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US and EU Regulators Increase Scrutiny of Vertical Mergers

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Key Points

- On both sides of the Atlantic, regulators are taking expansive approaches to merger control, scrutinizing vertical combinations they previously would have approved and asking whether deals are likely to stifle nascent competition.
- In the U.S., the DOJ and FTC are increasingly reluctant to settle reviews with divestitures and instead are challenging more deals in court, pressing their "big is bad" approach to consolidation.
- As the EU has grown more receptive to behavioral remedies, Biden administration officials have expressed skepticism about their effectiveness.
- Different jurisdictions are increasingly coordinating their reviews, but that does not guarantee similar outcomes. Parties need to plan for the possibility of divergent results when negotiating merger agreements.

US Regulators Pursue an Expansive View of Antitrust Laws

For almost two years, industry participants have felt the effects of the Biden administration's "big is bad" approach to antitrust — not only in technology sectors, but also in health care, pharmaceuticals, transportation and manufacturing. This is not expected to change in 2023, even though Republicans will control the House of Representatives. In 2022, the antitrust agencies showed through word (policy changes) and deed (more litigation) that they are committed to pressing various theories to challenge mergers that historically faced little scrutiny, creating uncertainty for firms seeking to do deals. Despite several losses in court in 2022, the agencies show no signs of slowing their efforts to gain acceptance of their approach in the courts.

DOJ and FTC Continue To Litigate Aggressively

The leadership of both the Department of Justice (DOJ) Antitrust Division and the Federal Trade Commission (FTC) lived up to their articulated goal of litigating more merger challenges in 2022. Through November 2022, the agencies filed a total of nine complaints challenging mergers this year and tried four to conclusion.

As Assistant Attorney General (AAG) Jonathan Kanter noted in a recent speech, this level of activity means the DOJ "litigate[d] more merger trials this year than in any fiscal year on record."

These cases reflect the administration's preference to take matters to court rather than accept divestitures that may not fully address alleged anticompetitive effects of a merger. Divestitures are now "the exception, not the rule," AAG Kanter said in a January 2022 speech.

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The agencies were largely unsuccessful in court this year. The DOJ's Antitrust Division sustained three back-to-back losses in September 2022 before winning an injunction against the tie-up between publishers Penguin Random House and Simon & Schuster. (The deal has since been terminated.) But the FTC and DOJ appear undeterred. In April 2022 remarks, AAG Kanter suggested that the agencies' "capacity for litigation must grow with the demands of modern antitrust enforcement" and that the DOJ "must have the scale to litigate multiples of [its] current docket."

Bases for Agency Challenges

This year, the agencies continued to pursue numerous theories that both go beyond traditional concerns about vertical consolidation and inject further uncertainty into the review process.

Vertical mergers. FTC Chair Lina Khan testified before Congress in September 2022 that the FTC has reoriented its "enforcement efforts to better capture harm from mergers involving firms at different levels of the supply chain," as part of a push to ensure enforcement "better correspond[s] to new market realities."

While the agencies historically considered vertical integrations to be largely pro-competitive — potentially generating efficiencies that could result in lower consumer prices, for instance — challenges filed this year embraced vertical theories of antitrust harm. They included attempts to block two health care deals, both unsuccessfully: one between insurer UnitedHealth and Change Healthcare, which operates a network for health care providers to seek reimbursement, and another between Illumina and GRAIL, two medical technology businesses.

Nascent competition. Enforcers continue to challenge mergers involving supposed nascent competitors, particularly in the technology sector. Such competition theories play a central role in the administration's push to rein in purported consolidation. As Chair Khan explained in a March 2022 speech, "The particular business strategies that digital markets reward require [enforcers] to look beyond concepts like foreclosure and exclusion."

One example is the FTC's ongoing challenge to Facebook parent Meta's acquisition of virtual reality app developer Within. There, the FTC alleges that Meta is attempting to buy out a potential competitor in the virtual reality fitness app market rather than compete on the merits by developing its own virtual reality fitness app.

Illumina/GRAIL is another example. There, the FTC and the European Commission (EC) adopted the same approach, arguing that a vertical merger could foreclose nascent competition. Illumina supplies next-generation sequencing technology (upstream market), while GRAIL develops early cancer detection tests using that sequencing technology (downstream market). Both regulators contended that Illumina could prevent GRAIL's rivals from accessing its essential technology to develop and bring tests to market in the future.

In September 2022, an FTC administrative law judge rejected the agency's challenge, finding that Illumina's proposal to supply GRAIL's rivals under standard conditions was sufficient to protect innovation and competition. The EC, however, blocked the deal (see discussion below). Both decisions have been appealed — by the FTC in the U.S. and by the companies in Europe.

Monopsony theories. The DOJ's sole successful lawsuit this year, which prevented a merger between publishers Penguin Random House and Simon & Schuster, reveals an increasing emphasis on labor issues and monopsony theories in antitrust enforcement. Rather than focusing on prices to consumers, the DOJ advanced a theory of harm based on decreasing commissions paid to authors. This case reflects the Biden administration's increased focus on labor markets and will likely incentivize greater attention to the effects of mergers on labor interests.

Policy Changes That Further a 'Big Is Bad' Approach

The FTC and DOJ are expected by year-end to issue revised Merger Guidelines that likely will reflect their expansive approach to enforcement. The FTC foreshadowed this in September 2021, when it withdrew the 2020 Vertical Merger Guidelines. In remarks when the public comment period on new guidelines began in January 2022, AAG Kanter said that the old guidelines "overstate the potential efficiencies of vertical mergers and fail to identify important relevant theories of harm." The heads of both agencies advocate assessing the impact of vertical mergers broadly, looking beyond traditional effects in a relevant market.

Consistent with this position, in November 2022, the FTC issued a policy statement providing guidance for the application of Section 5 of the FTC Act. Historically, Section 5, which makes unlawful "unfair methods of competition," has mostly been applied to conduct that violates the Sherman or Clayton Acts, or to attempted collusion. The new policy would extend Section 5 to conduct and mergers that may not violate the Sherman or Clayton Acts, using a relaxed analytical framework that eschews the rule of reason and questions the need to define a market or prove effects. It is possible that, in 2023, the FTC will look to Section 5 to challenge vertical deals, acquisitions of nascent or future competitors and deals implicating labor concerns.

The Bottom Line

There is no doubt 2023 will bring continued uncertainty for companies engaged in transactions. Despite a poor track record in court, the FTC and DOJ are likely to continue challenging mergers based on an expansive vision of antitrust law. With little to no judicial support to date for their "big is bad" approach, however, the agencies may find courts unwilling to break from precedent no matter how many cases are filed.

EU Regulators' New Focus on Vertical Mergers Makes for More Complex Reviews

In the European Union, as in the U.S., vertical mergers historically have been seen as less harmful than horizontal mergers from a competition perspective. But regulators in the EU and U.K., like their U.S. counterparts, have recently stepped up their scrutiny of vertical deals.

Novel Theories of Harm

The EC, in its review of vertical mergers, has started to test less traditional theories of harm that were previously typically seen in the context of horizontal mergers.

The EC's Phase II review of the Illumina/GRAIL combination was a test case for the new approach. It was the first time the regulator had applied a "loss of innovation" theory of harm to a vertical merger, and the first time since the introduction of the Non-Horizontal Merger Guidelines in 2007 that the EU had prohibited a deal purely on vertical concerns.

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The EC's emphasis of the merger's impact on the innovation efforts of third parties, rather than of the merging parties, made it challenging to agree on a suitable remedy. The EC rejected the proposed behavioral remedies put forward by Illumina, which the FTC administrative law judge cited in approving the deal (providing Illumina competitors with access to GRAIL technology). The EC concluded that those remedies were complex and would be hard to monitor.

Parallel Reviews May Lead to Divergent Outcomes

As can be seen in the Illumina/GRAIL example, while regulators globally are taking steps to coordinate with one another — including on their more detailed parallel reviews of vertical mergers — cross-border coordination does not necessarily prevent divergent outcomes. Each regulator has a unique legal framework, process and priorities.

Substance. Meta's acquisition of Kustomer (a start-up that provides customer relationship management software to businesses) was cleared unconditionally at Phase I in the U.K. in September 2021, but was cleared subject to remedies following a Phase II review by the EC in January 2022. The EC and the U.K.'s Competition and Markets Authority (CMA) pursued similar theories of harm but ultimately reached different conclusions. Moreover, in a rare exception to the EU one-stop-shop principle, Germany's merger control agency, the Bundeskartellamt, opened its own investigation in parallel to the EC's. It ultimately took into account the remedies already accepted by the EC and cleared the deal unconditionally in February 2022.

Timetable. Extended reviews of vertical mergers in some jurisdictions may impact the timing in others. Coordination among regulators in the U.S., EU, U.K. and China was the likely reason behind the protracted eight-month pre-filing investigation in China of the NVIDIA/Arm merger. The parties, which operate at different levels of the global semiconductor supply chain, eventually abandoned their proposed tie-up in February 2022 following an administrative challenge by the FTC.

Remedies. An increasing number of vertical mergers that might previously have been cleared unconditionally are now being approved conditioned on remedies. While there are examples of regulators coordinating to avoid conflicting remedy packages, this may not always be possible in cross-border cases. In particular, while some regulators (EU) are willing to consider behavioral remedies, others (among them the U.S., U.K. and Australia) remain highly skeptical.

The EC has shown a greater willingness in recent years to consider and, in some cases, accept behavioral remedies in vertical mergers, in particular to address concerns regarding data. Approved remedies include interoperability requirements, open access remedies and "data silo" commitments under which merging firms segregate their data.

Looking Ahead

The heightened focus on vertical merger enforcement, in innovation-driven sectors in particular, appears set to continue into 2023. Like U.S. regulators, the CMA has been updating its merger guidelines to reflect its less lenient approach.

The increased focus on vertical mergers in the EU, U.K. and U.S. may also influence other regulators, some of which are showing a growing interest in, and questioning, vertical mergers. For example, the Australian Competition and Consumer Commission (ACCC) identified vertical concerns that led to a divestment remedy in the proposed merger of business software providers Dye & Durham and Link Administration in September 2022. (The deal collapsed a month later.)

The bottom line. While many vertical mergers will continue to be cleared unconditionally in the EU in Phase I, the transactions most likely to attract closer competition attention are those involving:

- a party that holds a degree of market power;
- a target that is the only credible supplier of an essential input; or
- the acquisition of an innovative start-up or potential entrant (particularly in the life sciences and tech sectors).

How Should Dealmakers Prepare To Ensure the Best Outcome?

Parties may need to factor into their deal timetables the possibility of extended regulatory reviews and conditional clearances. They should also be prepared to address potential vertical concerns — including those based on speculative theories of harm — with credible factual and economic evidence or with acceptable remedies.

The risk of divergent regulatory outcomes will remain a key challenge. Ultimately, it only takes one regulator to prohibit a deal. Competition clearance strategies may need to reflect the risk that offering a global remedy may not be successful. In these cases, early consideration of possible remedies will allow more time to design a flexible package that addresses potential competition concerns while preserving the synergies of the transaction.

(See also "Demystifying China's Merger Review Process.")