SHEARMAN & STERLING LLP

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United States v. Oracle

On September 9, 2004, a federal judge ruled that Oracle, the nation's second-largest software company, could proceed with its hostile bid for PeopleSoft, handing the Department of Justice ("DOJ") a significant defeat in a legal challenge to a corporate merger.

DOJ had sought to block Oracle's $7.7 billion offer for PeopleSoft arguing that it would be anticompetitive under Section 7 of the Clayton Act because combining the two companies would substantially reduce competition in the market for software that large corporations use to manage their finances and employee records. Judge Walker of the Federal District Court in San Francisco, however, rejected the government's definition of the market as too narrow, noting that the software business is particularly dynamic, with a host of current and emerging competitors in that area, including Microsoft.

In particular, Judge Walker rejected DOJ's product market definition that the relevant market consisted only of high function (sales in excess of $500,000) financial and human resource management enterprise resource planning software ("ERP"), sold only by Oracle, Peoplesoft and SAP. Judge Walker found instead that Microsoft and Lawson participated in the market, as well as mid-market vendors, best of breed solution companies, and other companies providing outsourcing. In addition, Judge Walker rejected DOJ's geographic market definition, finding the market for business software was a global one, and not limited to the United States. Consequently, Judge Walker concluded that DOJ had failed to establish that the merged firm could exercise market power and thus, that the merger would substantially lessen competition.

Importance of *U.S. v. Oracle*

An enforcement agency will consider intervening in a merger transaction if it believes the combined firm will be able to exercise market power. Market power includes the ability to restrain output and raise prices above competitive levels. To determine whether the exercise of market power is possible, the enforcement agencies must first establish a relevant market and then measure the increase in the market's concentration level as a result of the transaction. This analysis is principally conducted by determining the number of firms actually or potentially participating in the market because DOJ believes that fewer firms usually mean the exercise of market power is more likely. Typically, in markets where the merger will reduce the number of participants from 3 to 2 and there is significant customer opposition to the transaction, the enforcement agencies will intervene.

Despite DOJ's evidence that the merger would result in a duopoly and the substantial customer opposition to the deal, the court refused to accept DOJ's narrow market definition, finding instead that numerous other products were substitutable with those offered by Oracle and Peoplesoft. Consequently, the court found that the merged firm could not exercise market power.

The principal reason the court rejected DOJ's proposed market definition is that the court imposed high standards on the witnesses, ultimately concluding that they were not compelling. To prove that the market was narrow in this case, DOJ called on industry witnesses, including key customers, who testified that they only looked to SAP, Oracle or Peoplesoft when they sought to purchase ERP software, that competition between Oracle and PeopleSoft had lowered prices by millions of dollars, that a 10% increase in Oracle's software would not cause them to switch to another supplier, and that they did not consider outsourcing, mid-market vendors, or companies offering best of breed solutions as adequate alternatives to purchasing software from Oracle, Peoplesoft or SAP. The court, however, found these witnesses "unhelpful," because they testified only as to their preferences rather then concrete alternatives. It also found their testimony regarding how the market would be affected after the merger as speculation not backed up by serious analyses. Notably, although the witnesses had testified that a 10% price increase would not cause them to switch products, the court found that none gave testimony about the cost of alternatives to the hypothetical price increase a post-merger Oracle would charge. In particular, the witnesses did not provide the court with data from actual or probable ERP purchases and installations to demonstrate that the witnesses had no choice but to submit to a 10% increase.

In contrast, the court found Oracle's witnesses, although fewer in number, much more credible. Unlike with the plaintiff's witnesses, these witnesses testified about concrete and specific actions that they

had taken and been able to complete in order to meet their firms' information processing needs, apart from relying on the three largest ERP vendors. Consequently, their testimony refuted DOJ's market definition as overly narrow.

The witness testimony illustrates the challenge U.S. enforcement agencies face in proving software markets where the software has multiple features. While some customers will find certain features that are in products produced only by a few companies crucial, other customers will not find these features important and instead care about features in products produced by a number of companies. Unless the agencies are able to break these customers into separate product markets and explain why companies producing common features will not enter the narrow market, the court may combine the two groups of consumers and conclude that the market is served by a large number of companies. This challenge is compounded by the fast-moving nature of the software industry, with which the courts have little experience.

Judge Walker also found that DOJ failed to prove the existence of a distinct "high-function" ERP market, which was defined as such products with sales in excess of $500,000. Noting that "high function" was not a term recognized in the industry, Judge Walker found that DOJ's expert witness was unable to develop a quantitative basis that could be used to distinguish a high function product from a mid-market product. Instead, the expert witness simply testified that there is "something different," which the court found unpersuasive.

This holding is somewhat counterintuitive. In industries where products range from low end to high end, some industry participants will not consider high end products substitutable with mid-range products. However, unless the enforcement agency is able to clearly distinguish high end products from mid-range products, or is able to categorize customers who only use high end products as distinct from other consumers, a court relying on the *Oracle* holding may be reluctant to find that companies manufacturing mid-range products are not in the same market as companies manufacturing high end products.

Finally, this case may make it easier for merging firms to argue that although a large, sophisticated firm like Microsoft does not actually compete in a market, the firm should be included in the merger analysis as a market participant if it has the money, sales force and reputation to compete. Although Microsoft testified here at trial that it did not compete in the high function market, Judge Walker concluded that Microsoft has the money, sales force and reputation to do so.

The bottom line is that although the *U.S. v. Oracle* decision was a significant defeat for DOJ, it is unlikely to change merger policy. However, the decision likely raises the bar for establishing a relevant market, especially in markets with differentiated products similar to those here. Given the central role the product market plays in merger analysis, DOJ will likely appeal the decision. Winning an appeal may be difficult, however, because DOJ will have to prove that the Judge's factual determinations were clearly erroneous. DOJ has 60 days to decide to appeal. Oracle is unlikely to close the transaction during this time due to other, pending regulatory approvals.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this memorandum, please contact:

Wayne Dale Collins
New York Office
(+1 212) 848-4127

Kenneth S. Prince
New York Office
(+1 212) 848-4139

www.shearman.com

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599 Lexington Avenue, New York, NY 10022
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