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Antitrust Alert

A Split FTC Accepts Fix-It-First Divestiture Remedy for Cigarette Merger

05.28.2015

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The Federal Trade Commission ("FTC") accepted on Tuesday from Reynolds American Inc. ("Reynolds") and Lorillard Inc. ("Lorillard"), subject to final approval, a Consent Order settling the agency's significant competitive concerns with Reynolds's proposed $27.4 billion acquisition of Lorillard by requiring the divestiture of four cigarette brands to Imperial Tobacco Group PLC. ("Imperial").[1] The proposed settlement will be subject to public comment through June 25, 2015, after which the FTC will decide whether to make the proposed Consent Order final.

Anticipating heavy antitrust scrutiny for the proposed merger announced last July, Reynolds and Lorillard proactively included a planned divestiture of $7.1 billion in cigarette brands and other assets to U.K.-based Imperial as a "fix-it-first" remedy. After nearly a year investigating the proposed transaction, the FTC voted 3-2 to accept the proposed remedy and permit the transaction to proceed, with Commissioners Brill and Wright issuing dissenting statements.

Background

The U.S. cigarette industry is highly concentrated, with the three largest manufacturers controlling approximately 90% of the market, according to the FTC. Reynolds is the second-largest cigarette manufacturer in the United States, with approximately 26% market share from several brands including Camel, Pall Mall, Winston, Kool, and Salem. Lorillard is the third-largest manufacturer at approximately 15%, with the Newport and Maverick brands. The market leader is Altria Group, Inc. ("Altria"), which includes Philip Morris USA and sells the Marlboro brand, with approximately 51% market share. Imperial has about 3% market share.

The FTC alleged in its Complaint, filed simultaneously with the proposed settlement, that the transaction would substantially lessen competition for the retail sale of traditional combustible cigarettes in the United States in violation of Section 7 of the Clayton Act and Section 5 of the FTC Act. In its Analysis, the FTC explained that competition in the U.S. cigarette market involves brand positioning, customer loyalty management, product promotion, and retail presence. With advertising severely restricted by law, the main form of promotion is retail price reduction. The FTC also argued that entry into the market is unlikely to deter any anticompetitive effects from the proposed transaction because of declining demand, slow and costly FDA processes, advertising restrictions, and limited retail space.

Proposed Settlement

Imperial is an international cigarette manufacturer, with $11.8 billion in revenue from operations in 160 countries. The divestiture to Imperial includes four brands (Winston, Kool, Salem, and Maverick) that have a combined market share of approximately 7%, bringing Imperial's U.S. market share to 10% and reducing Reynold's post-merger/divestiture market share to 34%. The settlement also requires Reynolds to sell to Imperial Lorillard's manufacturing facility and headquarters, as well as employment rights to Lorillard's employees. Reynolds is further required to guarantee Imperial visible retail shelf-space for five months and to provide transition services.

In its Analysis, the FTC reasoned that the divestiture package would provide Imperial an opportunity to rapidly increase its competitive significance in the U.S. market. The FTC determined that "Imperial's incentive to reduce the price of the divestiture brands, in order to grow their market share, is a procompetitive offset" to the anticompetitive effects of the proposed transaction. The FTC reviewed Imperial's U.S. strategy and was satisfied that it has "both the capability and incentives to become an effective U.S. competitor."

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Dissent

Interestingly, Commissioner Wright's dissent was that the investigation should have been closed without issuing a Complaint or Decision and Order. He analyzed the proposed merger and divestiture as a single three-way transaction which would not result in the lessening of competition. While his conclusion was essentially the same as the majority — the divestiture eliminates the harm to competition — his approach is quite different with important implications. The majority followed the traditional antitrust enforcement process of first examining the main transaction, then assessing whether the proposed remedy would resolve the anticompetitive effects of the main transaction, and finally entering into an enforceable settlement with the parties upon accepting the remedy. In contrast, viewing the main transaction and fix-it-first remedy as a single three-way transaction, Commissioner Wright's approach would eliminate the Commission's ability to enforce the remedy because no Consent Order would exist.

Commissioner Brill's dissent focused on Imperial's ability to restore competition in light of the fact that the Winston and Kool brands have been declining for years. She argued that "the Commission is betting on Imperial's ability and incentive to compete vigorously with a set of weak and declining brands." In its Statement on the settlement, however, the Commission responded that the brands' decline was due largely to Reynolds conscious decision not to promote them. Furthermore, the FTC argued that Imperial's prior success in turning around declining brands in foreign markets can be repeated here with the divested assets. The Commission was thus satisfied that Imperial's incentive to promote the Winston and Kool brands, along with its prior experience, would allow Imperial "to be a sufficiently robust and aggressive competitor."

This antitrust enforcement decision is interesting and stands in contrast to the FTC's broader consumer protection objectives in the smoking area. Under Section 5 of the FTC Act, the Commission can bring — and continues to be active in bringing — enforcement actions against unfair or deceptive acts or practices that constitute violations of the Cigarette Act, as amended by the Comprehensive Smoking Education Act of 1986 and the Family Smoking Prevention and Tobacco Control Act, which require health-related warnings on cigarette packages and advertisements designed to discourage smoking.[2] This activity of the consumer protection side of the FTC house does not appear to have affected the Commission's antitrust approach and its exercise of law enforcement discretion in this matter. Here, the Consent Order is designed to maintain competition for cigarettes in order to prevent anticompetitive price increases—whereas price increases might aid in the government's other policy goal to reduce smoking.
The FTC's public material on this matter is available here. Public comments are invited by the Commission and will be reviewed by it as it determines whether to make the Consent Agreement final.

If you have any questions about this topic, please contact the author(s) or your principal Mintz Levin attorney.

Endnotes

[1] In the Matter of Reynolds American Inc., and Lorillard, Inc., FTC File No. 141 0168 (May 26, 2015).

[2] The federal government received a victory earlier this month when the D.C. Circuit upheld most of a 2006 district court ruling that the tobacco industry must issue "corrective statements" about the dangers of tobacco and its practices of marketing to children. In fact, the D.C. Circuit only overturned one part of the lower court's ruling related to preambles for the corrective statements. In overturning that one part, the D.C. Circuit held that the 2006 decision exceeded the bounds of the RICO Act, but noted that if that case had been brought as an enforcement action by the FTC, the lower court's decision "might well represent a proper exercise of the court's remedial power." *United States v. Philip Morris USA Inc.*, No. 13-5028 (D.C. Cir. May 22, 2015).