New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 263—NO. 28
TUESDAY, FEBRUARY 11, 2020

ANTITRUST TRADE AND PRACTICE

Expert Analysis

Draft Guidelines Better Reflect Current Vertical Merger Practice

By **Karen Hoffman Lent**

And **Kenneth Schwartz**

On Jan. 10, 2020, the Department of Justice (DOJ) and the Federal Trade Commission (FTC) (collectively, the agencies) released Draft Vertical Merger Guidelines (draft guidelines), marking the first update to the guidelines for vertical merger enforcement since the now-withdrawn 1984 Non-Horizontal Merger Guidelines (1984 guidelines). The draft guidelines aim to increase "the transparency of the analytical process underlying the agencies' enforcement decisions" for mergers between firms at different levels of the supply chain. U.S. Dept. of Just. and Fed. Trade Comm'n, *Draft Vertical Merger Guidelines* (Jan. 10, 2020).

According to FTC Chairman Joseph Simons, "the agencies' vertical merger policy has evolved substantially since the issuance of the 1984 non-horizontal merger guidelines, and our guidelines should reflect the current enforcement approach." DOJ Office of Public Affairs, *DOJ and FTC Announce Draft Vertical Merger Guidelines for Public Comment* (Jan. 10, 2020). Assistant Attorney General Makan Delrahim of the DOJ's Antitrust Division echoed Chairman Simons, stating that "the revised draft guidelines are based on new economic understandings and the agencies' experience over the past several decades and better reflect the agencies' actual practice in evaluating proposed vertical mergers." Id.

KAREN HOFFMAN LENT *and* KENNETH SCHWARTZ *are partners at Skadden, Arps, Slate, Meagher & Flom.* ALENA PERSZYK, *an associate at the firm, assisted in the preparation of this column.*

1984 Non-Horizontal Merger Guidelines

The push for revised guidance on non-horizontal merger enforcement is nothing new, as the 1984 guidelines have received a significant amount of criticism over the past 36 years. The 1984 guidelines noted the relatively low likelihood of competitive concerns with vertical mergers, while also articulating theories of harm that could result, including (1) the creation of "competitively objectionable barriers to entry," (2) the facilitation of collusion and (3) the evasion of rate regulation. U.S. Dept. of Just., *non-horizontal merger guidelines* (June 14, 1984). Democratic FTC Commissioner Rebecca Slaughter, who abstained from the vote to release the draft guidelines, has criticized these theories as taking "a particularly narrow view of harm from vertical integration…inconsistent with contemporary analysis [that is] ripe for revision." *Dissenting Statement of Comm'r Rebecca Kelly Slaughter In the Matter of Sycamore Partners, Staples, and Essendant* (Jan. 28, 2019). Recent developments in vertical merger activity over the past few years, such as the DOJ's unsuccessful challenge of the AT&T/Time Warner transaction, have further fueled calls for revisions of the 1984 guidelines. Indeed, FTC Chairman Simons conceded that "the DOJ's case against AT&T/Time Warner

exposed significant misconceptions about the government's interest in and willingness to challenge vertical mergers, and the extent to which any particular merger should have a presumption of legality." Joseph Simons, Remarks, *Fordham University's 46th Conference on Int'l Antitrust Law and Pol'y* (Sept. 13, 2019).

The DOJ's AT&T/Time Warner challenge marked the first litigated vertical merger case with a court opinion since before the 1984 guidelines were issued, as the agencies have typically addressed concerns arising out of these non-horizontal deals through settlements. Pallavi Guniganti, *US Agencies Issue Draft Vertical Merger Guidelines*, Global Competition Review (Jan. 13, 2020). Interestingly, the DOJ's complaint against AT&T/Time Warner did not neatly align with the theories of harm articulated in the 1984 guidelines. Instead, the DOJ challenged the transaction on the grounds that AT&T/Time Warner could leverage its combined market power to raise the costs of licensing content for competing cable providers or entirely foreclose competitors from accessing Time Warner's content. *United States v. AT & T Inc.*, 310 F. Supp. 3d 161, 164 (D.D.C. 2018). Judge Richard Leon acknowledged the important role the 1984 guidelines played in making his decision to rule in favor of the transaction, stating that while the 1984 guidelines are not binding on courts, "they are 'a helpful tool, in view of the many years of thoughtful analysis they represent, for analyzing proposed mergers.'" Id. at 193 (citation omitted). In affirming his decision, the D.C. Circuit noted "the dearth of modern judicial precedent on vertical mergers and the multiplicity of contemporary viewpoints about how they might optimally be adjudicated and enforced." *United States v. AT&T*, 916 F.3d 1029, 1037 (D.C. Cir. 2019). In releasing the draft guidelines, the agencies have seized the opportunity to add current thinking to the vertical theories of harm developed in the thirty-six years since the release of the 1984 guidelines.

Theories of Harm

The draft guidelines identify two ways in which a vertical merger may increase the ability of a firm to act anticompetitively on its own ("unilateral effects"). First, as was alleged in the DOJ's AT&T/Time Warner challenge, the draft guidelines note that a vertical merger may lessen competition by enabling the combined entity to foreclose competitors by refusing to supply them with necessary inputs, denying them access to vital distribution channels or altering the cost or quality of necessary products or services (e.g., providing inferior inputs to a competitor).

> The draft guidelines aim to increase "the transparency of the analytical process underlying the agencies' enforcement decisions" for mergers between firms at different levels of the supply chain.

The draft guidelines explain that the agencies will consider whether: (1) the combined entity's strategy of foreclosure or raising its rivals' costs would cause those rivals to lose sales; (2) those sales would be diverted to the combined entity; (3) those diverted sales would render the strategy of foreclosure or raising rivals' costs profitable; and (4) the magnitude of this strategy rises above a de minimis level such that it would substantially lessen competition.

The second unilateral effect identified in the draft guidelines is the ability of a combined firm to "gain access to and control of sensitive business information about its upstream or downstream rivals." Some of the most valuable and sensitive business information is what inputs a company is buying, or where specifically it is investing its research and development, and at what cost. Per the draft guidelines, a combined entity could abuse competitively sensitive information by using it to "preempt or react quickly to a rival's procompetitive business actions."

The draft guidelines state that this could dissuade the combined entity from undertaking procompetitive initiatives such as investing in research and development, or make rivals reluctant to do business with the combined entity over fears that the merged firm will abuse its access to such information, running the risk of dampening the intensity of competition as rivals are forced to turn to less preferred or more expensive suppliers.

The draft guidelines also identify several ways in which vertical

mergers may increase the ability of multiple firms to coordinate anticompetitive behavior ("coordinated effects"). The draft guidelines posit that vertical mergers can further a market's susceptibility to unlawful coordination through the elimination or weakening of a "maverick firm," changes in the market structure and the combined entity's access to competitors' confidential information. The agencies expressed particular concern in the draft guidelines with instances in which post-merger changes or access to information could facilitate market participants reaching tacit agreements, detecting cheating on those agreements or punishing participants cheating on the agreements.

On the flip side, the draft guidelines recognize that vertical mergers have the potential to generate significant efficiencies by "combin[ing] complementary economic functions and eliminat[ing] contracting friction" at different levels of the supply chain. Because of this, the agencies will assess efficiency claims as set forth in the Horizontal Merger Guidelines—namely, the merging parties will bear the burden of substantiating verifiable, merger-specific efficiencies to justify approval of a merger with likely adverse competitive effects. U.S. Dept. of Just. and Fed. Trade Comm'n, *Horizontal Merger Guidelines* (Aug. 19, 2010).

Provisions Indicating More Aggressive Enforcement

In some respects, the draft guidelines take a more aggressive approach to enforcement of vertical mergers than the 1984 guidelines. For example, there is no explicit presumption of legality or de minimis effects, even in cases where the merged entity's market share is less than the 5 percent threshold that the 1984 guidelines stated was unlikely to require a merger challenge. The same stringent efficiencies analysis outlined in the Horizontal Merger Guidelines will apply to vertical deals, without the countervailing acknowledgment stated in the 1984 guidelines that "non-horizontal mergers are less likely than horizontal mergers to create competitive problems."

The draft guidelines were originally subject to a 30-day comment period expiring on Feb. 11, 2020, which has since been extended to Feb. 26, 2020. The agencies will hold public workshops on March 11, 2020 and March 18, 2020 to solicit public dialogue on the guidelines.

Additionally, instead of defining separate product markets at different levels of the supply chain to determine competitive effects, the draft guidelines dictate that the agencies will consider the competitive significance of related products to identify mergers warranting further scrutiny. The draft guidelines define a related product or service as one that "is supplied by the merged firm, is vertically related to the products and services in the relevant market, and to which access by the merged firm's rivals affects competition in the relevant market."

Provisions Indicating Less Aggressive Enforcement

Safe Harbor: In contrast to the provisions above, several sections of the draft guidelines indicate less aggressive enforcement from what was contemplated in the 1984 guidelines. Concerns with this less aggressive approach were summarized in a statement released by Commissioner Slaughter. For example, the draft guidelines state that the "Agencies are unlikely to challenge a vertical merger where the parties to the merger have a share in the relevant market of less than 20 percent, and the related product is used in less than 20 percent of the relevant market." Commissioner Slaughter expressed apprehension toward this safe harbor, explaining that "the justification for using 20 percent as the threshold is not clear" and lacks evidentiary support. See *Statement of Comm'r Rebecca Kelly Slaughter on the FTC-DOJ Draft Vertical Merger Guidelines*.

Commissioner Slaughter also criticized the lack of a corresponding presumption of harm when market shares are high and barriers to entry are present. Id. Commissioner Slaughter took particular issue with the lack of stronger language as to when a merger is likely to warrant scrutiny or enforcement. Id. While the draft guidelines provide examples of vertical merger fact patterns that "*may* warrant scrutiny," Commissioner Slaughter is of the opinion that the competitive concerns

identified "*do* warrant scrutiny, and *may* warrant enforcement," and that the language of the guidelines should reflect that skepticism. Id.

Elimination of Double Marginalization" In addition, the draft guidelines also provide insight into the procompetitive benefits of vertical mergers and how the agencies will take such benefits into account. One key benefit addressed in the draft guidelines, which were not acknowledged in the 1984 guidelines , is the elimination of double marginalization, which occurs when two successive firms in the distribution chain (each charging a profit-maximizing price) choose to merge. As a result of the merger, the combined entity is incentivized to reduce prices because of its direct and cheaper access to necessary inputs.

This price reduction is more likely to be profitable as the combined entity benefits from the margins on both upstream and downstream sales. Per the draft guidelines, the task of proving the procompetitive benefits of eliminating double marginalization will fall on the merging firms. Beyond Commissioner Slaughter's concerns and the recognition of double marginalization, the lack of more exotic vertical theories of harm, such as regulatory evasion, also indicates a less aggressive approach to vertical merger investigation and enforcement than in the 1984 guidelines.

Next Steps and Potential Implications

While the issuance of the draft guidelines attempts to address the calls for updated guidance in vertical merger enforcement, the fact remains that this is a mere draft and the Antitrust bar should keep a close eye on how they develop. Despite nearly unanimous agreement that the agencies needed to update the 1984 guidelines, the release of the draft guidelines has reiterated the divergence between the Republican and Democratic Commissioners at the FTC previously observed in vertical deals.

Substantively, the draft guidelines closely reflect the vertical merger analysis performed by the agencies today. However, the draft guidelines were approved along a party-line vote with both Democratic FTC Commissioners Rebecca Slaughter and Rohit Chopra abstaining and issuing statements criticizing the draft guidelines for not being aggressive enough. The language of the final version of the guidelines may vary depending on whether it is the product of bipartisan consensus. As Chairman Simons has noted, the agencies have an incentive to make the guidelines "as bipartisan as possible" to avoid reversal by a subsequent administration. Pallavi Guniganti, *US Agencies Issue Draft Vertical Merger Guidelines*, Global Competition Review (Jan. 13, 2020). With this in mind, should the Democratic Commissioners be persuaded to affirm the final guidelines, that would likely reflect meaningful alterations and a significantly more aggressive regulatory scheme. That said, the draft guidelines appear to provide a floor for the aggressiveness of the final guidelines.

Given the lack of precedent regarding non-horizontal mergers and the difficulty associated with assessing vertical deals, the level of bipartisan support of the final guidelines may also weigh on whether courts will recognize the final vertical merger guidelines as controlling in litigated cases. In the event that the vote to approve the final version of the vertical merger guidelines is not unanimous, the guidelines will likely have less precedential force and provide greater ability for future litigants to shape their application.

Timeline for Comments And Approval

The draft guidelines were originally subject to a 30-day comment period expiring on Feb. 11, 2020, which has since been extended to Feb. 26, 2020. The agencies will hold public workshops on March 11, 2020 and March 18, 2020 to solicit public dialogue on the draft guidelines. This process is similar to the process used to develop the horizontal merger guidelines, which were released in April 2010 and approved in August 2010. The agencies will consider comments before issuing a final version of the guidelines, which will be published in the spring.

Reprinted with permission from the February 11, 2020 edition of the NEW YORK LAW JOURNAL © 2020 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # NYLJ-02102020-435131