

Class 17 slides

Unit 8: Sysco/US Foods

Professor Dale Collins
Merger Antitrust Law
Georgetown University Law Center

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Good things
come from
Sysco

US.
FOODS™
KEEPING KITCHENS COOKING.™

Five new concepts

1. *Cluster markets* in product market definition
2. *Targeted customer markets* in product market definition
3. Use of *overlapping draw areas* to define geographic markets
4. *Auction* theory of unilateral effects
5. “Litigating the fix”

The Background

The deal

- Sysco Corporation to acquire US Foods
 - ❑ Announced December 9, 2013
 - ❑ \$3 billion of Sysco common stock (13% of combined company)
 - ❑ +\$500 million of cash
 - ❑ Assumption of \$4.7 billion of USF debt
 - ❑ Total transaction value: \$8.2 billion
 - ❑ Agreement expires September 8, 2015 (21 months)



The parties

■ Sysco

- ❑ Publicly traded “broadline” distributor
- ❑ Sales = \$44 billion in food distribution sales 2013
- ❑ #1 with about 17% of total food distribution sales nationally
- ❑ 72 broadline distribution facilities nationwide



■ US Foods

- ❑ Privately owned broadline distributor (Clayton, Dubilier & Rice and KKR)
- ❑ Sales = \$22 billion in food distribution sales in 2013
- ❑ #2 with about 8.6% of total food distribution sales nationally
- ❑ 61 broadline distribution facilities nationwide



Deal rationale

1. Creates a company with \$65 billion in sales

- ❑ Sysco (#1 w/17%) + USF (#2 w/8.6%) = Combined (#1 w/25.6% of total food distribution sales nationally)
 - Number 3: Performance Food Group (2.4%)
- ❑ Would employ over 14,000 sales reps
 - No other broadliner employs more than 1600
- ❑ Would operate over 13,000 trucks
 - The next-largest broadliners operate just over 1,600 trucks

2. Immediately accretive to earnings after adjusting for transaction-related costs and amortization of intangibles

3. Annual recurring synergies > \$600 million (after 3-4 years)

- ❑ Eliminate duplicative overhead
- ❑ More leverage to lower costs of goods (COGS)
- ❑ Optimize distribution facilities and logistics
- ❑ Integrate sales force
- ❑ Bigger platform for enhanced innovation and development of exclusive products

Industry background

- Food service distribution
 - Total industry sales nationwide = \$231 billion (2013)
 - Supply a broad range of fresh, frozen, canned and dry food and non-food products to away-from-home food service operations
 - Customers include—
 - Independently owned single location restaurants, regional and national chain restaurants (majority of sales)
 - Hotels, motels, and resorts
 - Hospitals
 - Schools
 - Government and military facilities
 - Retail locations

Industry background

- Types of food distributors: Product range/channel
 1. Broadline
 - “One-stop” shop—carry everything
 2. Specialized
 - Meat
 - Seafood
 - Produce
 - Baked goods
 3. Systems distributors
 - “Customized” distributors for fast food, casual chain restaurants (e.g., Burger King, Wendy’s, Applebee’s)
 - Small number of SKUs
 - Often proprietary to chain
 - Very small sales forces
 4. Cash-and-carry and club stores
 - E.g., Restaurant Depot, Costco, Sam’s Club
 - Generally do not deliver
 - No sales force dedicated to individual customers
 - Typical customer: independent restaurant

Industry background

- Types of food distributors: Geographical distribution footprint
 - National
 - Regional
 - Local

Industry background

- Largest food distributors in the United States

Distributor	Distribution Footprint	Distribution Centers
Sysco	Nationwide	72
US Foods	Nationwide	61
Performance Food Group	Eastern/Southern U.S.	24
Gordon Food Service	Midwest, Florida, TX	10
Reinhart Foodservice	East, Mideast	24
Ben E. Keith Co.	Texas and bordering states	7
Food Services of Am.	Northwest	10
Shamrock Foods	Southwest, Southern Calif.	4
Local distributors	Local	1-5 each

Industry background

- Distribution centers
 - Key for broadline distribution



- 28-foot clear-height ceilings
- “Super-flat” insulated floor systems to meet strict temperature control standards
- Zoned to accommodate the storage of both perishable and dry goods

Distribution centers

- US Foods distribution centers in 2017
 - Only three more centers than in 2013

A look at US Foods



250,000
Customers

350,000
SKUs

5,000
Suppliers

25,000
Employees

4,000
Sales
Associates

64
Distribution
Facilities

6,000
Trucks

GREAT FOOD. MADE EASY.

5

The FTC investigation and litigation

- FTC investigated for one year
 - Second request issued on February 18, 2014 (a little over two months after signing)
 - Investigation ended February 20, 2015
- Fix-it-first solution:
 - On February 2, 2015, Sysco signed a deal to sell 11 of 61 USF distribution centers to #3 Performance Food Group
 - Announced Feb. 2, 2015
 - Conditioned on closing main deal
 - The centers to be divested largely located in the western U.S.
 - PFG had only one center in the West
 - PFG had 24 broadline centers in total, mainly in East/South
 - Accounted for \$4.5 billion in sales
 - About 20% of USF premerger sales
 - Would give PFG a total of \$10.5 billion in broadline sales
 - Compare to \$60.5 billion for the combined firm post-divestiture
- FTC rejected the fix and brought suit
 - Joined by 10 states and D.C., later 11 states and D.C., under Clayton Act § 16
 - Parties “litigated the fix”

FTC complaint

■ Plaintiffs:

- Federal Trade Commission
- 10 states plus the District of Columbia

■ *Filed*: February 20, 2015

- 14 months after signing

■ *Claim*: Acquisition, if consummated, would violate Section 7 in—

1. Nationwide foodservice distribution to “national” customers

- Combined first and second largest broadline foodservice distributors
- Post-divestiture litigation estimates: combined share 59%-71%; HHI deltas 1500-1966

- Auction unilateral effects

2. 32 local markets

- Post-divestiture litigation estimates: shares up to 93.8%; HHI deltas up to 4123
- Auction unilateral effects

■ Prayer:

- Preliminary injunction blocking the deal pending a final adjudication of the merits
- *Query*: Should the states also have sought a permanent injunction?

The District Court

- Tried in the U.S. District Court for the District of Columbia
 - Judge Amit P. Mehta
 - Appointed by President Obama
 - Assumed office: December 19, 2014
 - Assigned case: February 20, 2015

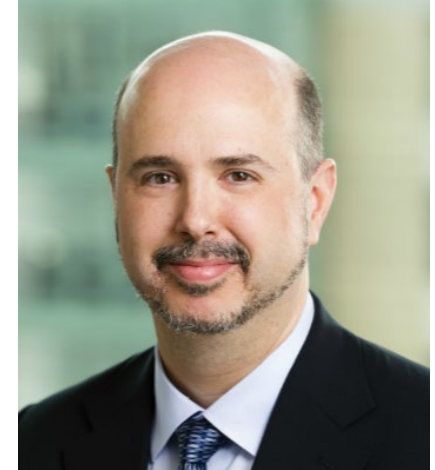


- Case was tried with the understanding that the parties would terminate their merger agreement if the PI was entered

Testifying experts

■ FTC: Dr. Mark A. Israel

- Senior Managing Director, Compass-Lexecon
- Ph.D in Economics, Stanford University (2001)
- Extensive testifying experience in antitrust cases (especially merger antitrust cases)



■ Parties: Dr. Jerry Hausman

- Professor of Economics, MIT
- D.Phil, Oxford (1972)
- Leading academic econometrician
- Extensive testifying experience in antitrust cases (including merger antitrust cases)



The District Court

- Entered the preliminary injunction blocking the deal
 - Relevant markets
 - Nationwide broadline foodservice distribution to national customers
 - Local broadline foodservice distribution to local customers
 - Anticompetitive effects (upward pricing pressure)
 - *PNB* presumption
 - Unilateral effects in the national broadline customer market
 - Unilateral effects in local broadline markets
 - Defenses insufficient to put the prima facie case into dispute
 - The PFG “fix”
 - Dealing regionally by national customers
 - Entry/expansion
 - Efficiencies
 - Equities favored granting of a preliminary injunction

PI entered: June 23, 2015
Deal terminated: June 26, 2015

Parties abandon the merger

■ Estimated costs to Sysco

- ❑ \$300 million breakup fee to US Foods
- ❑ \$12.5 million breakup fee to divestiture buyer Performance Food Group
- ❑ \$265 million in redemption and associated financing costs
- ❑ \$258 million on integration planning and advisers
- ❑ \$100 million in historical financing costs, and
- ❑ \$53 million in computer systems integration

Estimated total: \$1 billion

The District Court's Analysis

Organization of opinion

- Background/legal standard
 - Clayton Act § 7
 - FTC Act § 13(b)
 - *Baker-Hughes* three-step burden-shifting framework
- Relevant markets
 - The relevant product market
 - Broadline distribution as a relevant product market
 - Legal principles
 - Application of *Brown Shoe* “practical indicia”
 - Expert testimony (including the hypothetical monopolist test)
 - Conclusion
 - Broadline distribution to “national customers” as a relevant product market
 - Legal principles
 - Application of *Brown Shoe* “practical indicia”
 - Expert testimony (including the hypothetical monopolist test)
 - Conclusion
 - The relevant geographic market
 - National market
 - Local markets

Organization of opinion

- Probable effects on competition
 - *PNB* presumption
 - *PNB* presumption in the national customers broadline distribution market
 - *PNB* presumption in the local broadline distribution markets
 - Additional evidence of competitive harm
 - Unilateral effects in the national customers broadline distribution market
 - Merger simulation in the national customers broadline distribution market
 - Unilateral effects in local broadline markets
 - Event studies (“natural experiments”) in local broadline markets
- Defendants’ other rebuttal arguments
 - PFG divestiture
 - Existing competition
 - Entry/expansion
 - Efficiencies
- The equities
- Conclusion

The District Court Opinion

1. The Prima Facie Case

A. Relevant Product Markets

Product markets: Allegations

- FTC position: Two product markets
 1. Broadline foodservice distribution (as opposed to all food distribution) to all customers
 2. Broadline distribution to “national” customers
- Merging parties’ position
 - All foodservice distribution (including specialty distributors)
 - Reject a product market limited to national customers

Two new concepts here:

1. *Cluster market of nonsubstitutable products*
2. *“Targeted customer” market*

Broadline Foodservice Distribution Cluster Market

Cluster markets: Principles

- Both the FTC and the merging parties alleged *cluster markets* consisting of *largely nonsubstitutable products*
 - Widely accepted in the case law
 - Recognized in the Merger Guidelines since 1992
 - Some examples
 - Commercial banking services, grocery stores, drug stores, department stores, consumable office supplies, acute care inpatient hospital services
- Courts have generally accepted cluster markets as relevant product markets when:
 1. The products are traditionally offered by the same seller at the same point of sale
 2. The products appeal to the same type of customer
 3. The products exhibit significant economies of scope in purchasing
 4. The products roughly face the same level of competition from other firms
 - We will see a case where there was a significant and uniquely different level of competition for a specific product line later in Staples/Office Depot (which excluded that product line from the cluster market)

Cluster markets: Principles

- Price flexibility within a cluster market
 - Generally, sellers have some flexibility in setting the prices of individual products without being constrained by competition from partial line or single product sellers, provided that the sellers remain competitive within their product offering as a whole
- Observations
 - Not well defined in the case law, but frequently adopted by courts
 - Has a “know it when you see it” quality
 - Accepted “for analytical convenience” when competitive forces and market shares are likely to be the same across products within the putative cluster market
 - Typically, analytical similarity is simply asserted rather than analyzed by courts

Cluster markets: Application in *Sysco*

- In *Sysco*, the dispute was not over whether the court should find a cluster market, but rather *what* cluster market it should find
 - *FTC*: Broadline foodservice distribution
 - *Merging parties*: All foodservice distribution, including—
 - Specialized wholesalers of meat, seafood, produce, and baked goods
 - Systems distributors for retail food chains (e.g., Burger King, Wendy's, Applebee's)
 - Cash-and-carry and club stores (e.g., Restaurant Depot, Costco, Sam's Club)

Cluster markets: Application in *Sysco*

- **Court:** Broadline distribution is a relevant product market
 - *Brown Shoe* “practical indicia” support FTC’s definition
 1. Product breadth and diversity
 - “One-stop shop” for almost any type of customer
 - Number of SKUs carried by other types of distributors pales in comparison
 - Offer private label products
 - Customers may buy from other types of distributors on a limited basis
 2. Distinct facilities and operations
 - Massive distribution centers
 - Large sales forces
 - Run channel as a separate business
 3. Delivery
 - Timely and reliable delivery critical
 - Broadline has sufficient fleet of service vehicles to offer frequent and flexible delivery schedules to meet customer needs
 - Including next-day delivery

Cluster markets: Application in *Sysco*

■ *Court*: Broadline distribution as a product market

- *Brown Shoe* “practical indicia” support FTC’s definition
 4. Customer service and value-added services
 - For example, offer menu and nutrition-meal planning services
 - Food safety training for customers at distribution centers
 5. Distinct customers
 - Serve a wide range of customers that other channels cannot reach
 6. Distinct pricing
 - Typically price only against other broadline distributors
 - Not against higher-priced specialty or lower priced cash-and-carry
 7. Industry or public recognition
 - Recognizes broadline as a distinct channel

NB: The Court did not strictly look at the specific indicia listed in Brown Shoe, but considered any qualitative evidence probative of substitutability

Cluster markets: Application in *Sysco*

- **Court:** Broadline distribution as a product market
 - Hypothetical monopolist test supports FTC's definition
 - Israel used a sufficient aggregate diversion ratio implementation for a uniform SSNIP
 - Margin $> 10\%$ --That is, the percentage gross margins of all products in the candidate market were greater than 10%

The inequality indicates that Israel used a sufficiency test

- Israel used this relationship:

$$R_{Min} \equiv \frac{\delta}{\delta + \%m_{RMin}} \geq \frac{\delta}{\delta + \%m_{RAve}} = R_{Critical}$$

Remember, the smaller the denominator, the larger the fraction

- So

$$R^1 \geq R_{Min}^1 \Rightarrow R^1 \geq R_{Critical}^1$$

- Example

- Say $\%m_2 = 10\%$, $\%m_3 = 15\%$, and $\%m_4 = 20\%$, so $\%m_{Min} = 10\%$
- Regardless of the specific diversion ratios, $\%m_{RAve}$ is at least 10% and no more than 20%

$$R_{Min} \equiv \frac{5}{5 + 10} \geq \frac{5}{5 + \%m_{RAve}} = R_{Critical}$$

- If $R^1 \geq R_{Min}$, then $R^1 \geq R_{Critical}$ and the HMT is satisfied¹

¹ See the Appendix for more on sufficient and necessary recapture tests

Cluster markets: Application in *Sysco*

- **Court:** Broadline distribution as a product market
 - Hypothetical monopolist test supports FTC's definition
 - Israel used a sufficient aggregate diversion ratio implementation for a uniform SSNIP¹
 - Margin > 10% (using 10% as a lower bound is conservative since it gives a higher critical recapture rate than would the actual margins—making the HMT harder to satisfy)
 - SSNIP = 10% (Why?)
 - Critical recapture formula for a uniform SSNIP recapture sufficiency test:
$$R_{Min} = \frac{\delta}{\delta + \%m_{Min}} = \frac{10}{10 + 10} = 0.50 = 50\%$$

Indicates that the recapturing products have a SSNIP
 - Data for actual recapture rates
 - *Win/loss data:* For each company, built tracking database that showed, for each bidding opportunity, the incumbent distributor, the winning distributor, and the competing bidders
 - *Sysco:* Lost 70% of the bids to another broadline distributor as opposed to another type of food distributor
 - *USF:* Over 70% to another broadline distributor
 - Both recapture rates exceed the 50% sufficiency threshold, so broadline distribution satisfies the test
 - **Court:** Rejected defendants' challenges to data and application
 - BUT agreed that the flaws in the data reduced the probative value of the test but still corroborative of result from other evidence

¹ See the Appendix for sufficient and necessary recapture tests

Cluster markets: Application in *Sysco*

- Accepted: Broadline distribution as a product market
 - Hypothetical monopolist test supports FTC's definition
 - WDC: Some questions you should be asking:
 1. The FTC's expert used the formula for a uniform SSNIP recapture test. Is this the correct formula to use?
 2. Does the data used to estimate recapture rates suggest a one-product SSNIP or a uniform SSNIP?
 3. Are there any hidden assumptions?
 - What would have been the result of the analysis if the FTC's expert assumed that the data estimated one-product SSNIP diversions and used a one-product SSNIP critical recapture formula?
 - The FTC's expert used a sufficiency test here. Failing a sufficiency bound does not establish failure of the HMT.

Targeted Broadline Foodservice Distribution Market to National Customers

Targeted customer market: Allegations

- The allegations
 - *FTC*: Alleged that within the broader broadline foodservice distribution market, there existed a relevant market of “national customers”
 - *Merging parties*: Argued that there was no separate market of “national” customers
 - Can purchase more regionally or locally
 - Consortia will form to protect these customers if the combined firm seeks to act anticompetitively

Targeted customer market: Application in *Sysco*

- **Court:** Broadline distribution for national customers
 - **Rule:** A relevant market can be defined by a group of customers if they can be targeted for a price increase (citing the 2010 HMG § 4.1.4)
 - Here, national customers can be readily identified
 - Given the nature of the product, there is no arbitrage among purchasers
 - **Notes**
 - The targeted customers as a group may be charged discriminatorily *lower* prices than other customers
 - Nonetheless, the Merger Guidelines and the courts recognize that an actionable anticompetitive effect occurs when, as a result of a merger, the prices to the targeted customer group are likely to be higher than they were premerger, even if they remain below the prices charged to other customers

Targeted customer market: Application in *Sysco*

- *Court*: Broadline distribution for national customers is a relevant product market
 - Market supported by *Brown Shoe* “practical indicia”
 - Industry and public recognition of distinct customer needs
 - Regional broadliners have formed cooperatives to bid for national customers (formed specifically to compete against Sysco and US Foods)
 - McKinsey report (done for Sysco) and other industry research studies support national customers as a distinct customer group with distinct requirements
 - Industry trade group (International Food Distributors Association) recognizes the distinction
 - Defendants’ ordinary course of business documents support national customers as a distinct customer group
 - PROBABLY KEY: National customers testified that they would not switch to other channels to substitute for a broadline supplier
 - Aggregate diversion analysis corroborates the market
 - Analysis identical as in broadline generally
 - EXCEPT look to recapture only by broadline companies with a national footprint

Targeted customer market: Application in *Sysco*

- *Court*: Broadline distribution for national customers
 - Rejects defendants' arguments
 - The distinction between national and local is not arbitrary: reflects a preference by national customers for which they are willing to pay
 - National customers are identifiable—contracts are individually negotiated
 - No arbitrage of products, so national customers can be charged different prices
 - Sysco and US Foods earn higher margins on sales to local customers than from sales to national customers, indicating that national customers can constrain prices in ways that other customers cannot
 - *Court*: Customer testimony indicates that the lower margins more likely result from national customers playing Sysco and US Foods off each other

The District Court Opinion

1. The Prima Facie Case

B. The Geographic Markets

Geographic markets

- FTC allegations:
 1. National for broadline distribution to national customers
 2. Local for broadline generally
- Court: Legal standard
 - “[T]he area in which the goods or services at issue are marketed to a significant degree by the acquired firm” (*Marine Bancorp.*)
 - “[W]here, within the area of competitive overlap, the effect of the merger on competition will be direct and immediate” (*PNB*)
 - The Supreme Court has recognized that an “element of ‘fuzziness would seem inherent in any attempt to delineate the relevant geographical market,’ ” and therefore “such markets need not—indeed cannot—be defined with scientific precision.” (*Connecticut National Bank*)
 - *WDC*: Could have added that the Merger Guidelines give a more precise standard using the hypothetical monopolist test

Geographic markets: Application in *Sysco*

- **Court:** Accepts national broadline market for national customers:
 - Defendants plan on a national level and have “national account” teams dedicated to national customers
 - Their contractual pricing and service terms with national customers apply across regions
 - Their competition for national customers is largely other broadliners with nationwide coverage
 - “Although the physical act of delivering food products occurs locally, for national customers the relevant geographic area for competitive alternatives is nationwide”—given how they are:
 - Marketed
 - Sold
 - Priced
 - Serviced
 - These are essentially the same factors that established the national customer product market—No further analysis
 - Only here the Court is addressing the relevant geographic market, not the relevant product market

Geographic markets: Application in *Sysco*

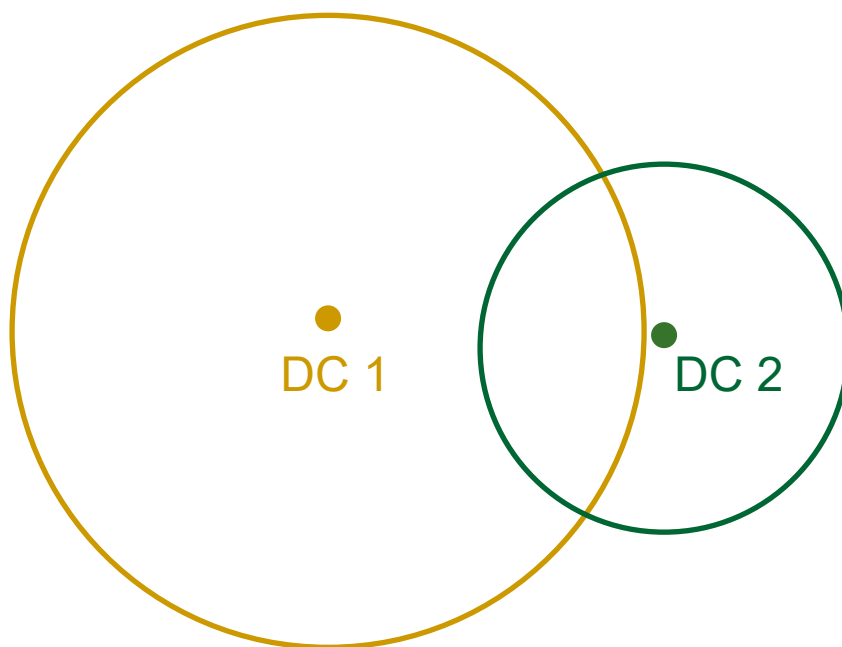
- *Court*: Accepts FTC's local markets for all broadline foodservice distribution
- FTC methodology (overlapping draw areas)
 - *Step 1*: For each distribution center, determine the radius in which the center draws 75% of its sales to local customers ("draw areas")
 - *Step 2*: Determine the "overlap areas"—these customers will have one less alternative supplier as a result of the merger
 - *Step 3*: Identify the broadline distributors who could compete for the overlap customers (using the distributor's 75% draw radius)
 - The relevant geographic market is the customer overlap area; the larger surrounding area identifies competing distributors

While there may be substantial data problems in applying this approach and some of the parameters can be debated, the "overlapping draw areas" approach is accepted as a valid geographic market definition technique

Local broadline markets

- FTC “draw area” methodology

- *Step 1:* For each distribution center, determine the radius in which the center draws 75% of its sales to local customers (“draw areas”)

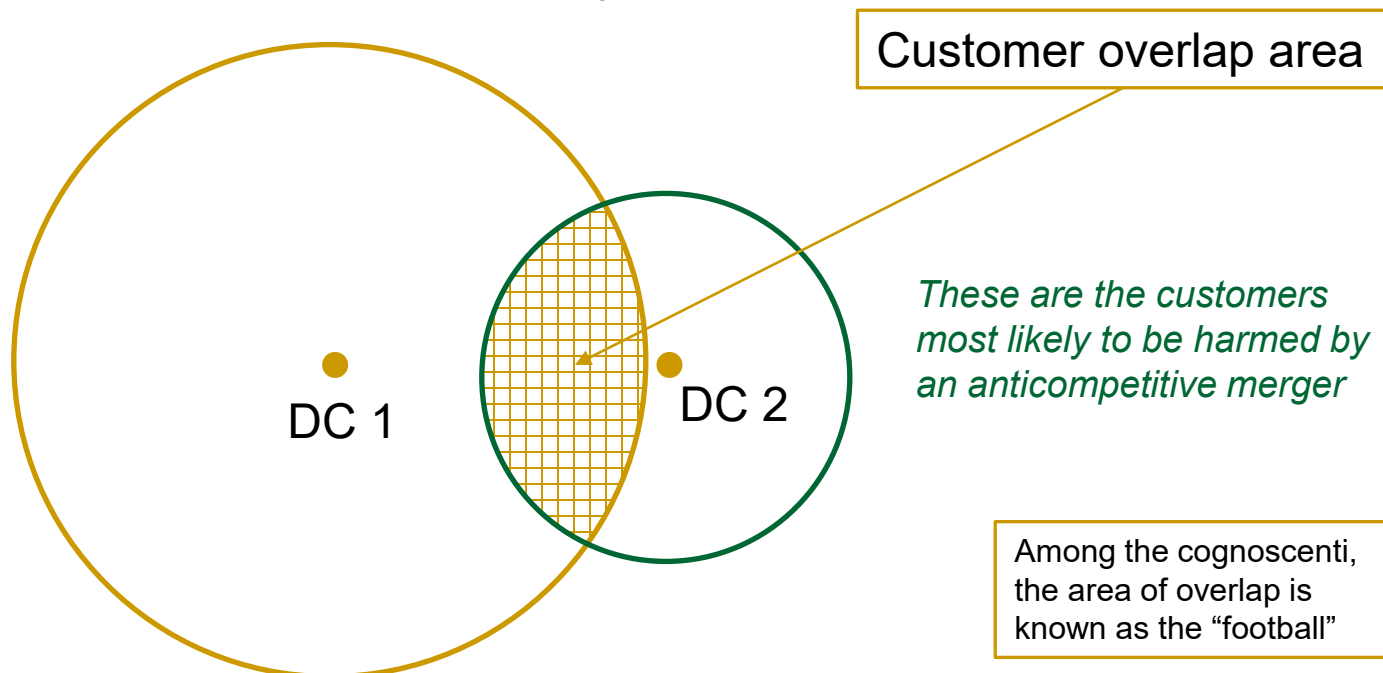


The percentage of revenues that determines the draw area can be a subject of dispute. But courts and agencies commonly accept 75%-80%. Careful practitioners and economists will perform a sensitivity analysis to see if the results change significantly with different percentages

Local broadband markets

■ FTC “draw area” methodology

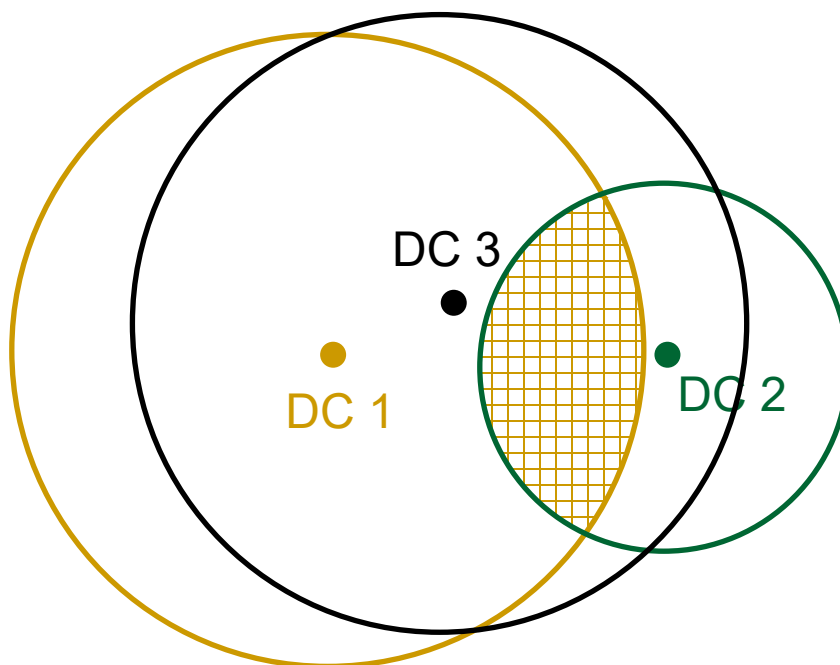
- Step 2: Determine the “overlap areas”—these customers will have one less alternative supplier as a result of the merger



NB: The price discrimination condition is critical in this model. It allows a firm to charge higher prices in the overlap area than in the remainder of the firm’s service area. If the firm could not price discriminate—as might be the case if customers travel to the supplier’s location (e.g., the typical retail situation)—then prices would have to increase for all customers. The union of draw areas would be a candidate market requiring further analysis.

Local broadband markets

- FTC “draw area” methodology
 - *Step 3*: Identify the market participants—those broadband distributors who could compete for the overlap customers (using the distributor’s 75% draw radius)

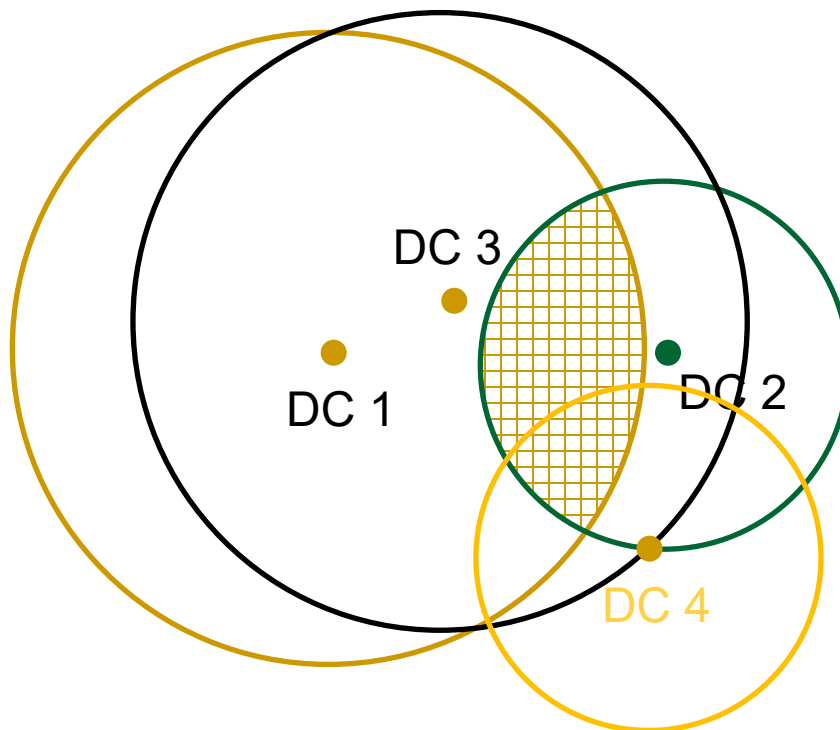


DC 3 is in the market

Local broadband markets

■ FTC “draw area” methodology

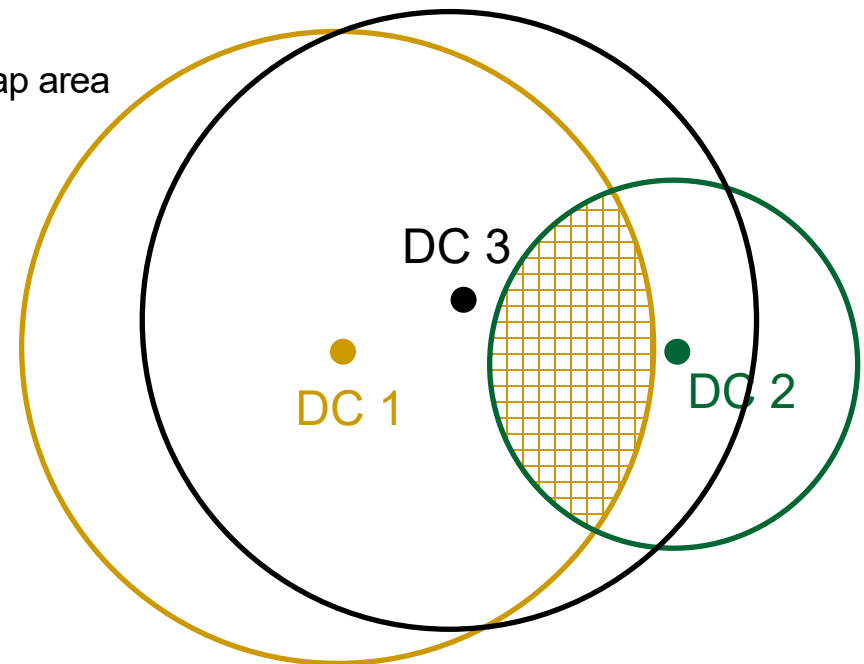
- *Step 3*: Identify the market participants—those broadband distributors who could compete for the overlap customers (using the distributor’s 75% draw radius)



DC 4 is not in the market
WDC: This is disputable. DC 4 has some competitive effect in the relevant market and that effect should be taken into account in one of two ways: (1) DC 4 could be deemed a market participant to the extent it sells into the relevant market, or (2) the overlap area could be divided into two distinct relevant markets, one with DC 4 as a participant and one where it is not.

Local broadline markets

- FTC “draw area” methodology—So what is the relevant geographic market?
 - The court defined the market by the overlap area (the “football”)—these are the customers that are most likely to be harmed by an anticompetitive merger
 - The market participants are suppliers who could serve customers throughout the overlap area (here, firms 1, 2, and 3)—but see the earlier slide for a critique
 - The market share of these participants should include:
 - Sales the distributor makes in the overlap area
 - PLUS any diversion of sales into the area if prices were to increase by 5%
 - WDC suggestion: If the data do not permit isolation, consider the union of the draw areas as a market-share proxy
 - Should still yield good results if suppliers will rapidly shift sales in response to a price increase in part of their sales area



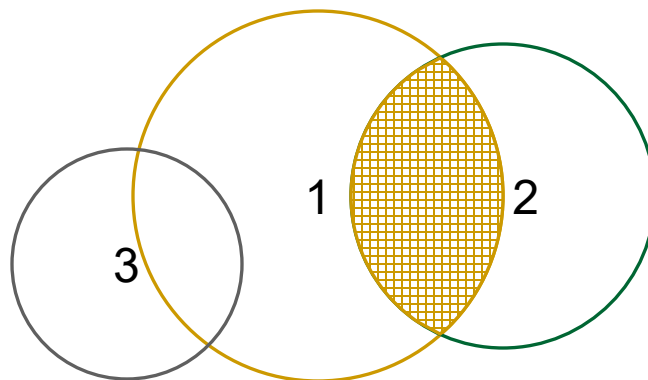
Local broadline markets

■ A quick recap

- *With price discrimination:* The prior analysis assumed that the firms could price discriminate based on customer locations
 - Requires that the customers use what products they purchase and do not resell them to other customers (that is, they do not engage in arbitrage)
 - This is often—but not always—the case when suppliers go to their customers' locations
 - Here, the relevant market is the *intersection* of the draw areas of the merging firms
 - The market participants are those firms that—
 - Compete throughout the “football” or
 - Compete in any portion of the “football” } Subject to dispute
 - with their market shares determined by their sales into the “football” plus any additional sales they would make with a SSNIP in the “football”
 - Another possibility is to divide the overlap into separate relevant geographic markets to isolate partial overlaps in the “football” by competitors
- *Without price discrimination:* What is the analysis when firms cannot price discriminate among their customers?
 - This is the typical retail situation: Customers travel to the retail store and buy products on the shelves at listed prices
 - All customers are charged the same price for a given product regardless of the customer's location
 - Here, the starting candidate market is the *union* of the draw areas of the merging firms—apply *Brown Shoe* factors and HMT to determine the relevant geographic market

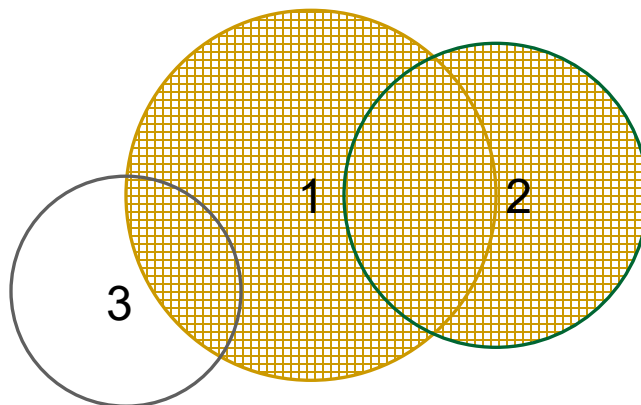
Local broadband markets

- A quick recap: Firms 1 and 2 merge
 - With discrimination (as when suppliers go to customers and customers cannot arbitrage)



Firm 3 is not a constraining force on the merged firm

- Without discrimination (as when customers go to suppliers)



Firm 3 is a constraining force on the merged firm

Local broadline markets

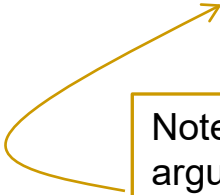
■ Defendants' response

□ Markets too small

- Some suppliers will ship into the overlap area even though it is outside their defined draw area
- By construction, 25% of a supplier's shipments will be outside its defined draw area

■ Court

- True, but the FTC's approach is a practical one that identifies areas that are likely to be competitively affected
- KEY: Also, no indication in the opinion that expanding markets to meet defendants' criticism would have materially changed the results



Note: This is typical of courts' reactions. If the merging parties are going to argue that the FTC's market definition is wrong, to be persuasive they should prove an alternative market *and* show that within that market the merger will not have the requisite anticompetitive effect.

The District Court Opinion

1. The Prima Facie Case

C. The *PNB* Presumption

National broadline market for national accounts

■ FTC's market shares

Table 18

Shares of Sales to National Broadline Customers, After Accounting for the Proposed
Divestiture

	Post-Divestiture Shares	Post-Divestiture HHI's	
	Combined Share	HHI	Δ HHI
Baseline	71%	5.119	1.966
(i) National	68%	4.935	1.953
(ii) National + Imputed National	65%	4.549	1.799
(iii) National + Regional	66%	4.614	1.822
(iv) National + Systems	62%	4.217	1.643
(v) National + Regional + Systems	61%	4.087	1.590
(vi) Parties' Ratio of National	59%	3.809	1.500

■ Defendants' position

- Contested methodology and inputs
- But offered no alternative calculations that showed that the *PNB* presumption was not triggered

National broadline market for national accounts

■ Court:

- “None of these arguments ultimately persuade the court that Dr. Israel’s methodology or his market shares and HHI calculations are unreliable. The FTC need not present market shares and HHI estimates with the precision of a NASA scientist. The ‘closest available approximation’ often will do.”
- WDC:
 - No doubt the Court was also impressed with the wide variety of market share metrics Israel used, all of which triggered the *PNB* presumption
 - Conducting this type of “sensitivity analysis” demonstrates that the analysis is robust to alternative approaches and considerably enhances its persuasive power

PNB presumption established in national broadline market

■ Also, don’t lose track of where we are in the analysis:

If the FTC prevails in establishing a national broadline customer market, the planned divestitures will not negate the prima facie case

Local broadline markets

- Merger challenged in 32 local markets
- Israel's estimates
 - Metrics
 - Square footage of distribution centers
 - Local broadline sales
 - Number of sales representatives

NB: The calculations account for any divestitures to PFG

Table 21

Examples of Areas with Large Change in HHI despite Divestitures

CBSA	Post-Merger Combined Share	Delta HHI
Omaha-Council Bluffs, NE-IA	90.3%	1,410
Sacramento--Roseville--Arden-Arcade, CA	88.6%	2,974
Durham-Chapel Hill, NC	75.4%	2,807
Charleston-North Charleston, SC	80.2%	2,947
Birmingham-Hoover, AL	57.5%	1,542
Jackson, MS	66.0%	2,155
Memphis, TN-MS-AR	93.8%	4,123
Columbia, SC	72.8%	2,315
Raleigh, NC	71.3%	2,188
Lynchburg, VA	63.3%	1,588
Rochester, NY	63.7%	1,574

Local broadline markets

■ Defendants

- Same types of arguments as before—contesting methodology and inputs
- But no alternative calculations showing that the *PNB* presumption is not applicable

■ Court:

- Numbers not perfect, but good enough to make a prima facie showing in the absence of opposition
- Defendants' challenges not persuasive → FTC has established its prima facie case

■ WDC:

- Same result in local broadline markets as in the national broadline customer market:

If the FTC prevails in establishing any of these local broadline markets, the planned divestitures will not negate the prima facie case

The District Court Opinion

1. The Prima Facie Case

D. Additional Evidence of Anticompetitive Effect

Additional evidence of anticompetitive effect

1. Auction unilateral effects in the national customer market
2. Merger simulation for the national customer market
3. Auction unilateral effects in local markets
4. Local event studies on unilateral effects in local markets

Unilateral effects in national customer market

■ Evidence

1. Sysco and US Foods are the top two choices for many national customers
 - Israel's RFP/bidding study (7 years of data—from merging firms' win-loss data or FTC subpoenas)
 - Sysco lost to USF 2.5 times as often as to the next closest competitor
 - USF lost to Sysco 3.5 times as often as to the next competitor
2. Parties' ordinary course of business documents show that they are each other's closest competitors
3. Testimony from industry participants
4. Independent market research reports

■ Court: Credited Israel's analysis

At this point, Israel has provided qualitative and win-loss data to predicate a unilateral effects theory, which the Court accepted as sufficient. The Court cited no further quantification.

- NB: This is a different theory of unilateral effects than we saw with recapture: It depends on “winner-take-all” bidding
 - This is called *auction unilateral effects*: It can (but need not) be quantified

Merger simulation for national customer market

- Israel: Used “auction model” to estimate price increases
 - Price and service terms shaped by the second-best bidder
 - The winning bidder offers price and service terms just good enough to beat the second-best bidder
 - Simplified price-only illustration: descending open-cry bidding, or customers privately negotiating and revealing the current lowest bid
 - The opinion describes competitive bids and bilateral negotiations, not this specific bidding procedure
 - The customer then informs other bidders of the bid price they must beat
 - Do this iteratively until no firm beats the lowest bid—the lowest bid firm then wins
 - This is the mechanism by which customers “play off” suppliers against one another
 - □ If #1 and #2 merge, then #3 becomes the second-best alternative and offers the next competitive constraint
 - Competitive harm: Difference in price and service value between #2 and #3
- Can also use costs rather than prices in an auction model
 - In other situations, where the bidders do not have good expectations of their competitors’ bid prices but “know” (have good estimates of) their costs, the auction model can use costs
 - The winning bidder will be the lowest cost firm to supply the customer and win at a price just below the cost of the second lowest-cost supplier to that customer
 - Auction unilateral effects models using either prices or costs will be accepted by the courts as indicative of an anticompetitive effect

Unilateral effects in national customer market

■ Auction theory: Example

- The city of Jacksonville seeks lime for its municipal water treatment facility
- Lime is mined and processed at a lime quarry and shipped to the customers
- The cost of extracting and processing the lime is essentially the same for all suppliers, but shipping costs differ depending on the distance



□ Predicted results:

- The closest lime quarry will win the contract at a price just below the cost of supply of the second-closest quarry
- If the first and second lowest-cost suppliers merge, the price will increase to just below the cost of the third lowest-cost quarry

Unilateral effects in national customer market

- *Requirements (costs version)*: The theory predicts a unilateral price increase from the merger if—
 1. The merger involves the first and second lowest-cost suppliers to one or more customers
 2. The customers can be targeted for price discrimination
 3. The third-lowest cost supplier has costs to supply the customer that are (materially) higher than the second lowest cost-supplier
 4. There are barriers to entry/expansion/repositioning that will impede a supplier postmerger from achieving the cost structure of the second lowest-cost supplier

- **Application**

- Requires bidders to have reasonably accurate expectations of the costs of their competitors
 - Typically use estimated costs rather than prices if projecting future anticompetitive effects
 - But can use prices to do a retrospective study if good price information is available
- This winner-take-all example differs from marginal-sales recapture analysis, but substitution between bidders remains relevant to auction competition

Note: We now have two distinct theories of unilateral effect:

1. *Recapture of diverted sales (“recapture unilateral effects”)*
2. *Auction unilateral effects in bidding situations (“auction unilateral effects”)*

Merger simulation for national customer market

- Israel's evidence
 - Company emails recognizing that—
 - Sysco and U.S. Foods are each other's closest competitors, *and*
 - The next closest substitute is a very distant third
 - Quantification of model
 - Using market shares and price-cost margins: annual harm > \$1.4 billion without divestiture, absent significant efficiencies or other mitigating factors
 - > \$900 million annually w/divestiture to PFG, on the same assumptions
 - Not clear from opinion what Israel did
- Defendants' criticism—bad data
- *Court*: Recognizes data deficiencies, but model is robust and consistent with other evidence of anticompetitive effect here

Unilateral effects in local markets

- Ordinary course of business documents
 - Show Sysco and US Foods are each other's closest competitors for local customers in jointly served markets
- Testimonial evidence more equivocal (each for particular markets)
 - *FTC testimony*: Uniquely strong competitors of one another
 - *Parties*: Other equally strong or stronger competitors for local customers
 - *Court*: "Because of these conflicting local market assessments, the court cannot draw firm conclusions about the competitiveness of the local broadline markets from the testimonial evidence."
- Empirical evidence of close competition
 - USF's Linc database and Sysco's requests for incentives identified the other merging party far more frequently than other competitors
 - *Court*: Less convincing, but still strengthens the FTC's prima facie case
- Court:

Though the court finds the evidence of unilateral effects in the local markets to be less convincing than in the national customer market, the evidence nonetheless strengthens the FTC's prima facie case of merger harm

Local event studies

■ Israel:

- Studied the effects of Sysco's opening of two distribution centers on prices paid by USF customers
 - USF operated distribution centers in the same 75% overlap area
- Long Island, NY—July 2012
 - Regression analysis showed that entry resulted in a 1.4% decrease in USF's prices
- Riverside, CA—June 2013
 - 0.06% decline

■ The idea

- If opening a merger partner's store in the draw area of the other merger partner's store lowers price, then the merger—which would eliminate competition between the stores—should increase price
- BUT opening a store puts new capacity in the market, whereas the merger will not reduce market capacity unless the combined firm closes one of the two stores
- The entry estimate cannot simply be treated as the predicted merger price increase
 - But it is directional: Prices falling after a competitor's entry supports an inference that eliminating competition could raise prices

Local event studies

- Another problem here
 - Not “clean” studies—Sysco already had centers in these areas
 - This could have suppressed the price effect
- Israel: Interpreting the results
 - The new Riverside center was close to the existing Sysco center—so presumably price effects of Sysco’s presence had already occurred
 - Trying to explain the low 0.06% price effects
 - By contrast, the new Long Island center was farther from the existing Sysco center and served more new business than the Riverside facility, resulting in larger price effects
 - Explains the larger 1.4% price effect

Local event studies

- *Court*: Not convincing evidence that merger would harm local customers
 - Even if the Long Island study is taken at face value, the price effect is much smaller than found in other cases
 - *Staples* (1997): 13% difference in markets where Staples was not competing with another superstore
 - *Whole Foods*: WF dropped prices by 5% when another organic supermarket opened
 - “[T]he absence of convincing pricing effects evidence is the weakest aspect of the FTC’s case”
- Why was the court skeptical of Israel’s results?
 - The court rejected Israel’s explanation: the difference in the facilities’ relative distances was only 14 miles
 - Both new facilities served similar fractions of existing Sysco customers, yet produced very different results that the evidence did not explain
 - Moreover, Section 7 requires a likelihood of a *substantial* lessening of competition
 - Estimates this small, even if accurate, may not rise to the level of a substantial effect
- *WDC*: Should FTC have presented these local event studies?

Anticompetitive effects: Conclusion

- *Court*: The FTC has presented a “compelling” prima facie case of anticompetitive effects

In summary, the FTC has bolstered its prima facie case with additional proof that the merger would harm competition in both the national and local broadband markets. Although the FTC’s case would have been strengthened with more convincing pricing effects evidence [the local event study], the court nevertheless finds that the FTC has presented a compelling prima facie case of anticompetitive effects. *See Baker Hughes*, 908 F.2d at 991 (“The more compelling the prima facie case, the more evidence the defendant must present to rebut it successfully.”). The court now turns to Defendants’ rebuttal arguments.

The District Court Opinion

2. Defendants' Rebuttal Arguments

Four lines of rebuttal

1. Post-divestiture, PFG (the divestiture buyer) will replace any competition potentially lost as a result of the merger (the “fix”)
2. National customers can protect themselves by dealing more regionally
3. The entry of new competition and the repositioning of existing competitors will keep the industry competitive
4. Customers will benefit from efficiencies arising from the merger

1. The PFG “fix”

- *Defense*: Sysco’s divestiture of 11 distribution centers to PFG, with PFG’s existing 24 distribution centers and 7 new centers to be financed by PFG’s owner, will be sufficient to ensure continued competition and negate any anticompetitive effects of the merger
 - Shortly before the FTC complaint was filed, Sysco entered into an agreement to sell 11 USF distribution centers to PFG contingent on the main deal closing
 - In addition, PFG’s owner, The Blackstone Group, committed to invest \$490 million to develop 7 more centers and increase capacity in 16 of PFG’s 24 existing centers
 - *Bottom line*: PFG would start with 35 distribution centers and eventually have 42 distribution centers

1. The PFG “fix”

■ *Court:*

- Appears to agree that merger should be analyzed with the PFG “fix” in place
 - Determine the anticompetitive effects of the merger in the absence of the fix
 - Ask if the fix negates the anticompetitive effects
- Does not doubt—
 - PFG management’s experience or commitment
 - Blackstone’s financial commitment to PFG

1. The PFG “fix”

■ Court:

- BUT PFG will not be nearly as competitive post-fix as USF is premerger:
 - PFG’s 5-year business plan projects 2019 national headline sales of less than ½ of USF’s 2013 national headline sales
 - Even assuming PFG will be able to integrate the 11 USF centers effectively into its operation, it will start with only 35 centers—compared to Sysco/USF at least 100 centers
 - WDC: Premerger, Sysco and USF had 72 and 61 distribution centers, respectively
 - So at least in some (many) markets, PFG will not be as close to the customers as Sysco and USF were premerger → Will not completely negate the auction unilateral effects problem
 - PFG’s pre-negotiation plans called for 14–20 additional distribution centers
 - PFG subsequently told the FTC that it needed at least 13 additional distribution centers
 - New centers and expansions PFG is planning to build, while perhaps they could plug the gap, will not come online for several years at best
 - PFG lacks experience in offering value-added services to some important segments (e.g., healthcare) that both Sysco and USF have premerger
 - Transition Services Agreement: reliance on the merged firm for private-label products for 3 years and the database for at least 5 years, with an option for 5 more (cuts against PFG as a strong independent competitive force)

Defense rejected

2. Protection through regional dealing

- *Defense*: National customers can protect themselves by dealing more regionally
 - Dealing with a single national distributor is merely a preference
 - National customers often deal with multiple sources of supply
- *Court*: Rejected defense
 - Multiple sources for some national customers are often a “one-off” phenomenon—national customers still purchase the bulk of their products from national distributors (61% to 100%)
 - Regionalization available today, but national customers are not moving in that direction—the “clear trend” is to move toward centralization in a single supplier
 - Not merely a customer preference—driven by rational business considerations:
 - Management and supply chain costs increase
 - Multiple points of sales and logistics contact
 - Multiple, different order entry/communications/IT systems
 - Multiple billing systems
 - Consistency in products can suffer (especially private label)

Defense rejected

3. Entry/expansion

- *Defense:*

- No technological, legal or regulatory barriers to entry or expansion
- New firms will enter or smaller incumbent firms will expand in the event of a postmerger price increase and compete prices back down to premerger levels

3. Entry/expansion

■ *Court:*

- Rule: To be a defense, entry must be—
 1. Timely
 2. Likely, *and*
 3. Sufficient to deter or counteract the anticompetitive effect
- *Not likely:* There exist significant barriers to entry and expansion
 - Broadline extraordinarily capital- and labor-intensive
 - New distribution center: \$35 million to build (2015 record estimate)
 - + stock
 - + Delivery trucks (including expensive refrigerated trucks)
 - + People to sell the service, maintain and stock the warehouse, deliver the products, handle the back office
 - Reputation barriers
- *Not timely*
 - Even if barriers could be overcome, it would take years to enter (especially in national market)
- *Not sufficient:* Individual ability and incentive:
 - Incumbent distributors testified that they have no plans to expand to serve national customers—dissuaded by time, costs, and risk
 - If incumbent distributors will not expand, de novo entry even less likely

4. Efficiencies

■ *Defense:*

- Defendants claimed over \$1 billion in annual savings and synergies, and over \$600 million after discounting for integration complications, possible customer losses, and the divestiture
- Rigorously derived:
 - Developed over 8 months involving over 100 employees at McKinsey and over 170 Sysco and USF employees

4. Efficiencies

■ *Court:*

- Adopted Merger Guidelines requirements:
 1. Merger specificity
 2. Verifiability
 3. Timeliness and sufficiency to negate the merger's anticompetitive effects
- Did not question rigor of analysis or accuracy of McKinsey's total annual savings estimate
 - The court accepted the rigor of McKinsey's total-savings analysis but questioned the support for Hausman's identification of merger-specific savings

4. Efficiencies

■ Court:

- ❑ *Question:* Have defendants “shown that the projected ‘merger-specific’ cost savings are substantial enough to overcome the presumption of harm arising from the increase in market concentration and other evidence of anticompetitive harm?”
- ❑ *Court:* Not persuaded
 - Not merger specific
 - ❑ McKinsey was not hired to evaluate merger-specific efficiencies
 - ❑ McKinsey witness could not establish whether the \$281 million category-management estimate excluded savings the companies could achieve independently
 - Sysco, for example, had some projects going to achieve some of the same types of synergies that McKinsey identified (e.g., savings from “category management”)
 - ❑ Hausman (a defense expert) reduced number to \$490 million, but performed no independent analysis of McKinsey results
 - ❑ → Failure of proof on which merging parties bore the burden (Query: What burden? Production?)
 - Not sufficient
 - ❑ Even crediting Hausman’s estimate of \$490 million, insufficient to offset anticompetitive effect
 - ❑ <1% merged company’s annual revenue
 - ❑ So even assuming 100% was passed on to consumers, even a small increase in price could offset any cost savings (merged firm would have \$66 billion in annual sales) [WDC: 0.7% of sales]
 - ❑ → Failure of proof on which merging parties bore the burden (Query: What burden? Production?)
- ❑ WDC: In the efficiencies section, the court did not rely on Israel’s quantification of anticompetitive harm to find that efficiencies were insufficient

The District Court Opinion

3. Determining the Net Anticompetitive Effect

Determining the net anticompetitive effect

- Unnecessary to proceed to Step 3 of *Baker Hughes* since the defendants failed to produce sufficient evidence to put the prima facie case in dispute

The District Court Opinion

4. Balancing the Equities

The FTC's alleged equities

1. Public interest in effectively enforcing antitrust laws
2. Public interest in ensuring that the FTC can order effective relief if it succeeds at the merits trial—Would have to confront:
 - ❑ Consolidation of Sysco's and USF's distribution centers and infrastructure and possible departure of significant personnel (e.g., management, sales, logistics) would make it difficult to restore both parties to premerger condition, AND
 - ❑ Sale of 11 distribution facilities to PFG, which presumably could not be rolled back
 - ❑ PLUS inevitable disruption to the food service industry caused by a postmerger divestiture of USF from Sysco

The defendants' alleged equities

- Public interest in allowing customers to have the advantage of the efficiencies of the transaction
 - *Court*: Rejected for failure of proof (in the efficiencies defense)
 - *WDC*: Could add that this factor could at most count the harm from the *delay* in the realization of the efficiencies if the defendants succeeded on the merits
- The public and private harm that would result if the merger terminates as a result of injunction in the case where the merger is not anticompetitive
 - *Court*: This is a “private equity” that does not outweigh the public equities in favor of the preliminary injunction
 - *WDC*: Could add that the election to terminate the transaction and not defend on the merits was made by the parties and was not compelled by the FTC or the court

The District Court Opinion

5. Conclusion

Conclusion

■ Court:

- FTC proved a prima facie case of anticompetitive effect in two markets:
 1. Broadline distribution to national customers
 2. Broadline distribution in local markets
- Defendants failed to discharge their burden of production on any of their defenses:
 1. The PFG “fix”
 2. Protection through regional dealing (for national customers)
 3. Entry/expansion
 4. Efficiencies
- FTC showed a likelihood of success on the merits at a full trial
- Equities weighed in favor of entering a preliminary injunction
- Preliminary injunction entered June 23, 2015

■ Aftermath

- Parties terminated the merger agreement on June 26, 2015; announced June 29

Appendix

Sufficient and Necessary Recapture Tests

One-product SSNIP sufficiency test

■ A sufficient recapture rate

- Recapture share-weighted averages can be cumbersome to calculate in the general one-product SSNIP recapture formula for the critical aggregate recapture rate:

$$R_{Critical}^1 = \frac{\delta p_1}{\$m_{RAve}} \left(= \frac{\$SSNIP_1}{\$m_{RAve}} \right).$$

- *Rule:* However, we can create a number $R_{Sufficient}^1$ that is at least as large as $R_{Critical}^1$. Then if R_{Actual}^1 is greater than $R_{Sufficient}^1$, it necessarily will be greater than $R_{Critical}^1$ and the HMT will be satisfied. That is:

If $R_{Actual}^1 > R_{Sufficient}^1 (\geq R_{Critical}^1)$, then the HMT is satisfied

- *Method.* To create the sufficient recapture rate, simply use the smallest dollar margin of the recapturing products in the denominator:

$$R_{Sufficient}^1 = \frac{\delta p_1}{\$m_{Min}} \left(= \frac{\$SSNIP_1}{\$m_{Min}} \right),$$

If you fix the numerator, then the fraction with the smaller denominator will be the larger number (e.g., $10/5 > 10/10$).

where $\$m_{Min}$ is the smallest dollar margin of the recapturing products

One-product SSNIP sufficiency test: Ex. 1

■ Gourmet pizzas

- Suppose the candidate market is the four firms that make gourmet pizzas. The four firms have the following prices and dollar margins:

	Price	Dollar margin	Recapture Shares
Firm 1	\$3.00	\$1.60	—
Firm 2	\$4.00	\$2.50	60%
Firm 3	\$3.50	\$1.60	30%
Firm 4	\$2.80	\$1.50	10%

Suppose further that the actual aggregate recapture rate for Firm 1 is 80% for a 5% SSNIP. Do gourmet pizzas satisfy the HMT?

- Use a one-product SSNIP sufficient test. The minimum dollar margin $\$m_{Min}$ is \$1.50. So

$$R_{Sufficient}^1 = \frac{\$SSNIP_1}{\$m_{Min}} = \frac{\$3.00 \times 5\%}{\$1.50} = \frac{\$0.15}{\$1.50} = 10\%.$$

Since $R_{Actual}^1 = 80\%$ is greater than $R_{Sufficient}^1 = 10\%$, the HMT is satisfied.

One-product SSNIP sufficiency test

■ A sufficient but not necessary test

□ The idea

- Whatever the diversion rates to individual products, if some recapturing product has both a positive recapture weight and a dollar margin above the minimum, the recapture-share weighted average dollar margin exceeds the minimum. Therefore, the sufficient recapture ratio exceeds the critical recapture ratio.
- Because of the difference, it is possible that the actual recapture rate will fall below the sufficient recapture rate but above the critical recapture rate, thus failing the sufficiency test but satisfying the HMT. This shows that satisfaction of the sufficiency test is sufficient, but not necessary, to satisfy the HMT.

□ Example

- In the previous example, the recapture-share weighted average of the recapturing products' dollar margins is:

$$\$m_{RAve} = (0.60)(2.50) + (0.30)(1.60) + (0.10)(1.50) = \$2.13.$$

- The critical recapture rate is:

$$R_{Critical}^1 = \frac{\$SSNIP_1}{\$m_{RAve}} = \frac{\$3.00 \times 5\%}{\$2.13} = \frac{\$0.15}{\$2.13} = 7\%.$$

- So if the actual recapture rate was 9%, the candidate market would have failed the sufficiency test (which required at least 10%), but would have satisfied the one-product SSNIP recapture test using the correct recapture-weighted dollar margin.

One-product SSNIP necessary test

- A necessary but not sufficient test

- The idea

- We can create a necessary test that *every* market must pass in order to satisfy the HMT under a one-product SSNIP recapture implementation, even though passing the necessary test will not mean that the candidate market satisfies the HMT
- The test imposes a necessary but not sufficient condition on satisfying the HMT

- A necessary aggregate recapture rate

- We can create the necessary aggregate rate by doing just the opposite of what we did to create the sufficient aggregate recapture rate: Use the *maximum* dollar margin in the denominator in the critical recapture rate formula in place of the diversion weighted average:

$$R_{Necessary}^1 = \frac{\delta p_1}{\$m_{Max}} \left(= \frac{\$SSNIP_1}{\$m_{Max}} \right),$$

where $\$m_{Max}$ is the largest dollar margin of the recapturing products

- Using the largest dollar margin gives a bound no greater than the critical recapture rate. If actual recapture is below this necessary bound, the candidate market cannot satisfy the HMT

If $R_{Actual}^1 < R_{Necessary}^1 (\leq R_{Critical}^1)$, then the candidate market *cannot* satisfy the HMT

- BUT actual recapture above the necessary bound may still be below the critical rate. Passing this necessary test therefore does not establish that the HMT is satisfied.