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ANTITRUST TRADE AND PRACTICE

Expert Analysis

The State of Vertical Merger Enforcement in the U.S.

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Late last month, a three-judge panel from the U.S. Court of Appeals for the D.C. Circuit announced its much-anticipated decision in the AT&T-Time Warner case, upholding the district court's decision that the transaction did not violate the antitrust laws. Immediately after, the Department of Justice (DOJ) announced that it is not planning to appeal the decision to the Supreme Court, ending the agency's quest to block the merger.

AT&T-Time Warner was the first vertical merger challenge litigated to judgment in nearly forty years and, along with increased political attention to the antitrust laws, immensely renewed interest about vertical merger enforcement in the United States. While the merger was not enjoined, the D.C. Circuit did not rule out the potential for successful challenges to vertical mergers. Instead, the court abstained from speaking definitively on the proper legal standard for evaluating vertical mergers, despite noting the "dearth of modern judicial precedent on vertical mergers and a multiplicity of contemporary viewpoints about how they might optimally be adjudicated and enforced." See United States v. AT&T, —F.3d— (2019).

While awaiting the decision in the AT&T-Time Warner case, antitrust regulators cleared several other vertical mergers and made various public statements on economic theories of harm and enforcement strategies. Analyzed together, these decisions and statements provide insights and expose uncertainties about the regulation of vertical mergers in the United States going forward.

AT&T-Time Warner

The appellate ruling in AT&T-Time Warner did not come as much of a surprise to antitrust pundits, given the detailed factual findings in the district court and the D.C. Circuit's adherence to the highly deferential "clearly erroneous" standard of review. One critical issue on appeal was whether the district court clearly erred in finding that the government failed to meet its threshold burden of showing that the proposed merger is likely to increase Turner Broadcasting's bargaining leverage. The district court found that it is industry practice for content distributors to

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negotiate with content providers to agree on favorable terms. Failure to reach an agreement can result in a "black out," in which the distributor loses the right to display the provider's content to its customers. In its challenge of the merger, the government argued that the merged entity could threaten or foreclose rival distributors, causing "black outs" and incentivizing customers to switch to DirecTV. In order to address this concern head on, a week after the government filed suit, and nearly a year post-signing, Time Warner sent letters to approximately one thousand distributors "irrevocably offering" to engage in "baseball style" arbitration—where each side makes a final offer and the arbitrator chooses between them—at any time for a seven-year period. See id. Both the district and appellate courts focused in large part on Time Warner's irrevocable offers to engage in arbitration, including its impact on the modeling of the parties' economic experts, finding that since blackouts were contractually no longer possible, Time Warner would not have increased bargaining leverage. See id.

While many were disappointed that the appellate court did not weigh in on the proper legal standard for evaluating vertical mergers, the case highlights two key takeaways. First, the antitrust agencies can and will challenge vertical transactions and merging parties need to be prepared to address both traditional and unconventional theories of harm. Second, the appellate court decision in part endorses an often used practitioners' tool in vertical transactions of commercially dealing with asserted competition harms to moot antitrust enforcement. Such practices, however, are seldom successful in transactions that raise horizontal issues.

Recent Enforcement

Even before the announcement of the D.C. Circuit's decision in AT&T-Time Warner, both antitrust agencies cleared several vertical deals, an analysis of which can shed some light on how the agencies will enforce vertical mergers moving forward. Commentary offered by the agencies surrounding their decisions also illuminates their current thinking, and their disagreements, on vertical merger enforcement.

On January 28, the FTC announced that it had accepted a consent order clearing the acquisition of Essendant, the largest wholesale distributor of office products in the United States, by Staples, the largest retailer of office products in the world. The acquisition was cleared with a behavioral remedy—a firewall to limit Staples' access to commercially sensitive information of Essendant's office supply customers, which compete with Staples. See *Statement of Chairman Joseph J. Simons, Commissioner Noah Joshua Phillips, and Commissioner Christine S. Wilson Concerning the Proposed Acquisition of Essendant, Inc. by Staples, Inc.* The decision was noteworthy because it imposed a behavioral remedy in a vertical merger—a measure that both agencies believe should be used sparingly to avoid remedies that look like regulatory schemes—and also because it highlighted the political and theoretical divide among the commissioners. In voting on whether to allow the merger, the FTC commissioners were split three to two along party lines. The majority, consisting of the Commission's Republican members, Chairman Joseph Simons and Commissioners Noah Phillips and Christine Wilson, found no evidence to support "any claims of likely anticompetitive harm other than the one for which remedy has been obtained." See *Statement of Chairman Joseph J. Simons, Commissioner Noah Joshua Phillips, and Commissioner Christine S. Wilson Concerning the Proposed Acquisition of Essendant, Inc. by Staples, Inc.*

In their highly charged dissents, Democratic Commissioners Rebecca Slaughter and Rohit Chopra expressed doubt that the merger—even with the behavioral remedy—is in the public interest. Commissioner Slaughter expressed concern about the Commission's enforcement of vertical mergers generally, noting that "the current approach to vertical integration has led to substantial underenforcement" and suggesting

that in close cases the Commission should "commit publicly, at the time the investigation concludes, to a follow-up retrospective investigation a few years after the merger is consummated." See *Dissenting Statement of Commissioner Rebecca Kelly Slaughter In the Matter of Sycamore Partners, Staples, and Essendant.*

Addressing the dissent, Commissioner Wilson reminded the public that when analyzing a vertical merger, the FTC seeks to "determine not whether harm is theoretically possible, but whether—as required by Section 7 of the Clayton Act—such harm is likely to 'substantially lessen competition, or to tend to create a monopoly' in a relevant antitrust market." She added that while some competitive harm is possible as a result of vertical integration, "integrating operations at different levels of production often yields clear economic benefits," and urged her counterparts to act only when the "theory and the facts both point to a potential diminution in competition." See *Statement of Commissioner Christine S. Wilson In the Matter of Staples, Inc./Essendant, Inc.*

Notably, in an area of bipartisan agreement, Commissioner Wilson expressed support for the retrospective program suggested by Commissioner Slaughter, adding that the retrospectives should "analyze prior enforcement decisions and determine whether, going forward, revisions to enforcement policy or remedies need to be undertaken." The others in the majority were also open to the idea of enhanced retrospectives, but caveated that the FTC "cannot commit to a program that is unsustainable with our current resources." See *Statement of Chairman Joseph J. Simons, Commissioner Noah Joshua Phillips, and Commissioner Christine S. Wilson Concerning the Proposed Acquisition of Essendant, Inc. by Staples, Inc.* On April 12, the FTC will hold a hearing (as part of the FTC's Hearings on Competition and Consumer Protection in the 21st Century) to gather information from experts to help structure its potential merger retrospective program, which could include reviews of both vertical and horizontal mergers.

> While precise standards for vertical merger enforcement in the United States remain unclear, recent enforcement and agency statements provide a number of key takeaways and areas for potential government focus.

The FTC's more recent, February 19 decision to clear the vertical merger of health care provider Fresenius and home dialysis equipment manufacturer NxStage reinforces themes introduced in Staples-Essendent. Again splitting along party lines, the FTC commissioners voted to approve the merger so long as the companies agreed to a structural remedy to alleviate horizontal competition concerns—divesting all rights and assets of NxStage's bloodline tubing set business, a product that both firms manufacture and sell. On the vertical front, the majority concluded that the transaction is procompetitive, "likely increase[ing] the sale of NxStage's in home machines and thereby improve[ing] health outcomes by making in-home hemodialysis available to more qualifying patients." See *Statement of Chairman Simons, Commissioner Phillips, and Commissioner Wilson Concerning the Proposed Acquisition of NxStage Medical, Inc. by Fresenius Medical Care AG & Co. KGaA*.

The dissenting commissioners had "strong reservations about the competitive implications of the vertical aspects of the transaction" and expressed concern that no remedy was imposed to address vertical issues. See *Dissenting Statement of Commissioner Rebecca Kelly Slaughter in the Matter of Fresenius Medical Care/NxStage*. Commissioner Chopra noted individually in dissent that "given the complexity of this and other transactions, the FTC should provide greater transparency to the public about its reasoning for a remedy—or lack thereof." See *Dissenting Statement of Commissioner Rohit Chopra In the Matter of Fresenius Medical Care AG & Co. KGaA and NxStage Medical, Inc*.

New Vertical Merger Guidelines?

Last updated in 1984, the U.S. Non-Horizontal Merger Guidelines

(Guidelines) cover the merger of firms that do not operate in the same market, including vertical mergers. The Guidelines focus on the creation of barriers to entry as the major theory of harm underlying vertical mergers, but in practice the antitrust agencies have gone beyond the Guidelines when alleging theories of harm for vertical mergers. Like their horizontal counterpart, the Guidelines are not meant to be a statement of law.

Calls for updated vertical guidelines are nothing new in the antitrust world and are almost a routine rallying cry for many practitioners, regulators and academics. The ABA's Antitrust Section recommended updating the Guidelines to provide transparency into how the agencies analyze non-horizontal mergers. At an FTC hearing on vertical mergers (held as part of the FTC's Hearings on Competition and Consumer Protection in the 21st Century), many economists asked for updated guidelines that would cover topics such as oligopoly markets. Legal practitioners also argued for new guidelines or agency clarity, noting that additional guidance would help lawyers better counsel their clients on potential enforcement actions.

The agencies, however, have not presented a united front in response to these repeated requests. Assistant Attorney General Makan Delrahim said that the DOJ will draft new guidance to supersede the 1984 Guidelines, while FTC Commissioner Wilson said that if the FTC does issue guidance on vertical mergers, it should do so only to identify and codify existing agency practices. See *DOJ Vertical Merger Guidelines Called 'Badly Out of Date', Vertical Merger Policy: What Do We Know and Where Do We Go?*. She noted that "case-by-case statements such as the FTC majority and individual commissioner opinions in Staples/Essendant provide soft guidance without being as 'definitive' as guidelines."

Key Takeaways

While precise standards for vertical merger enforcement in the United States remain unclear, recent enforcement and agency statements provide a number of key takeaways and areas for potential government focus.

- **Fact-Specific Assessment:** Given the appellate court's lack of development of vertical merger law in AT&T-Time Warner, practitioners and companies should continue to assess the facts and economics of a particular vertical merger when evaluating a potential transaction and be prepared to address foreclosure and raising rivals' costs theories of harm.

- **Which Regulator Reviews a Deal Can Greatly Impact Its Remedy:** The FTC is willing to agree to behavioral remedies in the right circumstances, as demonstrated by recent consents and public statements. In contrast, the DOJ continues to reiterate its commitment to aggressively pursue structural remedies as its preferred form of settlement.

- New Guidelines?: Finally, the DOJ and FTC may agree to release new Non-Horizontal Merger Guidelines, but it's too soon to say whether, or when, that may occur. In the interim, lawyers should continue to use existing agency decisions, including dissents, and regulator statements as a framework by which to analyze potential transactions.