deal. DOJ is moving to vacate Judge Stark's decision.

Also In This Issue

The Franchise No Poach Liability Continuum

Jonathan L. Walker discusses recent litigation concerning no-poach provisions within franchise agreements. Dr. Walker discusses recent remarks made by Washington State's Assistant Attorney General Rahul Rao, who believes that the *per se* standard is the appropriate mode of analysis for franchise no-poach cases. Dr. Walker also discusses the recent decision by a court in the Southern District of Florida ("the Court") that found Burger King Corporation ("BKC") is legally incapable of conspiring with its franchisees and dismissed a no-poach case against it. The Court found that there would be no franchises but for the challenged agreement and that, given the extensive operational control that BKC has over franchisees under the terms of the franchise agreement, the "residual economic autonomy with respect to employment decisions is insufficient to convert [the franchise] into a separate economic actor." Additionally, Dr. Walker notes that as no-poach cases move forward, there will be many questions concerning class certification issues, especially commonality and predominance of common issues.

Merger Efficiencies and Market Concentration

Jéssica Dutra considers whether market concentration measures, such as the Herfindahl Hirschman Index ("HHI"), are good indicators for assessing whether a proposed merger is likely to harm competition in the presence of merger-specific efficiencies. Dr. Dutra tests the accuracy of the HHI as a merger screening tool using Monte Carlo simulations. She classifies mergers into five potential categories based on the post-merger HHI and the change in HHI, uses four standard functional forms for demand, and considers efficiencies using two different cost formulations, Generalized Leontief and Quadratic functional forms. Dr. Dutra finds that the more substantial and significant the merger efficiencies are, the less likely it is that classifications using the post-merger HHI and the change in HHI will be accurate indicators of post-merger price increases.

The Franchise No-Poach Liability Continuum

Jonathan L. Walker

EI President Jonathan L. Walker has consulted and testified regarding single-entity status, antitrust merits, and class certification respectively.

No-poach provisions within franchise agreements prohibit franchisees from soliciting or employing the franchisor's or other franchisees' employees. Civil litigation regarding these provisions has exploded. The Office of the Attorney General for Washington State alone has actively investigated between 400 and 500 franchise systems since January 1, 2018 and has negotiated 225 agreements with over 100 franchisors to cease including no-poach provisions in their franchise agreements. Washington State and other plaintiffs argue that these agreements violate Section 1 of the Sherman Act and are so plainly anticompetitive that they should be assessed using a *per se* standard. However, a judge for the United States District Court for the Southern District of Florida ("the Court") recently ruled that Burger King Corporation ("BKC") is legally incapable of conspiring with its franchisees and dismissed a no-poach case against it. Plaintiffs' *per se* arguments and the Court opinion regarding BKC highlight legal and economic issues arising in no-poach cases, as well as other Section 1 cases.

Washington Assistant Attorney General Rahul Rao discussed in an April 2020 ABA Antitrust Section podcast why he believes that the *per se* standard is the appropriate mode of analysis for franchise no-poach cases. Mr. Rao reasons that franchisees are horizontal competitors in labor markets. Thus, agreements not to solicit or employ workers are agreements that allocate workers to their current employers. Further, workers within a franchise system develop franchise-specific skills for which other employers within the franchise system besides their current employer would pay a premium. Mr. Rao thus concludes that franchise no-poach provisions are price-fixing agreements that suppress wages.

Mr. Rao also considers arguments against using a *per se* standard, including that a franchisor and its franchisees cooperate to produce a single, branded product and that no-poach provisions fall under the ancillary restraints doctrine. Mr. Rao argues that a franchisor and franchisee are still distinct legal entities operating independently with respect to employment decisions, notwithstanding that they produce the same branded product in output markets. Mr. Rao also argues that no-poach provisions are not ancillary restraints, because they do not promise procompetitive benefits in the relevant product markets that are affected (i.e., labor markets) and are unnecessary to achieve the broader goals of the franchise agreements. Finally, Mr. Rao makes three arguments why apparently vertical agreements between franchisors and individual franchisees concern horizontal competition. First, some franchisors own and operate establishments at the same level of commerce as franchisees. Second, franchisors that do not compete with their franchisees in output markets may still compete with them for labor. Third, a franchisor may facilitate a horizontal hub and spoke conspiracy among its franchisees.

"The Court focused on two key issues -- the degree of control over franchise operations that the agreement vested with BKC and whether the franchises would exist absent the challenged agreement."

In contrast to these arguments for a *per se* standard, the Court dismissed a no-poaching suit against BKC, rejecting that BKC *could* conspire with its franchisees. The Court focused on two key issues -- the degree of control over franchise operations that the agreement vested with BKC and whether the franchises would exist absent the challenged agreement.

The Court explicitly acknowledged many of the facts and circumstances that plaintiffs have relied upon in arguing for a *per se* standard. BKC franchisees are independently owned and operated. Franchisees autonomously hire, fire, discipline, and promote their employees. BKC's franchise agreement warns that the franchisee may face competition from BKC or other franchisees. Nevertheless, the Court determined that these facts were not dispositive.

The Court relied upon Supreme Court precedent for guidance in determining when legally distinct entities may be a single entity for Section 1 purposes. The Court interpreted *American Needle, Inc. v. Nat'l Football League* (2010) to require a "totality of the circumstances approach" to determine whether the agreement deprives the market of independent decision making. The Court found that BKC's relationship with its franchisees is similar to the relationship

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Merger Efficiencies and Market Concentration

Jéssica Dutra

Senior Economist Jéssica Dutra consults on competition matters in a wide range of industries, including healthcare and electric power industries. This article is based on a published article in the Kansas Law Review.

A common practice in merger screening is to estimate and consider market shares and concentration. However, as stated in the United States Department of Justice ("DOJ") and Federal Trade Commission ("FTC") *Horizontal Merger Guidelines* ("Guidelines"), "[m]arket shares may not fully reflect the competitive significance of firms in the market or the impact of a merger." For example, standard measures of market concentration do not account for cost efficiencies that may occur as the result of a proposed merger. Thus, it is important to consider whether market concentration measures, such as the Herfindahl Hirschman Index ("HHI"), are good indicators for assessing whether a proposed merger is likely to harm competition in the presence of merger-specific efficiencies.

Nathan H. Miller, Marc Remer, Conor Ryan and Gloria Sheu ("Upward Pricing Pressure as a Predictor of Merger Price Effects," *International Journal of Industrial Organization*, 2017) test the accuracy of UPP and HHI as merger screening tools. The authors use a large-scale Monte Carlo experiment with a variety of merger scenarios — generated by randomly drawing market shares and using varying demand substitution patterns. The authors find that the change in HHI, in many cases, can be a good indicator of likelihood of price increases due to a merger.

> *"...the more substantial and significant the merger efficiencies are, the less likely it is that classifications using the post-merger HHI and the change in HHI will be accurate indicators of post-merger price increases."*

I extend on this approach to test the accuracy of the HHI as a merger screening tool in the presence of merger-specific efficiencies. Following *Miller et al*, I also use Monte Carlo simulations and classify mergers into five potential categories based on the post-merger HHI and the change in HHI. The five categories are 1) post-merger HHI greater than 2500 and change in HHI greater than 200; 2) post-merger HHI greater than 2500 and change in HHI greater than 100, but less than or equal to 200; 3) post-merger HHI greater than 1500 and less than 2500, and change in HHI greater than 100; 4) post-merger HHI less than or equal to 1500; and 5) change in HHI less than 100. These categories reflect the likelihood a merger will be investigated (categories one through three are likely to raise possible competitive concerns, while categories four and five are unlikely to raise competitive concerns).

For the Monte Carlo simulations, I use four standard functional forms for the demand side. These are Logit demand, Log-Linear demand, Linear demand and Almost Ideal demand. I also assume a market structure for each industry, which may contain four, six, or eight firms competing with differentiated products. I also consider efficiencies generated using two different cost formulations, Generalized Leontief and Quadratic functional forms. The Generalized Leontief cost formulation will generate higher merger-specific efficiencies than those generated through the Quadratic cost formulation, which allows for a comparison between mergers that are likely to generate more substantial merger efficiencies and those that are not. For each scenario, I draw 3,000 mergers, for a total of 72,000 merger simulations.

I find that the more substantial and significant the merger efficiencies are, the less likely it is that classifications using the post-merger HHI and the change in HHI will be accurate indicators of post-merger price increases. For example, consider the Monte Carlo simulations for mergers that fall under category one (with a post-merger HHI exceeding 2500 and a change in HHI exceeding 200) and that are in industries with four firms. For these simulations, I find that the probability of a five percent price increase ranges from approximately 30 percent to 58 percent, depending on the demand system, for mergers under a Generalized Leontief cost structure, while for mergers under a Quadratic cost structure, it ranges from approximately 61 percent to 90 percent. I also considered the probability of a ten percent price increase and find that the probability of a ten percent price increase ranges from approximately 17 percent to 54 percent for mergers under a Generalized Leontief cost structure and from approximately 21 percent to 80 percent for mergers under a Quadratic cost structure.

Additionally, any screening tool, including the HHI, is not

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that Citizens and Southern Bank Corp. had with its independently-owned, associated banks, a *de facto* parent subsidiary relationship as discussed in *United States v. Citizens & Southern Nat. Bank* (1975). Specifically, the Court found that there would be no franchises but for the challenged agreement, quoting *Citizens & Southern*, "because the sponsored banks were not set up to be competitors, Section 1 did not compel them to compete" and "[e]xcept for that sponsorship, they would very probably not exist." Given the extensive operational control that BKC has over franchisees under the terms of the franchise agreement, the Court found that the "residual economic autonomy with respect to employment decisions is insufficient to convert [the franchise] into a separate economic actor."

The Court also pointed to the paradox of treating BKC-owned restaurants differently than franchises despite their functional equivalence to BKC for interbrand competition and geographic expansion. Subjecting the relationship between BKC and its franchisees to Section 1 liability would raise BKC's costs of expansion by franchising. This may cause BKC to forego franchising in certain circumstances in which franchising is otherwise the more efficient expansion mode, thereby hampering interbrand competition. In marginal geographical marketing areas, the effect may be to deter expansion altogether--diminishing competition in both output and labor markets.

To date, the focus in the wave of no-poach class action cases has been to achieve or survive dismissal. As franchise no-poach cases move forward, the next battleground will be class certification, especially commonality and predominance of common issues. In that regard, the same franchise agreement will govern all franchisees within a system, thus presenting some common questions of legality for all employee-class members. On the other hand, wages often are set in local labor markets in which pay for many of the jobs at issue may be determined by minimum wage statutes or by competition external to the franchise system. Additionally, no-poach provisions limit competition among employees within a system. Some class members may have lost their jobs or never been hired but for these provisions. Thus, even if a particular franchisor's franchise agreement is found to violate Section 1, it does not mean that all workers within the franchise system were harmed by it.

Merger Efficiencies and Market Concentration

a perfect predictor of post-merger price increases, and this can lead to false positives and false negatives -- known as type I and type II errors. I estimate the likelihood of these type I and type II errors for the five merger categories, using each demand system and each functional form of cost efficiencies. I consider two thresholds, a price increase of five percent and a price increase of ten percent, as indicating that a merger is anticompetitive. For example, I consider the following combination: the merger is considered anticompetitive if it results in a price increase of more than five percent and the merger belongs to category one (post-merger HHI exceeding 2500 and change in HHI exceeding 200). Monte Carlo simulations for this combination indicate that the type I and type II errors increase with greater merger-specific efficiencies. I find that the sum of the type I and type II errors range from 40 percent to 48 percent for this combination, in industries with four firms, for mergers under a Generalized Leontief cost structure, while for mergers under a Quadratic cost structure, the sum of the type I and type II errors range from 24 percent to 33 percent.

The DOJ and FTC, following their *Guidelines*, use both the post-merger HHI and the change in HHI to classify mergers into those that are more likely to raise competitive concerns and those that are not. However, these classifications may not be strong predictors of whether a proposed merger will harm competition when there are substantial merger-specific efficiencies. There is a need to better understand merger screening models whenever efficiencies are involved and recognize that typical methods (such as market share and concentration) often do not reflect market dynamics. Structural-based models and estimates of unilateral effects are additional tools that may improve merger screening.

EI News and Notes

ABA Antitrust Law Section Announced EI Principal Philip Nelson Has Been Nominated to Serve on the Section's Council

On April 20th, the American Bar Association Antitrust Law Section announced that EI Principal Philip B. Nelson, who is currently co-chair of the Section's Content Committee, has been nominated to serve on the Section's Council. The Council has general supervision and control of the affairs of the Section.

Third Circuit Upholds Jury Verdict in Favor of Egg Producers

The U.S. Court of Appeals for the Third Circuit upheld a jury verdict in favor of the defendants in a class action involving over $1 billion in claimed overcharges related to an alleged conspiracy to restrict the supply of eggs. On appeal, plaintiffs argued for a *per se* standard. The Circuit panel affirmed the District Court's decision noting that "the jury's finding that the restraints on competition at issue in this case were reasonable is a good indicator that the plaintiffs' demand for *per se* liability is off." EI President Jonathan L. Walker testified on behalf of the egg producers at trial regarding competitive effects.

District Court Rules Against Class Certification in Automobile Insurance Case

A U.S. District Court for the Western District of Oklahoma denied certification to a putative class of automobile insurance policyholders whose vehicles were totaled. Plaintiff challenged the valuation tool used by her insurance company. The Court rejected plaintiff's argument that Oklahoma law required that settlement be based on NADA value, finding instead that the law required that insurance settlements reflect actual cash value. Consequently, proof of injury would require individualized assessment of actual cash value in light of the loss vehicle's make, model, model year, mileage, condition, and other factors. EI President Jonathan L. Walker submitted a declaration on defendant's behalf opposing class certification. King & Spalding LLP represented the defendants.

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