# If You Build It, They Will Come: Building an Efficiencies Case

**By Craig Malam and Russell Molter**

The recent decision by Judge Florence Y. Pan to exclude evidence of merger efficiencies in United States v. Bertelsmann SE & Co. KGaA et al. ("*Penguin Random House*") raises significant questions about the role of efficiencies in merger challenges.[1] Specifically, a broader adoption of Judge Pan's ruling would mean that claimed efficiencies cannot be cognizable under the 2010 U.S. Department of Justice ("DOJ") and Federal Trade Commission Horizontal Merger Guidelines ("Guidelines") without independent verification.

This article provides an overview of the *Penguin Random House* opinion and insights stemming from Judge Pan's decision to exclude the merger efficiencies evidence, including practical steps parties can take to best address efficiency issues when working with the agencies or preparing for trial.

## Background: Cognizable Efficiencies

The Guidelines specify certain principles under which efficiencies may be a cognizable element of merger analysis. The Guidelines state that efficiencies are cognizable when they are "merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service."[2]

For efficiencies to be merger-specific, they must be "likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects."[3] They could not "be attained by practical alternatives that mitigate competitive concerns, such as divestiture or licensing."[4] In simple terms, this means that, if the efficiencies could be achieved without the merger, then the agencies will not credit them against the potential anticompetitive effects of the merger.

The Guidelines also require that the merging parties quantify and verify the efficiencies. This reflects what the Guidelines describe as the difficulty that "much of the information relating to efficiencies is uniquely in the possession of the merging firms."[5] The Guidelines additionally state that it is therefore "incumbent upon the merging firms to substantiate efficiency claims so that the Agencies can verify by reasonable means the likelihood and magnitude of each asserted efficiency,

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[1] United States v. Bertelsmann SE & Co. KGaA, et al., 2022 WL 16949715 (D.D.C. Oct. 31, 2022), at *35 ("Penguin Random House Opinion").

[2] U.S. Dep't of Justice & Federal Trade Comm'n, Horizontal Merger Guidelines (2010), http://ftc.gov/os/2010/08/100819hmg.pdf, Section 10.

[3] Guidelines, Section 10.

[4] Guidelines, Section 10, n. 13.

[5] Guidelines, Section 10.

how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific."[6]

The Guidelines also describe a somewhat circumspect position on the possible magnitude of efficiencies that may be cognizable. The difference that efficiencies can ever make in the analysis has limits, with the Guidelines stating that "efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are not great."[7]

The Guidelines tightly confine the circumstances under which efficiencies may be credited against potential anticompetitive effects from any given merger. This is not surprising because the Guidelines acknowledge that "[t]he Agencies will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market."[8]

The position on efficiencies described in the Guidelines recognizes the economic reality that efficiencies ultimately explain most mergers. However, there are inherent challenges given the uncertainty of the forward-looking analysis. Therefore, the Agencies require that efficiencies be verified and substantiated if the parties seek to claim that the pro-competitive impact of those savings will offset the potential for anticompetitive effects. However, if the potential anticompetitive effects are significant for a given merger, the agencies would need to lean heavily on the claimed considerable cognizable efficiencies in their decision not to block the merger, which generally involves even further uncertainty.

*Judge Pan excluded from the record all of the efficiencies evidence put forward by the merging parties because they were not verified by an independent expert and could not, therefore, be cognizable under the Guidelines.*

As discussed in greater detail below, in many of the cases in which courts have analyzed claimed efficiencies, the substantiation proffered by the merging parties and deemed verified by their independent expert was found to be insufficient (i.e., not cognizable) by the court, with the T-Mobile/Sprint merger[9] being a notable exception. These court decisions have emphasized that merging parties bear the burden of demonstrating that their claimed efficiencies are independently verified to be cognizable and used to offset potential competitive harm.

Verifying claimed efficiencies played a substantial role in *Penguin Random House,* where the Court found that information used to project savings from the merger lacked the necessary substantiation and could not be shown to be directly applicable to the merging parties' activities. In her recent ruling, Judge Pan excluded from the record all of the efficiencies evidence put forward by the merging parties because they were not verified by an independent expert and could not, therefore, be cognizable under the Guidelines. Judge Pan reasoned that, because the efficiencies were unsupported, the Defendants' expert's opinions about efficiencies were not based on "sufficient facts and data" and thus were inadmissible under Federal Rule of Evidence 702. Other courts have similarly set aside efficiencies evidence, but not before hearing the evidence presented at trial.

## United States v. Bertelsmann

Bertelsmann, parent company of Penguin Random House, announced its plan to acquire Simon & Schuster, Inc. on November 25, 2020. According to the DOJ's Complaint, Penguin Random

6 Guidelines, Section 10.

7 Guidelines, Section 10.

8 Guidelines, Section 10.

9 New York v. Deutsche Telekom AG, 439 F. Supp. 3d 179 (S.D.N.Y. 2020).

House is the largest book publisher in the world, and Simon & Schuster is the fourth-largest book publisher in the United States.[10]

Following an investigation, in November 2021, the DOJ filed suit to block the proposed merger on the basis that "Penguin Random House's proposed acquisition of Simon & Schuster would result in substantial harm to authors, particularly authors of anticipated top-selling books."[11] The DOJ argued that existing competition between the parties to "acquire publishing rights from authors and provide publishing services to those authors" would be reduced.[12] Following a 12-day trial in early August, Judge Pan issued her Memorandum Opinion finding in favor of the DOJ and enjoining the merger on October 31, 2022.

*Judge Pan did not consider the Defendant's arguments on efficiencies because she had excluded them from the record as unreliable under Federal Rule of Evidence 702.*

The DOJ argued that "competition has resulted in substantial benefits for authors of anticipated top-selling books," as Penguin Random House and Simon & Schuster often compete head-to-head at auctions for these rights.[13] Authors typically shop around their work to various publishers seeking the best opportunity for advances, marketing support, and royalties, among other things.[14] The DOJ was concerned that consolidation into one company with control over two-thirds of the market (as defined by DOJ) would be harmful to authors.[15]

The DOJ alleged a market encompassing anticipated top-selling books for which publishers pay an advance of at least $250,000. Judge Pan accepted this definition and, along with other evidence brought forward by the government, concluded that the DOJ had made its prima facie case.[16] Judge Pan did not find Defendants' arguments in rebuttal persuasive.

Critically, as mentioned above, Judge Pan did not consider the Defendant's arguments on efficiencies because she had excluded them from the record as unreliable under Federal Rule of Evidence 702.[17]

As background, Defendants asserted that efficiencies were available in real estate, operating expenses, variable costs, and revenue—the same cost savings identified in a deal model created in anticipation of the proposed merger.[18] These claimed efficiencies were modeled along with the assumption that the combined entity would achieve certain economies of scale, including, for example, maximizing distribution channels via Penguin Random House's distribution network and processes, improved warehouse utilization, and a reduced headcount.[19]

Defendants' economic and efficiencies expert also opined that the achieved synergies would flow to the authors in the form of higher income and would result in greater availability of books to consumers.[20] The expert asserted that the efficiencies were merger-specific, but also clarified that he did not verify them independently.[21] But the merging parties claimed that the savings were

[10] United States v. Bertelsmann SE & Co. KGaA, No. 1:21-cv-02886 (D.D.C.), Dkt. 1 (Complaint, Nov. 2, 2021), ¶ 3.

[11] U.S. v. Bertelsmann Complaint ¶ 2.

[12] U.S. v. Bertelsmann Complaint ¶ 2.

[13] U.S. v. Bertelsmann Complaint ¶ 8.

[14] U.S. v. Bertelsmann Complaint ¶ 24-25.

[15] U.S. v. Bertelsmann Complaint ¶ 7.

[16] Penguin Random House Opinion at *29.

[17] Penguin Random House Opinion at *35; U.S. v. Bertelsmann SE & Co. KGaA, No. 1:21-cv-02886 (D.D.C.), Trial Transcript (Aug. 17, 2022) ("Penguin Random House Trial Transcript), at 2751:17-2771:4.

[18] Penguin Random House Trial Transcript at 2756:24-2757:1.

[19] *Id.* at 2758:9-2760:1.

[20] *Id.* at 2749:24-2850:8.

[21] *Id.* at 2750:4-5, 2750:9-15.

prepared as part of synergies modeling performed by an internal Penguin Random House acquisition team and could be verified.[22] In support of their claims, the parties called the Penguin Random House employee who prepared the model and much of the underlying analysis.[23] The Penguin Random House witness testified regarding his approach, research, and support to evaluate and determine the underlying savings expected to be achieved.[24] The work included significant effort and detailed documents and data to identify and evaluate the potential for savings.[25]

After considering this evidence, Judge Pan "precluded the defendants' evidence of efficiencies, after determining that the defendants had failed to verify the evidence, as required by law."[26] In precluding the evidence on efficiencies, Judge Pan reasoned that, "[a]lthough many of the projections may be verifiable, some are not verifiable. Moreover, the efficiencies have not, in fact, been independently verified by anyone, and they, therefore, are not cognizable under the horizontal merger guidelines and are not reliable under Rule 702."[27]

Judge Pan's decision affirmed that these synergy savings had been estimated using an outdated model and data, which were used to identify a valuation purchase price and had not been updated since the final bid to the seller.[28] While Defendants' witness testified that the model was subsequently updated in several iterations, the November 2020 model remained the most reliable model.[29] The Court ruled, however, that the November 2020 model needed to be updated because "it does not include actual updated performance numbers and also that the November 2020 model relied on proveably wrong projections and predictions."[30] Notably, Judge Pan rejected the modeled assumption that the future for the "book industry will revert to pre-pandemic levels of sales and costs," noting that "it is clear to this Court that we are in uncharted waters."[31] The model was "inconsistent with actual numbers for Simon & Schuster in 2021," rendering the use of the model "unpersuasive."[32]

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Judge Pan further recognized that, while many of the proposed cost savings from the November 2020 model might be verifiable, at least some were not. In particular, she noted that the revenue projections "are not verifiable" because they were based on the Penguin Random House employee's "personal judgment" and were not consistent with Penguin Random House's "most prominent experience" of the 2013 Penguin and Random House merger.[33] Judge Pan was not persuaded by the merging parties' argument that they relied on their more recent experience of incorporating new imprints and third-party distribution clients into Penguin Random House's wider distribution network, which would similarly allow for significant sales growth for Simon & Schuster's

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[22] *Id.* at 2749:16-23.

[23] *See, e.g., Penguin* Random House Trial Transcript at 2756:7-20.

[24] *Id.*

[25] *Id.* at 2756:24-2760:1.

[26] Penguin Random House Opinion at *35.

[27] Penguin Random House Trial Transcript at 2751:22-2751:1.

[28] Penguin Random House Trial Transcript at 2766:17-22.

[29] *Id.* at 2766:7-10.

[30] *Id.* at 2766:4-6.

[31] *Id.* at 2766:11-16.

[32] *Id.* at 2766:17-22.

[33] *Id.* at 2763:7-10.

less widely distributed books post-merger.[34] The parties asserted that they did not rely on their "experience" in the 2013 Penguin and Random House merger because that was at a time of an "industry-wide change" of reducing mass market titles in response to the impact of eBooks, which reduced sales.[35]

According to Judge Pan, many of the remaining projected efficiencies were "arguably verifiable because theoretically, an independent party could look at all the underlying data about the costs of each entity," including "detailed explanations about the assumptions," and "determine whether those assumptions were reasonable and based on past experience."[36] The projected efficiencies put forward included:

- Real estate savings primarily based on a reduced office space footprint at the combined company's headquarters[37]
- Operating expense reductions related to lower headcount and contract savings, for example, in the sales, IT, and administration departments[38]
- Variable cost savings, particularly reductions in return rates[39]

*The Court held, however, that none of these savings were cognizable because they had not been independently verified.*

The Court held, however, that none of these savings were cognizable because they had not been independently verified. Judge Pan agreed with the Defendants that neither the Guidelines, nor case law, required parties to use an expert to verify the estimated efficiencies independently but noted that the parties otherwise take the risk that a judge will not do that verification for them.[40] Defendants asserted that many of these savings were verifiable and could likely be easily verified, such as the real estate savings, IT, and the return rate differentials.[41] Judge Pan was not convinced and noted the Court was not "in a position to do the type of very careful, rigorous verification that is required to rely on this evidence."[42]

Judge Pan ruled that "legal standards and precedents place the burden on defendants to establish that the projected efficiency relied upon . . . are substantiated, that they are reasonably verifiable by an independent party, and that they are, in fact, verified."[43] She ultimately excluded the party's expert testimony on efficiencies under Federal Rule of Evidence 702, as the expert's testimony was not based on sufficient facts and data which could have helped the trier of fact.[44]

## Unverified Efficiencies May Be Excluded

As discussed, Judge Pan reached her decision to exclude the efficiencies evidence by considering each of the critical parts of the Penguin Random House employee's estimates and found that,

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[34] Penguin Random House Trial Transcript at 2760:2-2763:2.

[35] *Id.* at 2737:12-19 (summary of testimony by counsel).

[36] *Id.* at 2762:3-12.

[37] *Id.* at 2757:2-16.

[38] *Id.* at 2758:9-2759:10.

[39] *Id.* at 2759:11-2760:1.

[40] Penguin Random House at 2764:5-13.

[41] *See., e.g., id.* at 2739:17-22.

[42] *Id.* at 2742:15-17.

[43] *Id.* at 2755:6-10.

[44] *Id.* at 2770:20-2771:4; *see also id.* at 2750:16- ("The government filed a motion in limine to exclude [Defendants' expert's] testimony on efficiencies under Federal Rule of Evidence 702. The government argued, among other things, that [Defendant's expert's] reliance on unverified projections rendered his efficiencies testimony inadmissible under Rule 702, the horizontal merger guidelines, and cases applying the horizontal merger guidelines.").

in some cases, the calculations that were not verifiable and, in other instances, even if verifiable, they were not verified. The merging parties argued that the Court could verify the projected efficiencies by hearing how they were derived and concluding based on testimony that the Penguin Random House employee had made reasonable assumptions and carried out the necessary work. The Court "strongly disagree[d] that this is what is contemplated by horizontal merger guidelines and the case law."[45]

Our experience is that estimates created in the ordinary course of business are often reliable. Business people are closest to activities in the industry and are typically highly experienced in planning and reacting to information to ensure the success of their business. This frequently involves preparing budget forecasts on at least an annual basis, if not as far out as five years, and with varying objectives, such as planning for capacity needs, capital expenditures, marketing planning, inventory needs, and distribution network requirements. These are precisely the subject areas for many estimated merger efficiencies.

*To verify estimates that were prepared by experienced managers, an independent expert needs to analyze how the estimates were derived.*

However, the Court's ruling in this instance required that efficiency estimates be verified independently before they can be admitted as evidence because the calculations are a basis for opinion evidence which must be supported by sufficient facts or data.

The Court acknowledged that the law and policy are silent on whether the Court or another independent party must carry out that verification. Still, Judge Pan noted that the Guidelines are clear that it is the merging parties' burden to establish that the efficiencies were independently verified and that a court would rarely be well-positioned to do so on its own.[46]

We note that the Guidelines state that efficiencies should be "reasonably" verifiable, which perhaps sets some expectations for parties. To verify estimates that were prepared by experienced managers, an independent expert needs to analyze how the estimates were derived. This typically includes understanding the data sources that underlie the estimates and stress testing any assumptions that were used, such as projected growth rates.

The Guidelines also describe how the agencies may view projections "with skepticism, particularly when generated outside of the usual business planning process. By contrast, efficiency claims substantiated by analogous past experience are those most likely to be credited."[47] Thus, presenting a range of historical growth rates and the related outcomes could inform the reasonableness of the assumption.

Other means to evaluate the analytical methods used by the merging parties may include using financial statement analysis, budget forecasting, costing analysis, and so on. By providing context for these assumptions, an independent expert may be able to conduct a factual analysis to support and verify estimates otherwise based on management judgment.[48]

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[45] *Id.* at 2763:21-23.

[46] Penguin Random House Trial Transcript 2764:5-13.

[47] Guidelines, Section 10.

[48] Judge Pan cited to *United States v. H&R Block*, where the Court rejected efficiencies estimates that were premised on the defendant's managers' experiential judgment about likely costs rather than a detailed analysis of historical data. Judge Pan also noted that, in that decision, the Court recognized that the judgment of experienced executives about costs might be "perfectly sensible as a business matter." Still, the lack of a verifiable method of factual analysis resulting in the cost estimates renders them not cognizable by the Court. Penguin Random House Trial Transcript at 2767:11-20.

## Would Better Verification and Substantiation Lead to Fewer Courts Discounting Efficiencies at Trial?

*Judge Pan's approach suggests that parties may have a stronger incentive to ensure that claimed efficiencies are verified by a third party or risk not having those claims weighed at trial.*

If adopted by courts in the future, Judge Pan's approach suggests that parties may have a stronger incentive to ensure that claimed efficiencies are verified by a third party or risk not having those claims weighed at trial. Of course, it is not assured that those claimed efficiencies are likely to succeed even if independently verified. However, it bears noting that the five opinions cited by Judge Pan in support of her ruling span a wide variety of industries and types of efficiencies. This suggests that, when courts have taken issue with efficiencies estimates because they are unverified, they have done so regardless of the industry or issues in dispute.

In *United States v. H&R Block* (2011), the Court took issue with the fact that TaxACT's efficiency estimates relied on management judgment, rather than facts that could be verified by a third party. The Court emphasized that the difficulty in substantiating efficiency claims verifiably is one reason why courts have generally found an efficiencies defense to be inadequate.[49] As Judge Pan quoted from H&R Block, "while reliance on the estimation and judgment of experienced executives about costs may be perfectly sensible as a business matter, the lack of a verifiable method of factual analysis resulting in the cost estimates renders them not cognizable by the Court."[50]

Similarly, in *FTC v. Wilhelmsen Holding ASA* (2018), the Court ruled that verification of claimed efficiencies was a "critical issue."[51] Defendants argued that the merger would result in significant savings by eliminating duplicative product lines, service operations, and administrative costs. However, the Court found that Defendants had "failed to carry their burden to demonstrate the verifiability of their claimed efficiencies," and stated particularly that it "cannot substitute Defendants' assessments and projections for independent verification," by referencing Defendants' "past practices, managerial expertise and incentives, or internal verification processes [that] serve to substantiate any efficiencies."[52]

Going back further, in *FTC v. Staples* (1996), the Court found that Defendants' efficiency defense could not rebut the presumption that the merger was anticompetitive, because "defendants' projected 'Base Case' savings of $5 billion are in large part unverified, or at least the defendants failed to produce the necessary documentation for verification." The Court cited as an example that, for one category of savings, "the entire backup, source, and the calculations of . . . [cost savings] were not included in the Efficiencies Analysis."[53]

In *United States v. Aetna* (2017), the Court was unable to conclude whether particular efficiencies were verifiable and noted that "[t]hese issues may not be insurmountable but [Defendants' expert] did not wrestle with them by, for instance, reviewing the underlying provider contracts."[54] Notably, the Court cited *FTC v. Heinz*, 246 F.3d 708, for the proposition that "the high market concentration levels present in this case require, in rebuttal, proof of extraordinary efficiencies," and sided with the plaintiff's expert, as the expert believed only half the efficiencies would be passed through.[55]

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[49] United States v. H&R Block, Inc., 833 F. Supp. 2d 36 (D.D.C. 2011).

[50] Penguin Random House Trial Transcript 2767.

[51] FTC v. Wilhelm Wilhelmsen Holding ASA, 341 F. Supp. 3d 27, 73 (D.D.C. 2018).

[52] *Id.*

[53] *Id.*

[54] United States v. Aetna Inc., 240 F. Supp. 3d 1, 97 (D.D.C. 2017) (quoting FTC v. H.J. Heinz Co., 246 F.3d 708, 720 (D.C. Cir. 2001).

[55] *Id.* at 95.

In *FTC v. Sysco* (2015), the Court found that it was unlikely that a substantial portion of the $490 million in cost savings were merger-specific, as Defendant's expert did not perform an independent analysis and did not prove that the efficiencies were merger-specific.[56] As Judge Pan pointed out in her ruling in Penguin Random House, the Court was not questioning the "rigor and scale of the analysis conducted," but rather, it was observing that "the expert had not verified that the synergies were merger specific" and that "it was not clear what independent analysis the expert did to reduce [ ] projected savings to merger-specific savings."[57]

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In each of these cases, there appears to be nothing intrinsic to the identified efficiencies that made them particularly difficult to verify. That is, neither the subject matter nor the types of available data (e.g., spreadsheets or datasets) appear to present insurmountable challenges for an independent expert to verify or substantiate the proposed efficiencies.

That said, courts have recently looked favorably upon efficiencies evidence in certain circumstances, either acknowledging or specifically crediting efficiencies that could reduce a purported anticompetitive harm.

In *New York v. Deutsche Telekom AG, et al.* (2020), the Court accepted the proposed cost savings and potential benefits to consumers.[58] Attorneys general from several states and the District of Columbia sued to enjoin T-Mobile's merger with Sprint alleging that it would suppress competition in the retail mobile wireless telecommunications services market, causing consumers to pay higher prices for cell phone service.[59] Defendants submitted an efficiencies analysis to the Court that extensively analyzed and verified the estimates and argued that the merger would result in a variety of cost savings that would be passed on to consumers through more aggressive service offers.[60] The Court found that the merger would result in significant efficiencies, concluding that the efficiencies were verifiable and merger specific.[61]

*[T]he validation and verification of the challenged efficiencies by an independent party does not appear to be an insurmountable hurdle.*

As these cases illustrate, although each case presents a unique set of circumstances and requires evaluation in the context of potentially unique industry dynamics, the validation and verification of the challenged efficiencies by an independent party does not appear to be an insurmountable hurdle.

## Steps to Improve Your Efficiencies Case

The decision to undertake an efficiencies evaluation, including when to initiate the analysis, can be a complex and time-consuming effort. Therefore, while not prescriptive, we suggest the following key steps to improving any efficiencies case.

***Prepare a replicable submission.*** An organized and comprehensive submission can signal to the agencies that the parties are prepared and that the merging parties want to provide the agencies with a clear understanding of the cost savings, how they will be achieved, and the underlying assumptions used to support the estimates. While not comprehensive, these items will assist the reviewer in evaluating the cognizability of each cost savings.

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[56] FTC v. Sysco Corp., 113 F. Supp. 3d 1, 83 (D.D.C. 2015).

[57] Penguin Random House Trial Transcript 2770:6-11.

[58] Deutsche Telekom AG, 439 F. Supp. 3d 179, 210 (S.D.N.Y. 2020).

[59] *Id.* at 187.

[60] *Id.* at 213-216.

[61] *Id.* at 217.

*[T]he parties will often need to take the efficiencies analysis beyond what was prepared by management and/or consultants in the initial stages of valuing the merger.*

Judge Pan stated, in *Penguin Random House*, that many of the proposed savings were "arguably verifiable because theoretically an independent party could look at all the underlying data about the costs of each entity," including "detailed explanations about the assumptions" and "determine whether those assumptions were reasonable and based on past experience."[62] Merging parties can use a road map-type structure to present efficiencies that will help the reader follow the information presented from the summary to a detailed level. This format may also aid in replication by connecting the dots to the supporting data and analysis.

In addition to preparing a comprehensive package of information to support the claimed savings, the parties will often need to take the efficiencies analysis beyond what was prepared by management and/or consultants in the initial stages of valuing the merger. As discussed in *H&R Block*, reliance on estimation and management judgment is "perfectly sensible as a business matter," but without a verifiable method to analyze the cost estimates, the proposed efficiency will fall short.[63] Therefore, the parties will need to take their analysis one step further. We offer the following examples to illustrate.

Consider a transaction where two manufacturers of a similar product will merge, enabling increased access to distribution channels that could result in cost savings, and assume that these should be credited as a cognizable efficiency. In addition to up-to-date information and assumptions used to support the calculation, it may also include an analysis that "stress tests" the reasonableness of assumptions by assessing the capacity of the distribution channel constraints. Such an analysis would support the likely achievement of the cost savings and that they are merger specific, and would constitute an analysis that can be replicated and assessed for reasonableness.

*[T]he information presented by merging parties can be subject to some degree of natural skepticism on the part of the antitrust agencies and in court.*

Another scenario might involve one merging party, a manufacturing firm, that anticipates gaining the capability to incorporate acquired intellectual property to improve its product offerings. Substantiation for these claimed efficiencies may include the data and assumptions for existing and future costs, as well as any existing contracts impacted, along with the rationale and experience to support the firm's ability to implement the intellectual property.

***Offer independent substantiation.*** Even when efficiencies presentations are well organized and substantiated, the information presented by merging parties can be subject to some degree of natural skepticism on the part of the antitrust agencies and in court. Judge Pan explained that it is in the "parties' interest to be aggressive and optimistic in the projection of efficiencies to justify their own merger."[64] In addition, she stated that "because courts are not well-positioned to verify such projections, independent verification is critical in order to allow a court to determine whether such projections are reliable."[65] Thus, using an independent expert may be the best path forward when working with the agencies or at trial to demonstrate that efficiencies are not only substantiated but also verified.

In her ruling, Judge Pan found that while many of the efficiencies presented by the parties may have been verifiable, they were not verified,[66] and she was not able to evaluate the efficiencies. As discussed in more detail above, the Court stated that the Guidelines and case law do not require merging parties to use an expert to verify efficiencies, but the parties then face the risk that the

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[62] Penguin Random House Trial Transcript 2762.

[63] *H&R Block*, 833 F. Supp. 2d at 91.

[64] Penguin Random House Trial Transcript 2755:19-21.

[65] *Id.* 2755:21-24.

[66] *Id.* 2751:22-23.

*Guidelines and case law do not require merging parties to use an expert to verify efficiencies, but the parties then face the risk that the Court may not be "in a position to do the type of very careful, rigorous verification that is required to rely on this evidence."*

Court may not be "in a position to do the type of very careful, rigorous verification that is required to rely on this evidence."[67]

A third-party consultant or expert will not only replicate the analysis performed by the merging parties but also can offer an independent perspective providing an additional layer of review and analysis that may help resolve the agencies' residual skepticism surrounding assumptions based on management judgment.

***Start early and prioritize efficiencies.*** There is often no quick route to preparing an efficiencies case when facing an agency challenge of a given transaction. However, merging parties should get started early and prioritize identifying which synergies have the potential to be cognizable efficiencies.

Estimates created by the merging parties to support the deal rationale, purchase price, or the combined firm valuation will often identify potential cost savings or synergies. Merging parties can use materials created in the ordinary course that include estimates of the projected cost savings, but parties should be counseled that these savings will not automatically be considered cognizable as the preparation of these estimates may not have involved engaging with the analytical process described by the Guidelines.

For example, the cost savings identified have often been estimated using assumptions that reflect management judgment. Although this judgment may have been validated through review processes, it may not have been substantiated through references to concrete sources. However, it is possible in many circumstances to justify and confirm those assumptions through an analysis that is designed to be replicable under an independent review to verify the estimates as cognizable under the Guidelines.

As a second example, projected savings or synergies are routinely obtained through industry-standard savings amounts, such as general and administrative savings, as a percentage of total overall expenses. Such estimates are typically referred to as "top-down." However, this methodology may fall short of supporting a claimed efficiency if the savings amount has not been applied to the data and information available regarding the proposed merger. That is, it may not be possible to assume that generalized cost savings will be achieved by the companies involved in the merger since all companies operate differently and have different cost structures.

Merging parties can take practical steps to evaluate and substantiate those cost savings that will be used for their efficiencies case. Cognizable efficiencies require the evaluation to be verified and merger specific, and the efficiencies should not be simply the result of reduced output or service. In addition, this evaluation requires meaningful analysis to substantiate the underlying assumptions used in these cost projections. Typically, a third-party expert in merger efficiencies, or with related expertise, will evaluate documentation and assumptions presented by the parties to independently verify the efficiencies.[68]

Importantly, it may be possible to identify early on that only a subset of those efficiencies may ultimately be available to offset harm in a particular market. Certain geographies or product types may limit the value of the savings that pass through to the harmed market. For example, if harm is claimed to occur only in a particular geography (e.g., within city limits), it may need to be clarified whether all of the claimed cognizable efficiencies achieved in a wider geographic area can offset the harm in that particular geography. Similarly, suppose an organization produces multiple

[67] *Id.* 2742:15-17.

[68] See, for example, United States v. Aetna, 240 F. Supp. at 94-95, and FTC v. Sysco, 113 F. Supp. 3d at 82.

products. In that case, even if the marginal cost savings from one product are achievable, there are likely to be additional considerations before the savings can be credited to the alleged harmed market of a separate product. In this sense, gaining some early perspective as to where or how cognizable efficiencies may be available can be critical.

*[M]aking efficiencies a priority in case strategy can create opportunities to realize early in the evaluation process what limitations may exist.*

Although considerable effort may be necessary to prepare a meaningful efficiencies case, starting early and making efficiencies a priority in case strategy can create opportunities to realize early in the evaluation process what limitations may exist.

## Conclusions

Judge Pan's decision has highlighted the importance of verification when preparing a defense relying upon cognizable efficiencies. The elements for cognizability outlined in the Guidelines and case law reflect a reasonable approach in merger review for accounting for the procompetitive effects of efficiencies. However, our assessment of recent rulings on efficiencies suggests that there is an opportunity for merging parties to prepare efficiencies presentations that could move the needle.

It remains to be seen whether merging parties respond to the prospect of evidence being excluded by bolstering their efficiencies cases. However, if an improved track record for efficiencies is on the horizon, then it is most likely with respect to litigated mergers where, as the Guidelines note, the potential anticompetitive effects "absent the efficiencies, are not great."[69] Agencies may, in this scenario, feel less confident blocking mergers with moderate potential harm but with stronger efficiencies evidence. ●

[69] Guidelines, Section 10.