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Oracle in Brussels

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Oracle in Brussels

Christian Duvernoy and Sven Völcker

Abstract

It was hands across the water when both a U.S. district court and the European Commission cleared the $10.3 billion merger of Oracle and PeopleSoft. The Department of Justice, which had opposed the deal, had decided not to appeal its defeat in the San Francisco court, and it is thought that the Commission took this as a sign that U.S. regulators would not take it amiss if their European counterparts also let the merger proceed. In any event, there was none of the resentment and outrage that bubbled over not so long ago when U.S. antitrust authorities approved the GE/Honeywell deal and their European counterparts killed it. With Oracle/PeopleSoft, convergence was the word of the day. But a close look at the U.S. court decision and the European regulatory ruling in late 2004 reveals how often the San Francisco judge and the Brussels authorities took dramatically different approaches to important components of their decisions. Two lawyers representing Oracle before the European Commission, Wilmer Cutler Pickering Hale and Dorr ‘s Sven Völcker and Christian Duvernoy of the firm’s Brussels office, identify no fewer than six key issues on which the American court and the European Commission took diametrically opposed positions. Fielding a team led by former Director-General of DG Competition at the European Commission, Claus-Dieter Ehlermann, Wilmer was EU antitrust co-counsel to Oracle together with long-standing European antitrust2004 when the bidder announced that it had at last gained control of its target. Oracle CEO Lawrence Ellison had been reviewing strategic acquisitions for some time and PeopleSoft had been on his list of candidates. Larry Ellison has said publicly that software is due for consolidation and he clearly wanted to be a survivor.

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The progress of the deal also reveals how daunting it can be to manage two different procedures occurring virtually simultaneously not only physically but often metaphysically thousands of miles apart. Advisors to both sides were at times reluctant to speak for attribution given that they will have to appear again before regulators on each side of the Atlantic and elsewhere. Still, those involved in this deal, as well as outside experts who followed both proceedings closely, agree that Oracle's representatives did an enviable job of juggling two time schedules, two judicial systems, two sets of expert witness testimony, regulators about to retire, discovery requirements and legal theories in both California and Belgium.

An 18-Month Wrangle

The deal that turned into an 18-month wrangle began with Oracle's announcement of its intentions on June 6, 2003 and only ended shortly after 1 A.M. on December 29,

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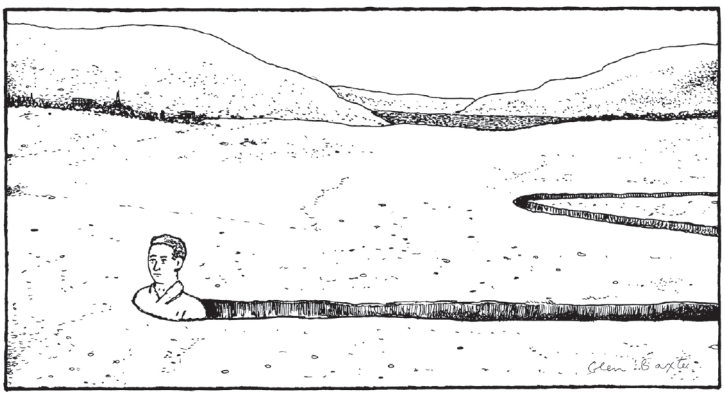

TIM'S PROGRESS THROUGH EUROPE REMAINED FAIRLY SLOW YET ABSOLUTELY STEADFAST.

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2004 when the bidder announced that it had at last gained control of its target. Oracle CEO Lawrence Ellison had been reviewing strategic acquisitions for some time and PeopleSoft had been on his list of candidates. Larry Ellison has said publicly that software is due for consolidation and he clearly wanted to be a survivor.

Craig Conway, the former CEO of PeopleSoft and a former Oracle employee, had himself once broached the possibility of a deal. However, the unsolicited takeover bid from Oracle did not go down well at PeopleSoft, and the fight quickly became personal. Mr. Ellison at one point was quoted as saying that if he had one bullet and was faced with a choice of shooting Mr. Conway or Mr. Conway's dog, he would know what to do.

PeopleSoft immediately raised an antitrust defense, which Oracle did not expect, and started its antitrust road show. Customers and state attorneys general argued that the deal would be a so-called 3-to-2 merger and would not get regulatory clearance. The Hart-Scott-Rodino filing was sent in on June 12 and the Department of Justice issued it Second Request on June 30, 2003.

Meanwhile, in Brussels, things moved more slowly. "The Commission was not keen to get us in early," recalls Mr. Volcker. Once a Form CO is filed, the Commission must follow a strict timetable and would have had only a month for an initial review period. The sense was that the Commission wanted time to educate itself on the software industry. Also, the Commission may have taken the view that the center of gravity for this particular deal lay in the U.S. and that the Commission should watch and wait. Perhaps not unrelated to the Commission's reticence was the fact that these were the summer months, with August, the traditional holiday month in Europe, rapidly approaching. "In August," says one antitrust specialist with experience in Brussels, "they don't like filings."

It was a long slow summer in Brussels, with the Second Request from the Department of Justice taking longer than anticipated. Then, as the autumn came, the pace accelerated and the Commission pressed Oracle to start the process. PeopleSoft was anxious to get an answer and had started to lobby for action. Oracle filed its Form CO on October 14, triggering the month-long initial phase of the Commission's inquiry. Pointed questions were being put to Oracle by the Commission, questions that seemed to articulate PeopleSoft's objections to the deal. Both sides began to assume that the Commission would decide to move to Phase II, giving itself another four months to investigate the deal. Sure enough, the Commission announced Phase II on November 17.

Oracle hoped that the Commission would hold off on any possible Statement of Objections until after the DOJ had decided whether or not to challenge the deal in the U.S. Best not to have opposition to the deal from Europe while American regulators were still deciding what to do. The bidder's team got the break they were hoping for.

Just before Christmas, the Commission issued an information request to Oracle. Recalls Mr. Duvernoy: "It was quite extensive and not easy to comply with in the short time frame." The Commission agreed to give Oracle more time and pressed the pause button. Through the stop-the-clock following Phase II, the Commission got synchronized with the U.S. timetable. It would not be issuing a Statement of Objections until after the DOJ would decide whether to take the deal to court."

The U.S. regulators filed suit on February 26, 2004 before Chief Judge Vaughn Walker of the Northern District of California. Soon after, on March 12, the Commission issued its Statement of Objections, just in time for the deadline for this step to occur, which is typically ten weeks after the start of a Phase II investigation. Says Mr. Volcker: "They couldn't have waited much longer."

The Commission had the choice of two analyses to apply to the Oracle/PeopleSoft proposed merger, either the unilateral effects test or the coordinated effects theory. The Oracle team had been discussing the latter test with Brussels, arguing that the deal would easily pass muster under the coordinated effects analysis.

Under the coordinated effects theory, as Judge Vaughn explains it in his ruling, "the merger may diminish competition by 'enabling the firms . . . more likely, more successfully, or more completely to engage in coordination interaction.' This behavior can be express or tacit (implied by silence), and the behavior may or may not be lawful in and of itself. The [DOJ and FTC Horizontal Merger] Guidelines," the judge writes, "explicitly recognize that successful coordinated interaction 'entails reaching (1) terms of coordination that are profitable to the firms involved and (2) an ability to detect and punish [cheating].' Examples of 'terms that are profitable' include common pricing, fixed price differentials, stable market shares and customer or territorial restrictions."

The unilateral effects theory, on the other hand, postulates that the merger will enable the new company to raise prices and inhibit competition just by virtue of the fact that the two former competitors are now one entity.

As Wachtell's Michael Byowitz, Joseph Larson and David Schwartz explain the test in a recent memo to clients: "Since the early 1990s, the Department of Justice and the Federal Trade Commission have premised most of their challenges to mergers on a 'unilateral effects' theory, which focuses on whether the elimination of competition between the merging parties will allow the combined firm to raise prices on its own (that is, without reference to other competitors). This theory postulates that when dealing with differentiated products or services, a merged firm may be able to raise its prices if the offerings of the parties are particularly close substitutes. Under the DOJ and FTC Horizontal Merger Guidelines, unless repositioning by competitors is sufficient to replace the reduction in competition between the merging parties, the DOJ and FTC will presume that a merger is anti-competitive if the offerings of the merging parties are close substitutes and account for 35 percent of the broad product market in which the firms compete."

The Department of Justice had sued to block the merger on the grounds that it failed the unilateral effects test. Judge Walker outlined the theory as follows: "There is little case law on unilateral effects merger analysis. Few published decisions have even discussed the issue, at least using the term 'unilateral effects' . . . Unilateral effects result from 'the tendency of a horizontal merger to lead to higher prices simply by virtue of the fact that the merger will eliminate direct competition between the two merging firms, even if all other firms in the market continue to compete independently.' "

Surprise!

On March 12, a surprise jumped from the pages of the Commission's Statement of Objections. The Commission was trying to challenge the deal under the unilateral effects theory after all, the same approach taken by the DOJ in California.

The Oracle team was now worried that Brussels might issue its ruling before the San Francisco court had time to make its decision. The Commission held an oral hearing on March 30 and April 1. "At the oral hearing," says Wilmer Cutler's Mr. Duvernoy, "we did raise a lot of questions about the Commission's analysis of the

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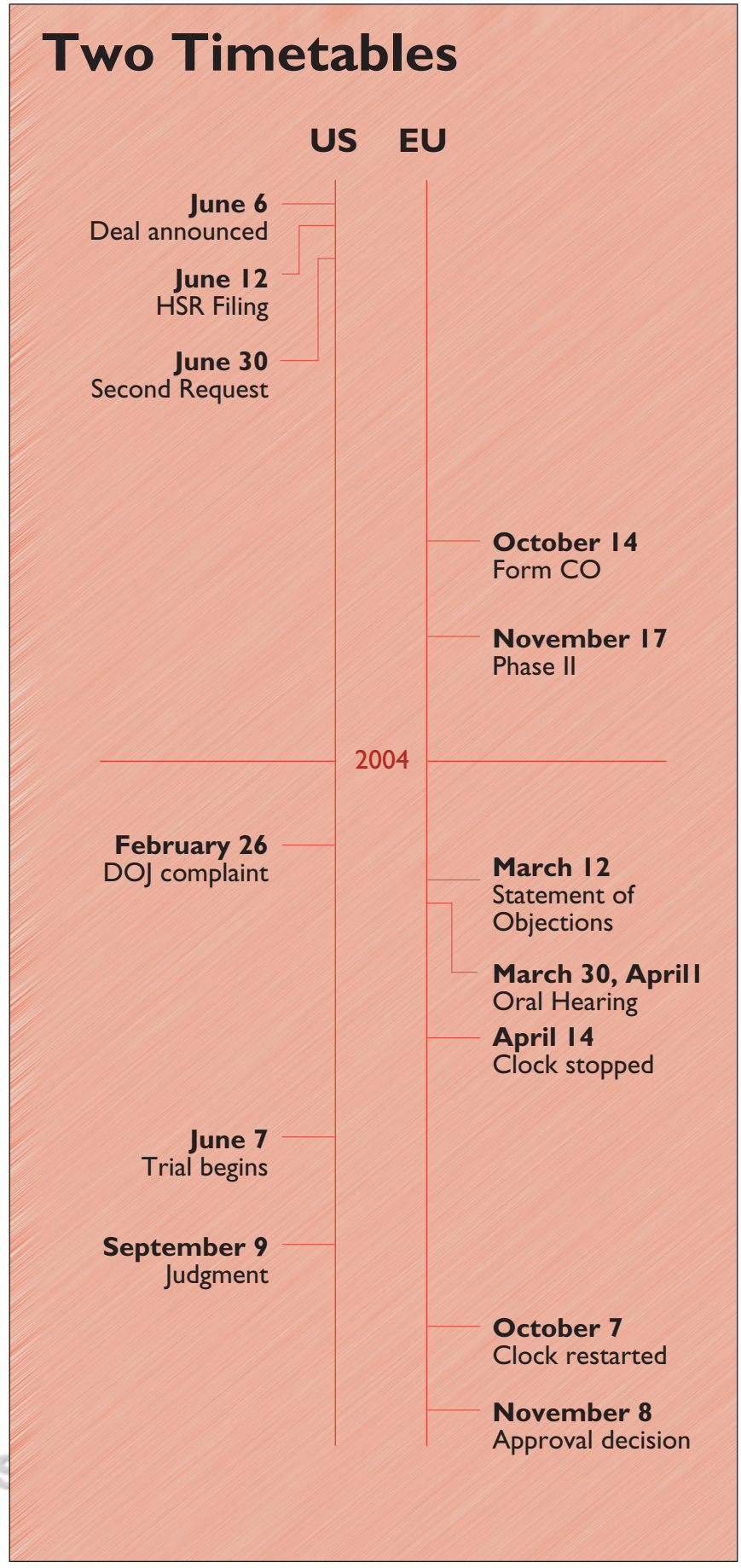

Sven Volcker (above) and Christian Duvernoy of Wilmer's Brussels office.

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market. They were pursuing a unilateral effects theory late in the game, and we talked about all the data they would need to prove that."

In response, the Commission issued what became known as "the request from hell": the Commission told the Oracle team to prepare a spread sheet covering all the bids in the market that had occurred over the previous three years, including whether it was each company's central purchasing or one of its subsidiaries that would be the buyer, who was bidding, who was selected for the final round, who won and who lost and at what prices, the geographical location of the buyer, the components of the bid, the automatic volume discount offered, and the additional discretionary discount. According to the Commission's decision, the list ended up covering 728 bids from 2001 to 2003 with an average license value of EUR 708,851.

Then came more good news. The Commission again gave Oracle time to comply and stopped the regulatory clock once again on April 14. The clock would not be restarted for just under six months, on October 7, 2005, a month after Judge Vaughn cleared the deal.

The Seven Deadlies

Although the result was the same in both, each of the two decisions rests on vastly differing premises: the very definition of the market in question; ways to identify the players in that market; and three forces that would arguably work to ensure that competition would not be constricted by the proposed merger—outsourcing; best-of-breed vendors and systems integrators.

The first question before both Judge Walker and the Commission was market definition. "This was the central issue in the cases," says Mr. Duvernoy. "Oracle and PeopleSoft both sell software that allows companies to automate back-office functions like human resources, accounting, customer relations management and supply chain management. PeopleSoft said there was a high-end to this market that only PeopleSoft, Oracle and Germany-based SAP could serve. Oracle argued, and convinced Judge Walker, that this market definition didn't make sense."

First, we turn to Judge Walker for both his explication of this segment of the software industry and for his analysis of PeopleSoft's definition of that market. As his opinion proceeds, we see that he "picks apart plaintiff's market definition piece by piece," which is how he describes what Oracle does to its adversary. The Commission, on the other hand, accepts the definition completely.

Here is Judge Walker:

> Of the many types of computer software, such as operating system software, database software, integration software (sometimes called "middleware" in software parlance) and utilities software, this case involved only one—application software. And within this type, the present case deals with only applications that automate the overall business data processing of business and similar entities; these applications are called "enterprise application software" (EAS). There are three main kinds of EAS. Plaintiffs single out one.
>
> Some EAS programs are mass market PC-based applications of fairly limited "functionality" (meaning capability). Other EAS programs are developed by or for a specific enterprise and its particular needs; most large organizations had such specially designed EAS (called "legacy software") prior to the advent of the products in this suit. Plaintiffs focus their claims on the third, intermediate category of EAS—enterprise resource planning (ERP) systems software. ERP is packaged software that integrates most of an entity's data across all or most of the entity's activities.…
>
> ERP programs have been developed to handle the full range of an enterprise's activities; these include human relations management (HRM), financial management systems (FMS), customer relations management (CRM), supply chain management (SCM), Product Life Cycle Management, Business Intelligence (BI), among others. These are called "pillars." Although ERP encompasses many pillars, plaintiffs assert claims with respect to only two pillars, HRM and FMS.
>
> Within these two pillars, plaintiffs further limit their claims to only those HRM and FMS products able to meet the needs of large and complex enterprises with "high functional needs." Plaintiffs label HRM and FMS products capable of meeting these high function needs "high function HRM software" and "high function FMS software," respectively. ERP pillars incapable of meeting these high function needs are called "mid-market" software by plaintiffs.
>
> "High function software" is a term adopted by plaintiffs to describe what they contend is the separate and distinct line of commerce in which they contend competition would be lessened by the proposed

acquisition. Plaintiffs apply the term "high function" to both HRM and FMS. "High function software," as defined by plaintiffs, has no recognized meaning in the industry.

Rather, industry participants and software vendors use the terms "enterprise" software, "up-market" software and "Tier One" software to denote ERP that is capable of executing a wide array of business processes at a superior level of performance. Software vendors use these terms to focus sales and marketing initiatives. . . .

Plaintiffs allege that the HRM and FMS sold by Oracle, PeopleSoft and SAP are the only HRM and FMS products that can appropriately be deemed "high function HRM and FMS."

Plaintiffs allege that these "high function" HRM and FMS products have the "scale and flexibility to support thousands of simultaneous users and many tens of thousands of simultaneous transactions and the ability to integrate seamlessly into bundles or 'suites' of associated HRM and FMS functions." Plaintiffs allege that "high function" HRM and FMS products compete in a market that is separate and distinct from that of all other ERP products, such as SCM, CRM or mid-market HRM and FMS, the latter being HRM or FMS products designed for organizations having less demanding needs. These mid-market products include Oracle's E-Business Suite Special Edition, SAP's MySAP and All-in-One, PeopleSoft's PeopleSoft EnterpriseOne and the products of ERP vendors such as Lawson and AMS.

Moreover, plaintiffs allege that this competition is geographically confined to the United States. Within this narrowly defined product and geographic market, plaintiffs allege that with limited and specially explained exceptions, only Oracle, PeopleSoft and, to a lesser degree, SAP's United States arm, SAP America, are in effective competition. The proposed merger would therefore, in plaintiffs' view, constrict this highly concentrated oligopoly to a duopoly of SAP America and a merged Oracle/PeopleSoft.

Oracle, predictably enough, contends that plaintiffs' market definition is legally and practicably too narrow. Oracle contends that (1) "high function" HRM and FMS software does not exist; "high function" is simply a label created by plaintiffs; (2) there is just one market for all HRM and FMS ERP products; (3) many firms other than the three identified by plaintiffs compete in the business of developing, producing, marketing and maintaining HRM and FMS ERP software; (4) this competition plays out in many more products than those in the HRM and FMS pillars; (5) price competition comes from sources in addition to ERP software vendors and includes competition from firms that provide outsourcing of data processing, the integration layer of the "software stack" and from the durability and adaptability of enterprises' installed base or legacy systems; (6) the geographic area of competition is worldwide or, at the very least, the United States and Europe; (7) the knowledgeable and sophisticated customers of ERP software would impede the exercise of any market power by a merged Oracle/PeopleSoft; and (8) potential entrants are poised to enter into competition, so that the proposed merger will not have an anticompetitive effect. . . .

The Commission issued what became known as the "request from hell." Then came the good news—the Commission stopped the clock once again.

Oracle did not propose a product market definition. Instead, Oracle picked apart plaintiffs' market definition piece by piece. Two expert witnesses, Professor Jerry Hausman, an industrial organization economist at MIT, and Tom Campbell, dean of the Haas Graduate School of Business at the University of California (Berkeley) testified for Oracle. . . .

Vague: Hausman characterized the "high function" label as vague and too "hard to get your arms around." . . .

Disconnected. Oracle also argued that plaintiffs' product market definition "does not address the market reality" of the way software is sold . . . Hausman posited that FMS and HRM are not products in and of themselves. Rather, "90 percent" of companies "are buying more than just FMS, more than just HRM. [they are] buying bundles of software."

Underinclusive. Finally, Oracle's witnesses stated that even if one assumes that a "high function HRM and FMS" market does exist and the market can be demarcated from other solutions, there are viable substitutes

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> for high function ERP that must be included in the product market. Specifically, Oracle argued that (1) mid-market vendors, (2) outsourcing, (3) incumbent systems, and (4) best of breed solutions, discussed above, must all be included in the product market, as all are potential substitutes constraining a post-merger SSNIP [small but significant non-transitory increase in price].

Throughout his opinion, Judge Walker has little time for PeopleSoft's definition of the product market. The Commission, in contrast, quickly takes hold of the proffered definition of "high function" software:

> (59) The market investigation has shown that, within complex EAS solutions, a delineation according to EAS "pillars" or groups of functionalities is necessary. This segmentation would in particular single out "high-function" solutions in the field of FMS and of HR, as opposed to other specific pillars (or group of functionalities) such as CRM, SCM or PM. Apart from the fact that each pillar, i.e. HR, FMS, SCM, CRM, is intrinsically linked to specific business functions and therefore is hardly substitutable from both a demand and (to a lesser extent) supply side viewpoint, it is important to note that, in contrast with other business application software, FMS and HR solutions are the administrative and financial backbone of an entire organization and represent the key application software in an undertaking (their "back office" functions), regardless of the industry sector in which the company may be active.
>
> (60) For these two groups of functionalities (HR and FMS), customers having high level functional needs (such as large organizations with complex functional needs) require software and accompanying services with performance characteristics of a particularly high standard. The FMS and HR software solutions concerned by this transaction are those that can be integrated into suites of associated functions and are usually accompanied by a high level of service and support. These solutions normally exhibit the specific characteristics of complexity and performance that satisfy the high-standard requirements and are therefore typically purchased and used by large customers having complex needs (hereinafter these EAS solutions are also referred to as "high-function" solutions or software).
>
> (61) In reply to the Commission's statement of objections, Oracle submitted that the Commission used vague concepts such as large enterprise with complex functional

Two Roads

The issues that divided the US district court and the European Commission

Issue	US District Court	European Commission
"High function" software definition	Rejected	Accepted
Proxies for enterprises with "high function needs" (employees, revenue)	Not pleaded, rejected by implication	10,000 employees/ EUR 1 bn revenue proxy used
Total license value as proxy for high-function software	$500,000 threshold rejected	EUR 1 million threshold used
Outsourcing as competitive restraint	Accepted	Rejected
"Mid-market vendors" as competitive restraint	Lawson, AMS, Microsoft	Lawson, Microsoft, Intentia, IFS, QAD
Best-of-breed vendors as competitive restraint	Accepted	Rejected
Systems integrators as competitive restraint	Accepted (?)	Rejected

needs (LCE) and "High-function HR and FMS solutions" which are not defined, except for "circular" references, nor do they have a recognized meaning in the industry.

(62) In this respect, at the outset, it has to be stated that the investigation allowed a progressively refined understanding of the market. Within HR and FMS software, product pricing, characteristics and intended use make it possible to distinguish—from an antitrust analysis perspective—software having particularly high standards of performance, suitable for organizations having the highest functional requirements, from simpler software performing at a lower rate of throughput and suitable for less complex, or simpler organizations. This software having the capability of executing a wide array of business processes at a superior level of performance has been identified in the Commission's statement of objections as "high-function". This high-function software has certain characteristics in terms of, *inter alia*, scalability, configurability, sophistication, pricing, of the software and of reliability, quality and brand recognition of the vendor. In the industry, this software is referred to in different ways, using various terminologies ("upmarket software", "tier-one software," "enterprise software"). The sales process of this "high-function" or "enterprise" software is lengthy and involves extensive sharing of information between candidate vendors and the customer.

Proxies

The next issue on which the two part company is the question of proxies. Not surprisingly, Judge Walker has little interest in what sort of proxy to use to identify enterprises with high-function needs since he does not accept the existence of such a market. Conversely, the Commission does make such choices since it does see a high-function market and does agree that there is such an animal as an LCE, or "Large Complex Enterprise," that will be affected by the proposed merger of Oracle and PeopleSoft.

The judge writes:

"Large Complex Enterprises" (LCE) is a term adopted by plaintiffs to describe the ERP customers that have "high function software" needs. Based on the testimony described hereafter, the court finds that industry participants and software vendors do not typically use this term and it has no widely accepted meaning in the industry.

While many in the software industry differentiate between large customers and mid-market customers, there is no "bright line" test for what is a "large" or "up-market" customer. Likewise, there is no "bright line" test for what is a "mid-market" customer. ERP vendors, analysts, systems integrators and others in the industry define the mid-market variously. Compare TR at 864:19-865:2 (Keating) (noting variability of definitions and that Bearing Point generally refers to mid-market as customers in its General Business Group, which is synonymous with companies having less than $2 billion in revenue) with TR at 1846:17-1847:15 (Wilmington) (PeopleSoft formerly defined mid-market as less than $500 million revenue, but after acquiring JD Edwards, it raised mid-market to include companies with less than $1 billion revenue).

Prior to Oracle's tender offer, PeopleSoft used a proxy of $500 million in revenue to distinguish mid-market customers from large customers. SAP defines its "large enterprise" market as companies with more than $1.5 billion in revenues. Oracle segments the market based on the customers' revenue level or number of employees.

Plaintiffs failed to show ERP vendors distinguish mid-market customers from large customers on the amount of money spent in an ERP purchase. Yet, as discussed below, this was the basis on which plaintiffs attempted to quantify the ERP market.

The Commission takes a different approach:

(116) [I]t is concluded that there are separate products aimed at satisfying the needs of large enterprises with complex functional needs for HR and FMS application software which also constitute distinct product markets. The Commission further established who the suppliers of such products are. Those suppliers form the competitive constraints for a combined Oracle/PeopleSoft in the markets at stake.

(117) The high-function HR and FMS solutions are applications to serve complex organizations/companies which have a very high level of functional needs. The Commission established the suppliers in

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the market by looking at the bids made by suppliers for such customers, thus for large enterprises needing complex functionality in the field of HR and FMS applications. However, it appears difficult to draw a clear-cut line between the customers on the basis of the complexity of their needs and therefore between high-function software and customers on the one hand, and mid-market software and customers on the other hand. In order to be able to carry out an investigation in this respect, the Commission used proxies to describe those customers and the transactions for such software applications.

As his opinion proceeds, we see that the judge "picks apart plaintiffs' market definition piece by piece," which is how he describes what Oracle does to its adversary.

(118) As a first suitable proxy for the "complexity" of the requirements for large organizations, the Commission considered the net license value of the sale to be appropriate. It appeared that a net license value of EUR 1 million would be an appropriate benchmark for EAS solutions responding to a high standard of complexity. Considering the results of the market investigation in terms of the value of bids launched by typical large enterprises with complex functional needs, the value of EUR 1 million can be considered as a significant proxy for the value of a deal being launched by such a customer for a set of HR and/or FMS functionalities. Nevertheless, it is apparent from the analysis of the latest bid data provided by Oracle on 27 September 2004 (in reply to the Commission's request for information adopted by decision pursuant to Article 11(5) of the Merger Regulation on 14 April 2004 after the Oral Hearing) that this value may be considered appropriate, but that bids falling short of this license value need not necessarily be excluded from the markets for high-function HR and FMS solutions for this reason alone.

(119) This may be true even though Oracle's data do not appear to be representative of the FMS and HR high-function markets. Oracle submitted data for 728 bids between 2001 and 2003 with an average license value of EUR 708,851. These data contain a number of bids for niche products and best-of-breed solutions not falling into the product market and having a much lower license value (for example, 235 bids with license values between EUR2,000 and EUR 100,000). As Oracle was not able to specify the modules contained in these bids, the Commission could not verify whether or not they fell within the markets for high-function FMS and HR solutions. Furthermore, in his testimony in the US trial, Professor Elzinga used a threshold of EUR 500,000 in order to define an appropriate sample of bids belonging to the markets for high function FMS and HR applications.

(120) On the basis of the market investigation and the bid data submitted by Oracle, the Commission used the value of EUR 1 million for the net license fee as one proxy for the value of bids containing high-function FMS and HR software. Given the considerations set out in the preceding recital, it can be safely assumed that anyone winning a bid above this threshold for applications in the field of HR and FMS may be considered as a supplier of high-function FMS and HR solutions.

(121) The Commission further complemented this proxy by a delineation of "large enterprises with complex functional needs" as customers of such software solutions that cope with the complexity of their overall needs. The great majority of the respondents in the market investigation confirmed that thresholds of 10,000 employees or of revenues exceeding EUR 1 billion might be an appropriate proxy for a rough qualification of large undertakings with complex functional needs.

Competitive Constraints

The California court and the Brussels panel also disagree on the power of three forces that can purportedly rein in a merged company's ability to control prices in the market: best-of-breed suppliers, outsourcing, and systems integrators. Judge Walker agrees that all three will act as competitive restraints, although he barely discusses the last of the three, and the Commission rules that none of them will.

Here is Judge Walker on the question of best-of-breed suppliers:

> Each ERP pillar consists of "modules" that automate particular processes or functions. HRM and FMS software each consists of numerous modules. HRM modules include such functions as payroll, benefits, sales incentives, time management and many others. FMS modules include such functions as general ledger, accounts receivable, accounts payable, asset management and many others.
>
> "Core" HRM modules are those specific ERP modules that individually or collectively automate payroll, employee tracking and benefits administration. Core FMS modules are those ERP modules that individually or collectively track general ledger, accounts receivable, accounts payable and cash and asset management business processes. Core FMS and HRM modules are offered by all the ERP vendors that have HRM and FMS offerings. Large enterprise customers rarely, if ever, buy core HRM or FMS modules in isolation. Customarily, FMS and HRM software are purchased in bundles with other products. Customers purchase a cluster of products such as Oracle's E-Business Suite that provide the customer with a "stack" of software and technology, which may include core HRM or FMS applications, add-on modules, "customer-facing" business applications such as CRM software [customer relations management], and the infrastructure components (application servers and database) on which the applications run.
>
> ERP vendors, including Oracle and PeopleSoft, sell modules individually as well as integrated suite products. Some ERP vendors sell only one or a few modules. Individual modules are referred to as "point solutions" as they address a particular need of the enterprise. ERP vendors that sell products for only one or a limited number [of] pillars are referred to as point solution or "best of breed" providers. A customer licensing a particular module because it fits the specific needs of the enterprise is sometimes said to be seeking a best of breed or point solution. An ERP customer that acquires best of breed or point solutions faces the task of integrating these solutions with one another and with the customer's existing ERP or legacy footprint. . . .
>
> *Best of breed vendors.* Ninety percent of ERP sales are purchases of software "bundles" containing several pillars; rarely does a consumer purchase a single pillar. FMS and HRM pillars typically are sold in a bundle along with additional kinds of ERP, such as CRM or SCM. Further, the discounts that are offered to potential consumers are based on the value of the entire bundle, not simply based upon the presence of an HRM or FMS pillar. Accordingly, when Oracle or PeopleSoft offers a discount on a bundle, it is doing so in order to ensure that the customer purchases all the pillars from Oracle or PeopleSoft, rather than turn to a best of breed vendor that specializes in selling a single kind of pillar. One best of breed vendor, Siebel, sells individual pillars of CRM. Testimony suggests Siebel is recognized industry-wide as selling high-quality CRM, equal to or better than the CRM pillars in Tier One software. . . .
>
> *Best of breed solutions.* The court does not dismiss defendant's bundle argument as an "elaborate distraction" or "economical nonsense" as plaintiffs urge. The reality of this industry is that 90 percent of consumers purchase software "bundles" containing several pillars; rarely does a consumer purchase a single pillar. FMS and HRM pillars typically are sold in bundle along with additional kinds of EAS, such as CRM or SCM. Further, the discounts that are offered to potential consumers are based on the value of the entire bundle, not simply based upon the presence of an HRM or FMS pillar. Accordingly, when Oracle or PeopleSoft offer a discount on a bundle, they are doing so in order to ensure that the customer purchases all the pillars from Oracle or PeopleSoft, rather than turn to a best of breed vendor.

Judge Walker has little time for PeopleSoft's definition of the product market. The Commission, in contrast, quickly takes hold of "high function" software.

The Commission, in contrast, decides that best-of-breed vendors would not be able to act as a competitive restraint should the new Oracle raises its prices.

The Commission writes as follows:

> (93) In response to the Commission's state-

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ment of objections, Oracle stated that the Commission's investigation would prove that LCEs (large enterprises with complex functional needs) are as likely to buy best-of-breed software as they are likely to buy "suites". In particular, the responses to the market investigation suggest that many LCEs mix and match suites and best of breed in HR and FMS functionalities, thereby showing that demand is extremely heterogeneous. Oracle CEO Larry Ellison's own prediction that best-of-breed would lose sales to the advantage of suites finally proved to be wrong.

"The Commission was for some reason reluctant to accept the outsourcing argument. They cite [the U.S. trial] and then come to the opposite conclusion."

(94) Oracle's claim is incorrect insofar as it would allegedly demonstrate that best-of-breed software is a competitive constraint to "high-function" software. Customers do not consider best-of-breed software as an alternative to high-function HR and FMS solutions. In the market investigation, the majority of the customers stated that they do not at all consider best-of-breed providers as a suitable alternative, even in response to an adverse change in the market conditions for high-function HR and FMS "core functionalities" resulting from the proposed merger. The main reasons are that the implementation of a large number of small packages would lead to disparate applications and a disparate technical architecture with the consequence that the applications would not be well integrated with each other. In any case, such an approach of integrating different best-of-breed solutions would result in high integration costs (which already for the implementation of integrated EAS suites may exceed the license costs by up to 10 times as the EAS software has to be adapted to the needs of the individual enterprise and the IT used outside the scope of EAS solutions). Respondents further pointed to the fact that the very purpose of the packaged software is to eliminate the integration problems and costs which were associated with such a best-of-breed approach and that an assembling of best-of-breed solutions would mean a return to the situation in which most companies found themselves before implementing EAS suites.

(95) Other respondents pointed out that they consider best-of-breed applications only as complementary solutions to FMS and HR suites (or FMS core functionalities). This results from the fact that best-of-breed vendors are niche market providers with a very specific focus. Also those respondents, therefore, do not consider best-of-breed solutions as an alternative to high-function FMS and HR core functionalities, but only as complements if the functionality is not available from the EAS provider.

(96) This is further confirmed by the market investigation as regards the applications already in use by customers (installed base). In particular, between 0 percent and 6 percent of respondents use only best-of-breed software for core FMS functionalities (general ledger, account payable, account receivable, asset management) and between 8 percent and 20 percent use only best-of-breed software for core HR functionalities (personnel data, payroll benefits). As the installed base of applications at customers includes software which was installed before those companies usually purchased suites, the installed base may even be deemed to overstate the importance of best-of-breed solutions for core FMS and HR functionalities.

(97) Given the above, best-of-breed solutions do not provide a competitive constraint on providers of HR and FMS high-function core functionality. They may be used—in any case alongside HR and FMS suites—to complement the functionalities offered by such suites or to serve very specific needs which are not covered by the suites. In such circumstances bids may occur in which best-of-breed providers compete only for a certain functionality with providers typically offering suites, such as SAP, PeopleSoft or Oracle. However, this does not mean that best-of-breed providers can replace HR and FMS core functionalities packaged in suites or that they have a constraining effect on the providers of HR and FMS high-function suites in this respect.

Outsourcing

Again, the two disagree on the affect of outsourcing, with Judge Walker viewing this as a force that will help sustain competition, and the Commission dismissing it as a corollary rather than a substitute product:

Judge Walker describes outsourcing as follows:

> Outsourcing: Because of the extensive amount of training and maintenance involved in implementing ERP packages purchased from ERP vendors, some companies have chosen an alternative solution—outsourcing. Outsourcing occurs when a company hires another firm to perform business functions, often HRM functions. A company may outsource a single HRM function, such as benefits, pensions or payroll, or it may choose to outsource its entire continuum of HRM needs. Many firms have outsourcing capabilities. Some of the outsources discussed at trail include: Accenture, Fidelity, ADP, Mellon, Exult, Hewitt, Aon and Convergys. Outsourcing firms may process a company's HR data using HRM software manufactured by an ERP vendor, such as Oracle, but some outsourcing firms use internally created HRM software (such as Fidelity using HR Access). . . .
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> Regarding outsourcing, Hausman presented evidence of over twenty large enterprises, such as Bank of America and AT&T, who currently outsource all or some of their HRM needs. And this phenomenon was occurring long before Oracle made its takeover offer to PeopleSoft. These large enterprise customers would not be outsourcing if they did not find this option to be equal to or better than the purchase of high function software from a vendor. If this many corporations can currently have their HRM needs effectively met by outsourcing, it only follows that many more customers could follow suit should a post-merger SSNIP occur in the high function market.
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> Hausman gave the example of MIT, his employer, outsourcing its HRM to Fidelity, who he claims do "a heck of a lot better" than MIT personnel. Hausman presented evidence that many companies have chosen outsourcing; these include: Bank of America, Motorola, International Paper, McKesson, American Express and Sony. These are "sophisticated" companies, with a lot of complex transactions, and they have clearly found outsourcing a satisfactory alternative. Hausman's demonstratives alone listed seven outsourcing firms capable of handling the HR for large companies; these include Fidelity, Accenture, ACS, Exult and Mellon, among others.
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> Accordingly, both Campbell and Hausman asserted that any product market must include outsourcing solutions as a viable substitute to which consumers can turn in the event that a merger Oracle/PeopleSoft imposes a SSNIP.

The Commission is not impressed with the argument that outsourcing will alleviate any constricting effects of the proposed deal. Says Mr. Volcker: "The Commission was for some reason reluctant to accept the outsourcing argument. They cite very little evidence from their own investigation but they have lengthy footnotes about what was said in the U.S. trial. They cite these factual elements and then come to the opposite conclusion."

"The Commission still uses and in fact defends the high-function software definition despite Walker's judgment. But this is completely abstract and does not tie back to the facts of the case."

Here is how the Commission dismisses outsourcing as a competitive restraint:

> (100) In reply to the Commission's statement of objections, Oracle claimed that outsourcers are too easily dismissed by the Commission as providing no relevant competitive constraints on EAS suppliers. Oracle claimed that the Commission is wrong in asserting that outsourcers having their own HR or FMS license from third party EAS vendors do not provide competitive constraints, since, in this way, it misunderstands the outsourcers' role of "arbitrage" (similar to that of system integrators) vis-à-vis the EAS vendors (offsetting any attempt of possible price discrimination by EAS vendors).
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> (101) According to Oracle, outsourcers do compete head-on with HR and FMS vendors and the Commission's assertion to the contrary would not be based on any customer response (apart from one by Deutsche Telekom, who, according to

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Oracle, misunderstood the Commission's question). Overwhelming evidence represented by surveys and analyst reports would instead show an incontrovertible reality: the importance of outsourcing in both HR and FMS, including for large customers. Moreover, outsourcing would not be limited to regions of the world, HR or FMS functionalities, or industry verticals, as important BPO outsourcers like ADP, Ceridian, Exult are expanding their scope of activity beyond core HR to also include tasks such as recruiting, employees effectiveness, and compensation. All the above would demonstrate that outsourcers do form a significant competitive constraint vis-à-vis EAS software providers.

Was the Commission more willing to cooperate given the fact that Oracle had made it so clear that it would fight to the end?

(102) The Commission does not contest the fact that EAS outsourcing takes place on a large-scale basis in the industry and that it is a very significant phenomenon. However, the Commission's investigation, as well as evidence stemming from the US trial, demonstrated that customers would not outsource in response to a SSNIP of high-function software. First, outsourcing only involves HR functionalities, not FMS. Therefore, Oracle's claim about competitive constraints stemming from outsourcing, theoretically, could have a standing only as regards HR software. Second, it could only be valid as regards Business Process Outsourcing, that is to say, outsourcing performed on the basis of proprietary software of the outsourcer. If the customers are to provide the software licenses to the outsourcer, they face the consequences of the proposed transaction in the same way as if no outsourcer is [sic] would be involved. If the outsourcer uses software licenses from one of the software vendors, the outsourcer is faced with the consequences of the present transaction as any other customer. Even if an outsourcer were purchasing a global license for its business (and therefore for several customers), such a purchase may involve high discounts as in the case of other large customers, but it would not enable the outsourcer to avoid any adverse consequences which may arise from the present transaction. In any case, outsourcers provide a service which goes far beyond the provision of the necessary software as done by EAS providers. In the US trial, a representative of Fidelity, a major outsourcer, stated that the cost of the license fee paid by Fidelity for use of Oracle human resources management software is probably less than 1 or 2 percent of the total cost of human resources outsourcing. A price increase of the software licenses for customers may therefore be considered to be nearly negligible compared to the total costs of outsourcing. The decision on outsourcing is usually driven by other factors (for example, the cost of HR personnel) rather than by a price increase of the application software.

(103) In this respect, Mr. Larry Ellison (Oracle's CEO), in his deposition of 20 January 2004 in front of the US Department of Justice, stated that the choice to outsource a particular function is a corporate decision and is not driven by the prices of software license or maintenance. He also added that the reason why outsourcers can be in the business is that they have a uniform process and benefit from economies of scale. This means that Mr. Ellison himself acknowledges that outsourcers have less flexibility to customize the process of each customer.

(104) Moreover, evidence shows that outsourcing vendors targeting larger and most complex organizations will support those customers using an HR software licensed from Oracle, PeopleSoft and SAP, which makes them a complement of high-function HR software rather than a substitute for them.

Systems Integrators

As for systems integrators, Judge Walker seems to be impressed with the argument that they, too, will help dilute any monopolistic urges of a new Oracle by serving as a platform for sales and market entry by smaller software developers. But he does not come out with a definite statement that sytems integrators would act as a competitive restraint on a newly merged Oracle.

Says Mr. Volcker: "It looks like Judge Walker had an even more ambitious judgment in mind but then decided that he'd had enough. The court finds that systems integrators are a competitive restraint, and then you read through the judgment and there is no section on that. Maybe in drafting he realized that his judgment was overdue and that what he had done was already good enough."

The Commission rejects the notion explicitly, and finds that systems integrators offer services rather than products:

> (110) In reply to the Commission's statement of objections, Oracle stated that the Commission did not understand the central role played by consultants and system integrators in the EAS market and, in particular, misunderstood the massive competitive constraint that they play vis-à-vis EAS vendors as regards the following aspects: (1) They provide customers with an asymmetrical information advantage over vendors (this in itself offsets any possible attempt by EAS vendors to price discriminate). (2) They have the incentive to use their bargaining power in order to squeeze EAS's vendor license fee as much as possible in order to gain a higher share of integration/consultancy fees. (3) They have an incentive and an interest in maintaining a diversified supply structure and will even sponsor a niche vendor through strategic alliances if they feel that there are not sufficient numbers of competitive alternatives on the supply side.
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> (111) The Commission cannot reach a conclusion on the basis of Oracle's unsupported contentions. Based on the information in the file, it can be stated, in general terms, that consultants and systems integrators "[…] offer a solution that [is] consider[ed] to be the best for the client. On occasions this may include upgrading legacy solutions in preference to implementing an EAS solution such as SAP, Oracle, or PeopleSoft. This will be determined by factors such as the projected costs and benefits of different solutions and the risks associated with enhancing legacy systems versus implementing an EAS.
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> (112) Consultants/systems integrators work with clients to define their requirements and help them to meet those requirements through standard software, the modification thereof being a last resort. Sometimes, when modifications are necessary, they may well recommend that these are done outside the core software in order to facilitate upgrading (using APIs, for example). In this respect they view themselves as providing customers with a kind of service that is nearly at odds with any possible competitive constraint vis-à-vis EAS vendors. As regards the cost of integration services, it appears that these integration services may range from one time to six times the product's license cost. The costs of after sales service vary substantially depending on the company's applications support sourcing approach.
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> (113) These companies are not "product companies", they are selling a service. That is the reason why they generally claim to offer clients the most genuine and independent advice on all areas of IT, also with a view to providing IT outsourcing services to them. In order to achieve this, they generally enter into strategic partnerships with various EAS suppliers and are able to supply clients with "best of breed" and tailor-made solutions in respect of their requirements across the EAS "pillars". They also offer both set-up and implementation. That is also one reason why, generally, consultants/integrators do not necessarily regard themselves as direct competitors of EAS suppliers, but rather as complementary partners.

What would have happened if the Department of Justice had decided to appeal?

The Same Result

On September 9, 2004, Judge Walker denied the DOJ's request to enjoin the Oracle/PeopleSoft merger:

> In order to succeed on their claim, plaintiffs must prove by a preponderance of the evidence (1) the relevant product and geographic market, and within this market (2) the effect of Oracle's acquisition of PeopleSoft may be substantially to diminish competition.
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> Plaintiffs alleged a product market limited to HRM and FMS software licensed by Oracle, PeopleSoft and SAP. Plaintiffs also alleged a geographic market limited to the United States.

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Plaintiffs have proven that the relevant product market does not include incumbent systems or the integration layer. But plaintiffs failed to prove that outsourcing solutions, best of breed solutions and so-called mid-market vendors should be excluded from the relevant product market. Furthermore, plaintiffs have failed to establish that the area of effective competition is limited to the United States. Accordingly, plaintiffs have failed to meet their burden of proving the relevant market for section 7 analysis.

"One theory is that after GE/Honeywell, the Commission was making a political decision and hiding that fact."

Because plaintiffs have failed to meet this predicative burden, plaintiffs are not entitled to a presumption of illegality under *Philadelphia Nat Bank* or the Guidelines.

Plaintiffs have failed to prove the likelihood that a post-merger Oracle and SAP would tacitly coordinate by allocating customers or markets. Accordingly, the plaintiffs have not met their burden of establishing anticompetitive coordinated effects.

Plaintiffs have failed to prove an area of localized competition between Oracle and PeopleSoft in which a post-merger Oracle could profitably impose a SSNIP. Accordingly, plaintiffs have not met their burden of establishing the likelihood of anticompetitive unilateral effects. . . .

Because plaintiffs have not shown by a preponderance of the evidence that the merger of Oracle and PeopleSoft is likely substantially to lessen competition in a relevant product and geographic market in violation of 15 USC Section 7, the court directs the entry of judgment against plaintiffs and in favor of Oracle Corporation.

Antitrust experts at Freshfields Bruckhaus Deringer described the decision as follows: "The court rejected the DOJ's product market definition, holding that "high-function" HRM and FMS does not exist as a separate and distinct line of commerce. It concluded that the DOJ had not proved that HRM and FMS software products from vendors such as Lawson, AMS and Microsoft, and from outsourcing firms such as Fidelity, would not constrain a combined Oracle/PeopleSoft from imposing a small but significant non-transitory price increase. . . . [T]he court concluded that the witnesses testified about the products they preferred to use, not the products they could use. The court concluded that customer preferences could not support a separate product market. . . . Because of the DOJ's failure to define a product market that would result in 'anti-competitive unilateral effects,' the court held that the DOJ failed to show that the merger of Oracle and PeopleSoft was likely to substantially lessen competition in a relevant product market."

The Commission accepts the product definition argued by PeopleSoft, but finds that there are enough players in that market to prevent a merged Oracle from exercising undue power. Says Wilmer Cutler's Mr. Volcker: "The Commission decided that it was not a three-to-two merger, but a much more populated field."

Adds another competition expert in Brussels: "The Commission still uses and in fact defends the high-function software definition despite Walker's judgment. But this is completely abstract and does not tie back to the facts of the case."

The Commission concludes its ruling as follows:

> (205) [I]n the light of the Commission's findings that buyers are very sophisticated when acquiring software, that they can structure the competitive bidding process as they prefer in order to exert competitive pressure on the bidders, including re-inviting bidders previously excluded from the contest, that they are in control of the flow of information to the bidders about who else is bidding, that the market after the merger will still contain more bidders than buyers usually invite to the final round and that SAP remains a very strong competitor, it cannot be concluded that Oracle is likely to be in a position to profitably increase prices after the merger.
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> (206) In the statement of objections the Commission also based its concerns on the finding that, in addition to the non-coordinated effects, the two remaining players would be in a position to further soften competition by coordinating their competitive behaviour. The theory of coordination was based on a definition of the market which, after the merger, would consist of only Oracle and SAP and which relied in particular on the symmetrical market shares of a combined Oracle/PeopleSoft and SAP and

an alignment of incentives between them due to the fact that SAP is by far the largest reseller of Oracle databases. As parameters for adopting a common policy, the Commission identified the allocation of customers in a duopoly, a reduction in price competition and a common understanding to slow-down the addition of further functionalities and the improvement of products.

(207) In the light of the conclusions regarding the market definition it is not possible to conclude that the merger will lead to a collective dominant position of a combined Oracle/PeopleSoft and SAP on the basis of coordinated effects. . . .

(209) In a market in which—in addition to Oracle, PeopleSoft and SAP—Lawson, Intentia, IFS, QAD and Microsoft are also present as vendors of high-function FMS and HM applications it appears difficult to argue that these players may reach a common understanding as regards the parameters outlined above. In particular, an allocation of customers according to geography or sector will not be possible due to the larger group of possible vendors of such software. Also, among seven credible bidders a common understanding as regards a softening of price competition and a slow-down of product improvements appears difficult to reach and to sustain. The difficulty in reaching a common understanding lies in particular in the fact that HR and FMS high-function software are differentiated products. These products do not only differ between the various vendors, but also between the products sold by one vendor to different customers due to the adaptation of the products to the needs of the respective customer. The larger number of vendors also reduces the transparency in the market and would make retaliatory actions more difficult. . . .

(218) Given the limited strength of a combined Oracle/PeopleSoft in the markets for HR and FMS applications adapted to and typically purchased by mid-size companies and the numerous other players also active in these markets, it can be excluded that the transaction would lead to competition concerns in the markets for mid-market HR and FMS applications, irrespective of the exact delineation of such markets.

(219) For the reasons set out above, it is concluded that the proposed concentration does not create nor strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it. The concentration is therefore to be declared compatible with the common market pursuant to Article 8(2) of the Merger Regulation and with the EEA Agreement pursuant to Article 57 thereof.

Super Mario

Aside from the purely theoretical issues at play, what effect did such extra-legal factors as saber-rattling, Mario Monti's impending retirement, and trans-Atlantic politics exert on the Commission's ruling?

Was the Commission more willing to cooperate given the fact that Oracle had made it so clear that it would fight to the end? Says one insider: "It did have something to do with it. They realized they would be taking a considerable risk."

"We were told by the officials that Mario Monti wanted to decide this case before he left office."

What would have happened if the Department of Justice had not accepted the district court's ruling and had decided to appeal instead? "By announcing that it would not appeal, " says one M&A expert, "the DOJ took the political heat off the commission. Even though the DOJ had opposed the transaction, they seemed to be saying to the Commission that after the judgment they could not reach a different conclusion without causing a big rift with the U.S."

What about all the ways in which the Commission's decision differed from the district court ruling? "One theory is that after GE/Honeywell, the Commission was making a political decision and hiding that fact: 'Let's look different and independent, but let's also come out with the same result.' "

Some in Brussels believe that Mario Monti wanted to preside over a decision that would stand in contrast to the brouhaha over the GE/Honeywell case. It is certainly true that the Commission restarted its clock just in time for it to fall within Mr. Monti's tenure. Says one member of the Oracle team: "We were told by the officials that Mr. Monti wanted to decide this case before he left office. Perhaps he did not want to leave his successor, Mrs. Kroes, with a hot potato as had happened to him when he took office."

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