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**International Mergers:
The Highest Common Denominator Effect**

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(Cross-border Divestiture & Licensing Remedies)

In April 1997 the United States Federal Trade Commission approved a consent order regarding the merger of Ciba-Geigy and Sandoz to form Novartis (see *In the Matter of Ciba-Geigy Limited, Ciba-Geigy Corporation, Chiron Corporation, Sandoz Ltd., Sandoz Corporation, Novartis AG*, Docket No. C-3725, Decision and Consent Order).

The order is particularly noteworthy for two reasons:

- the FTC sought and obtained divestitures of corn herbicide and flea control businesses which extended beyond the territorial boundary of the United States; and
- in the field of gene therapy (defined by the FTC as "therapeutic intervention in humans based on modifications of the genetic material in living cells"), where viable products are not expected to be commercialized for many years, the FTC required that Novartis licence worldwide technology and patent rights so as to place other firms in a stronger position with respect to research and development.

The Novartis Merger

The merger of Ciba-Geigy Limited and Sandoz Ltd. to form Novartis Ltd. was announced in March 1996. With a combined stock value of U. S. \$63 billion, it represented the world's largest industrial merger. Novartis has over 100,000 employees worldwide and is active in 75 countries. Its operations focus on three broad areas: health care, nutrition and agribusiness.

The Novartis transaction was subject to competition law review in several jurisdictions, including the United States, the European Union and Canada. The European Commission approved the merger in July 1996 based on certain licencing commitments from the parties in the areas of flea control products and gene therapy. A consent order settlement received interim approval from the United States Federal Trade Commission in December 1996 and was finalized in April 1997. There was no enforcement action taken in jurisdictions other than the United States and the European Union.

Divestitures of Herbicide and Flea Control Businesses

The FTC alleged that Ciba-Geigy and Sandoz together controlled approximately 45 percent of a relevant market defined as corn herbicide sales in the United States. Ciba-Geigy and Sandoz were also the two largest suppliers of flea control products in the United States. In both instances the FTC believed that a merger would lessen competition and result in higher prices. Although there were recent or looming entrants with effective new products in each sector, the FTC staff was not persuaded that such entry would be sufficient to prevent a "substantial lessening of competition" under the *Clayton Act*. Accordingly, the consent order required Sandoz to divest a corn herbicide plant in Beaumont, Texas, along with the worldwide assets and business related to its dimethenamid-based products, and the U. S. and Canadian assets and business related to its dicamba-based products. Similarly, the consent order

required the divestiture of a facility in Dallas which formulated flea control products for sale in the United States and Canada, along with other related U. S. and Canadian assets.

It is now routine for U. S. antitrust enforcement agencies to ensure that the product lines included in a divestiture comprise a business unit with sufficient critical mass to provide vigorous and effective competition to the merged entity. The *Ciba-Geigy/Sandoz* order extends this critical mass principle to include geographic considerations. Although the United States was identified as the relevant market, divestitures of businesses in other countries were considered necessary to ensure that the purchaser would be able to provide strong competition to the merged entity in the United States. The case illustrates how one jurisdiction may exact remedies in other countries even though conditions in those markets are different and the local competition law agencies have not concluded that a remedy is necessary (or have determined — as in the case of flea control products in the European Union — that a less intrusive remedy is appropriate).

Licensing of Gene Therapy Patents

Gene therapy involves complex, unproven and enormously risky technologies. No gene therapy product has been approved for sale anywhere in the world. While acknowledging that the first regulatory approvals were not expected before the year 2000, the FTC's complaint stated that "gene therapy treatments now in clinical trials offer patients the prospect of significant medical improvements or cures for diseases" and highlighted the possibility of spectacular sales results (*eg.* that sales of gene therapy products could reach U. S. \$45 billion by 2010). The complaint alleged that there is a "market" for research and development of gene therapy products which is highly concentrated, with Ciba-Geigy (through its approximately 46.5% investment in Chiron Corporation, a publicly-traded biotechnology company based in California) and Sandoz being the two major firms that "control the substantial proprietary rights necessary to commercialize gene therapy products" and possess the "expertise and manufacturing capability to commercially develop gene therapy products." Thus, although the FTC states that there are a "substantial number" of other companies capable of inventing and marketing gene therapy products, the FTC concluded that the merger would result in a lessening of competition by reducing incentives to innovate and raising barriers to entry. As a result, the consent order required that Rhône-Poulenc Rorer or another credible potential competitor be granted non-exclusive licences in respect of a broad portfolio of U.S. and foreign patents.

This case represents the most ambitious application to date of the "innovation market" concept (which was outlined by Richard Gilbert and Steven Sunshine in a 1995 *Antitrust Law Journal* article entitled "Incorporating Dynamic Efficiency Concerns in Merger Analysis: The Use of Innovation Markets" vol. 63, p. 569). In earlier cases, the FTC had employed innovation markets where products already existed or were close to introduction (see, for example, *In the Matter of Boston Scientific Corporation*, File No. 951-0002 (1995) and *In the Matter of Glaxo PLC*, Docket No. C-3586, (1995)). *Ciba-Geigy/Sandoz* extends the concept to situations where commercialization is not only far from imminent but subject to massive uncertainty.

The innovation markets concept — which has not been the subject of an adjudicated decision by any court or tribunal — is highly controversial. Even Gilbert and Sunshine admit that various "complicating factors" cloud the relationship between market structure and the pace of innovation. For example:

- It is difficult to predict what new products or processes will be developed successfully, let alone when, where and by which firms (including firms in unrelated industries and entrepreneurs).

- Many new inventions are revolutionary, making comparisons to existing product markets difficult.
- Innovation influences market structure as well as being influenced by it.
- Firms vary greatly in terms of effectiveness of innovation efforts.
- Greater R&D expenditures may reflect greater R&D efforts, but not necessarily increased R&D effectiveness.
- Monopolists may have stronger capabilities and incentives to innovate than competing firms.
- A merger may enhance efficiency even if research and development activities are rationalized (eg. by reducing duplication of efforts, allowing R&D scale or scope economies to be realized, raising R&D quality or lowering its cost).

The FTC staff report on *Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace* (1996), acknowledged the difficulty in determining *ex ante* whether a merger will increase or decrease innovation competition and that it is essential to "proceed with care in enforcing the law in this area." Nevertheless, the FTC has displayed a greater willingness to intervene in mergers based on innovation theories than any other competition law enforcement agency. This often will have global implications because the effects of R&D activities tend to spill over into other jurisdictions. In this case, future product markets in every country in the world will be impacted by the changes to the gene therapy R&D environment resulting from the *Ciba-Geigy/Sandoz* consent order.

The Highest Common Denominator Effect of Extraterritorial Remedies

Historical debates over extraterritoriality have focussed on the reach of the United States' and other countries' domestic legislation. Remedies were considered primarily in terms of enforcing orders against parties located abroad. More recently, competition law enforcement agencies have begun exploring "positive comity" which includes the possibility that the agency best-positioned to effect a remedy may take action to address competition concerns of an agency in another jurisdiction. The leading example is the *Agreement Between the Commission of the European Communities and the Government of the United States of America Regarding the Application of their Competition Laws* (the agreement was developed in 1991 but was struck down for constitutional reasons by the European Court of Justice. A slightly revised version entered into force in 1995. Amendments currently being negotiated would transform positive comity into a mandatory obligation in respect of certain market access concerns). The *Ciba-Geigy/Sandoz* merger illustrates a very different scenario: divestitures or intellectual property licences which have deliberate extraterritorial components in order to remedy perceived domestic competition concerns. If other agencies imitate the FTC's approach to innovation markets and its willingness to consider geographic scope as a component of critical mass in divestiture packages, the result will be a "highest common denominator effect" in which the most interventionist jurisdiction impacts on the worldwide structure and value of the transaction.

When an international merger raises competition concerns in a particular jurisdiction, it is tempting to assume that a prohibition or divestiture remedy related to that jurisdiction will be feasible and sufficient. Large international mergers tend to be time sensitive and vulnerable to regulatory uncertainty. As a result, merging parties are reluctant to litigate, even when faced with onerous demands from antitrust enforcement agencies. Any agency of significance may therefore have the leverage to obtain remedies which have international spillover effects. Merging parties may find that they are forced to divest of businesses or licence intellectual property in countries where the merger has been cleared or where no

competition concerns exist. Thorough coordination and contingency planning will be all the more critical to manage the risks resulting from this highest common denominator effect.