

Chinese Antitrust Authorities Approve Western Digital/ Hitachi GST Deal with Significant Conditions

In a sign of the growing importance of Chinese competition law to global M&A transactions, the Chinese Ministry of Commerce (MOFCOM) recently approved Western Digital Corp.'s acquisition of Hitachi, Ltd.'s data storage business with a set of unprecedented remedies that could require Western Digital to rethink its post-transaction business plans.

Transaction Background

Western Digital and Hitachi Global Storage Technologies (Hitachi GST), a subsidiary of Hitachi, are among the world's largest manufacturers of data storage drives, and their products include hard disk drives (HDDs) of varying sizes and capacities. These HDDs are used in a wide array of products, including desktop computers, notebooks, and enterprise servers. (Hitachi GST is sometimes also referred to by the name of its holding company, Viviti Technologies Ltd.)

In March 2011, Western Digital announced that it would acquire Hitachi GST for \$3.5 billion in cash and Western Digital stock valued at \$750 million at the time. The transaction included a reverse breakup fee of \$250 million payable to Hitachi if regulatory approvals were not obtained. The deal was subject to review by numerous antitrust authorities around the world, including in the U.S., the E.U., China, Australia, Canada, Japan, Korea, Mexico, New Zealand, Singapore, and Turkey.

The U.S. Federal Trade Commission (FTC) and European Commission (EC) both approved the transaction, subject to a condition requiring Western Digital to divest Hitachi GST assets relating to the manufacture of 3.5-inch HDDs (so-called "desktop" HDDs) to Toshiba Corp.

The MOFCOM Decision

MOFCOM issued its decision approving the transaction with remedies on March 2, 2012.¹ Most notable among the conditions imposed by MOFCOM was the requirement that Western Digital maintain Hitachi GST as an independent competitor in the global HDD market. This condition apparently applies on a worldwide basis. As part of this condition, under close supervision of a monitoring trustee and MOFCOM, Western Digital must:

- ensure that Hitachi GST products are independently manufactured, priced, and marketed;
- refrain from exercising its shareholder rights in Hitachi GST in an "anticompetitive" manner;
- maintain independence between the two entities' research and development groups; and
- establish firewalls to prevent the transmission of competitively sensitive information between the two entities.

¹ MOFCOM has posted its decision, in Chinese only, at <http://fdj.mofcom.gov.cn/aarticle/zcfb/201203/20120307993758.html?4252340157=207726312>.

MOFCOM further required that Western Digital and Hitachi GST report every month to the monitoring trustee on their capacity and production volumes. The foregoing conditions remain in place indefinitely, although Western Digital may apply for a waiver of them two years after the decision date. In addition, Western Digital and Hitachi GST may not substantially alter their business models or coerce customers into exclusively purchasing their HDDs, and they must maintain their respective investment levels in research and development.

MOFCOM's approach differs markedly from that of the FTC and EC, which (as noted above) only required Western Digital to divest Hitachi GST assets relating to the manufacture of 3.5-inch HDDs to Toshiba Corp. MOFCOM's decision included the FTC- and EC-mandated divestiture as an additional condition for approval.

The conditions imposed by MOFCOM in the Western Digital/Hitachi GST transaction appear to be even more stringent than those it applied in December 2011 to Seagate Technology plc's acquisition of Samsung Electronics Co., Ltd.'s HDD manufacturing division. In that deal, MOFCOM mandated no divestitures but required that Seagate maintain Samsung's HDD business as a separate competitor for at least one year. It also imposed a reporting requirement to a monitoring trustee, and required that Seagate increase the production capacity of Samsung HDDs and annually invest at least \$800 million in additional research and development over three years. The FTC and EC approved the Seagate/Samsung merger without conditions.²

Analysis

MOFCOM's remedies in the Seagate/Samsung deal and the Western Digital/Hitachi GST deal are highly unusual in that they permitted the deals to close, but then prohibited the parties from integrating the acquired businesses and required the acquired businesses to operate separately as if no acquisition had taken place.

Both of these deals involve acquisitions of competitors – so-called “horizontal” mergers. In the U.S. and Europe, when horizontal transactions raise competition concerns, antitrust enforcers prefer so-called “structural” remedies – such as divestitures or, in some cases, blocking the deal in its entirety. This is what recently happened when the U.S. Department of Justice sued to block AT&T's proposed acquisition of its wireless competitor T-Mobile. “Behavioral” remedies (such as firewalls and non-discrimination requirements) are typically reserved for vertical transactions, where firms acquire complementary assets at a different level of the distribution chain.

² The FTC and EC relied upon different reasons in deciding not to impose any remedies on Seagate/Samsung. The EC decision was driven by the fact that Seagate/Samsung filed first (one day earlier than Western Digital/Hitachi GST) and, under EU rules, competitive impact was assessed “independently” of the second deal, and on the basis that the transaction left four competitors, even though the EC was well aware of the proposed Western Digital/Hitachi GST merger. See EC Press Release, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1213>. In contrast, in the US, the FTC reviewed both deals in tandem to assess their “cumulative” effects. The FTC explained that it challenged Western Digital/Hitachi GST, but not Seagate/Samsung, because that Hitachi, unlike Samsung, had been a uniquely aggressive discounter. See FTC Statement, available at <http://www.ftc.gov/os/caselist/1110122/120305westerndigitalstmt.pdf>.

MOFCOM's remedies, on the other hand, impose stringent behavioral restraints to remedy the perceived anticompetitive impact of a horizontal merger of two competitors. These remedies are likely to impose significant burdens on all concerned. In particular, they may effectively prohibit Western Digital and Seagate from achieving the efficiencies and synergies that they expected through their respective acquisitions, at least until such time that MOFCOM may grant the acquiring companies waivers from the condition to maintain their targets as competing enterprises.

In crafting its decisions, MOFCOM may have been reluctant to block the deal entirely in light of the fact that it had been approved by all other competition authorities worldwide. But MOFCOM had serious enough concerns to impose remedies that go far beyond those required by the FTC or the EC.

MOFCOM's unique responses to both the Western Digital/Hitachi GST and Seagate/Samsung transactions may be driven partly by the fact that China is home to many manufacturing firms that purchase HDDs for inclusion in their products (like desktop and notebook computers) and is one of the world's largest consumers of PCs. For this reason, MOFCOM may have considered China particularly vulnerable to consolidations in the HDD industry that would reduce the number of players from five to three. In its decisions, MOFCOM emphasized that the global HDD market was highly concentrated and transparent, and that the number of competitors in the market is crucial for maintaining price competition because large computer manufacturers – HDD companies' main customers – normally divide their total demand among two to four HDD companies and generally do not oppose price increases because they are able to transfer the higher costs to end-use consumers.

MOFCOM's apparent willingness to act independently of the world's other antitrust agencies, and to impose unusual behavioral remedies, highlights the increasingly critical role that Chinese competition law plays in M&A activity worldwide – particularly in transactions that the Chinese authorities may believe will affect China disproportionately.

Other Observations

The Western Digital/Hitachi GST deal closed on March 8, 2012, only a few days after MOFCOM's decision. Did Western Digital have to close the deal?

The merger agreement contained a broad regulatory covenant obligating Western Digital to take “any and all action necessary to obtain the required antitrust approvals or clearances” (with numerous examples). This provision arguably required Western Digital to accept the MOFCOM conditions. The contract also had a provision, however, that permitted Western Digital to forego taking any actions that, “individually or in the aggregate, would reasonably be expected to materially impair the business operations of the combined company absent such imposed conditions.”

Western Digital might have taken the position that the MOFCOM order had the effect of “materially impair[ing]” the business of the merged company – especially given its worldwide application – and thereby permitted Western Digital not to close the transaction. This approach would have, at a minimum, required Western Digital to pay Hitachi a \$250 million reverse breakup fee and potentially resulted in litigation. Western Digital apparently weighed the various options and elected to proceed with the deal.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Arthur Burke	212 450 4352	arthur.burke@davispolk.com
Joel Cohen	212 450 4592	joel.cohen@davispolk.com
Arthur Golden	212 450 4388	arthur.golden@davispolk.com
Ronan Harty	212 450 4870	ronan.harty@davispolk.com
Christopher Hockett	650 752 2009	chris.hockett@davispolk.com
Stephen Pepper	212 450 4108	stephen.pepper@davispolk.com
Howard Shelanski	202 962 7030	howard.shelanski@davispolk.com
Michael Sohn	202 962 7145	michael.sohn@davispolk.com
Howard Zhang	86 10 8567 5002	howard.zhang@davispolk.com

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