Steven Salop and Jennifer Sturiale: Vertical Merger Enforcement in the Draft Merger Guidelines

BY STEVEN SALOP, JENNIFER STURIALE July 28, 2023

Stephanie Kim/ProMarket

Steven Salop and Jennifer Sturiale provide their round-one comments on the draft Merger Guidelines.

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To establish the Merger Guidelines' context, we first review recent antitrust enforcement. Vertical merger enforcement has certainly heated up. While Steven Salop and Daniel Culley list about 2.25 challenges per year between 1994–2016 for mergers that include vertical issues, the 2017–July 2023 period has seen approximately 3 challenges per year, an increase of 33%.

No cases reached trial between 1979 and 2017. But beginning with *AT&T/Time Warner in 2019*, foreclosure has entered the litigation mainstream. Not just vertical mergers like *Illumina/Grail* and *Microsoft/Activision*, but also the *Amgen/Horizon* complaint that alleges anticompetitive foreclosure from a conglomerate merger.

Some transactions, such as *UHG/Change* and *ICE/Black Knight*, also are horizontal. But, where the Department of Justice Antitrust Division and Federal Trade Commission (the agencies) previously would focus solely on the horizontal elements (*e.g.*, *St. Lukes/Saltzer*), the vertical aspects now are also litigated. But not always. In *Sabre/Farelogix*, the DOJ unsuccessfully alleged only a purely horizontal merger. Similarly, in *Meta/Within*, the FTC focused solely on the potential competition issue and did not allege vertical foreclosure.

The fact that the agencies have lost each of these trials might suggest a total enforcement failure. The only win at trial was the *Jeld-Wen/CMI* merger private case.

Autopsy Results

These trial losses have occurred along several dimensions.

First, absent a structural presumption, the courts rejected the agencies' quantitative analysis and testimony on the ability and incentive to foreclose.

Judge Leon's *AT&T/Time Warner* decision accepted the defendants' argument that the increased foreclosure incentive was too insubstantial to matter. He also preferred AT&T's quantitative analysis based on different data. He was more skeptical of economic analysis than testimony by the merging firms' executives, calling the Nash bargaining model analysis a Rube Goldberg machine. In reviewing this matter, the DC Circuit explained that quantitative evidence was not required, but it was not clear whether it was applying this point to price effects as well as innovative concerns.

In *Illumina/Grail*, the administrative law judge (ALJ) rejected the FTC's quantitative foreclosure incentives analysis. After spinning off Grail in 2017, Illumina retained a 12% minority interest. Raising its ownership stake from 12% to 100% through the reacquisition of Grail obviously would *increase* Illumina's foreclosure incentives. But the parties' quantitative analysis alleged pre-merger incentives to foreclose *even with the 12% ownership*, and they argued that the acquisition would not change its incentives. The ALJ accepted this argument. But the Commission reversed the ALJ, finding that when Illumina spun off Grail ownership, it reduced its special treatment of Grail and wrote that this change "leveled the playing field."

Likewise, in *Microsoft/Activision*, the court rejected the FTC's quantitative economic analysis of the effects of denying Sony access to Call of Duty, a popular video game series. Partial foreclosure (*e.g.*, delayed availability, quality degradation, or increased licensing fees) is generally more profitable than total denial. But the court missed this point, concluding, "[i]f the FTC has not shown a financial incentive to engage in full foreclosure, then it has not shown a financial incentive to engage in partial foreclosure."

Second, the courts have trusted merging firms to fulfill their voluntary commitments even without a consent decree overseen by the court, *e.g.*, *UHG/Change* and *Microsoft/Activision*. In *AT&T/Time Warner*, the likely effectiveness of the arbitration remedy was erroneously accepted.

Third, courts have credited claims that reputational concerns would deter firms from either foreclosing or misusing information—again, see *UHG/Change* and *Microsoft/Activision*. The Microsoft court accepted Microsoft's claim of an "irreparable" reputational loss.

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Fourth, the courts did not demand robust evidence of merger specificity. In *Microsoft/Activision*, Microsoft claimed that its acquisition would increase output by adding Call of Duty to its subscription service—a strategic move the Activision CEO testified he had not taken because he had concluded it would have been unprofitable. The court treated this merger-induced change in business strategy as merger-specific, contrary to the suggested approach in the 2010 Merger Guidelines. And in *AT&T/Time Warner*, Judge Leon did not question the merger-specificity of the merged firm being able to engage in targeted advertising for Time Warner programs by using AT&T user information.

Finally, in stating the standard for assessing the competitive effects of a proposed merger, some opinions use language other than "may be substantially to lessen competition" such as "will probably substantially lessen" (*Microsoft/Activision*) or "is likely to lessen competition" (*UHG/Change*, citing the D.C. Circuit in *AT&T/Time Warner*). This language may suggest the agencies must carry a higher burden of proof such as "more likely than not" to substantially lessen competition.

But Modern Vertical Merger Enforcement Is Not Dead

Focusing on these trial losses misses part of the story.

First, while Judge Leon in *AT&T/Time Warner* expressed some affinity for it, the courts have not applied the old discredited Borkian approach of offering erroneous reasons why vertical merger enforcement was economically irrational. They have also followed the modern theory and empirical literature by not applying a procompetitive presumption.

Second, while these cases were lost, they were "Litigating the Fix" trials, where the key issue was the adequacy of the voluntary remedies *already offered*. In addition, the agencies sometimes secured *additional relief* from the act of going to trial, regardless of the outcome. In *Illumina/Grail*, for example, Illumina offered additional contractual commitments to Grail's rivals after the complaint. And in *Microsoft/Activision*, Microsoft agreed to license Call of Duty to rival consoles in the United States. Microsoft also has contracts with several cloud-streaming firms. To be sure, Microsoft's commitments are not embedded in a consent decree, whereas Microsoft agreed to binding commitments in Europe. (Perhaps the FTC will negotiate a consent decree in exchange for dropping its appeal.)

Third, two major proposed vertical mergers, *Lockheed Martin/Aerojet Rocketdyne* and *NVIDIA/ARM* were abandoned when challenged.

Fourth, some losses may have resulted from litigation errors that provide valuable learning experience. The DOJ erred by litigating *Sabre/Farelogix* purely as a horizontal merger. In *AT&T/Time Warner,* the DOJ did not offer detailed analysis of the flaws in the parties' proffered arbitration remedy, despite having argued to the same judge in the earlier *Comcast/NBCU* transaction that such an arbitration remedy was sufficient. In *UHG/Change*, no government witness testified that vertical integration was necessary for the divestee firm's success.

Finally it is still early in the game, and courts can be slow moving. (Recall that it took 15 years until *Actavis* finally affirmed the FTC's approach.) In addition, the courts did not have the new Guidelines.

With this context, we turn next to the draft Merger Guidelines

Vertical Mergers in the 2023 Merger Guidelines

The Guidelines' analysis of vertical concerns is a step forward from the 2020 Vertical Mergers Guidelines. Guideline 5 ("Mergers Should Not Substantially Lessen Competition by Creating a Firm That Controls Products or Services That Its Rivals May Use to Compete") applies the modern economic approach to foreclosure and misuse of competitively sensitive information. The general statement implicitly makes the point that these concerns also apply to complementary product and conglomerate mergers, as well as horizontal mergers that can raise "vertical" issues, such as elimination of interoperability. Foreclosure concerns also are a focus of Guideline 10 ("Multi-Sided Platforms") and Guideline 7 ("Mergers Should Not Entrench or Extend a Dominant Position").

The anticompetitive presumption in Guideline 6 ("Vertical Mergers Should Not Create Market Structures That Foreclose Competition") for transactions where the "foreclosure share" exceeds 50% also should apply to Guideline 5. This presumption eliminates the need for the agencies to provide quantitative analysis of foreclosure incentives to satisfy its *prima facie* case. As suggested in "Invigorating Vertical Merger Enforcement" and "Five Principles for Vertical Merger Enforcement Policy," such a presumption is justified. There often is insufficient reliable data to conduct a robust quantitative foreclosure analysis. Every model can be criticized and evaluating competing models may challenge the typical generalist judge. Moreover, Clayton Act Section 7 is focused more on fear of false negatives than false positives; therefore, placing the quantitative analysis burden on the parties can be justified.

In this regard, the Guidelines approach sets a high rebuttal standard, requiring the parties to show that there are "no plausible ways in which they could profitably worsen the terms for the related product and thereby make it harder for rivals to compete, or that the merged firm will be more competitive as a result of the merger."

Anticompetitive effects from foreclosure normally involve "critical inputs"—those that would lead to a material effect on rivals' costs, quality, or innovation efforts if they were unavailable. Illumina's product was a critical input, as were the inputs in *Lockheed Martin/Aerojet Rocketdyne* and *NVIDIA/ARM*. (Conversely, if the merged firm had the power to raise the price of paper clips by 20%, that price increase would not likely lead to significant competitive harm to rivals that use paper clips.) However, the "foreclosure share" presumption is not limited only to "critical inputs," suggesting a valid rebuttal argument to the "foreclosure share" presumption, but it is not explicitly acknowledged.

Guideline 5 includes reference to competitive harms from "self-foreclosure" (*e.g.*, rivals abandoning purchasing from a lower priced but now vertically merged supplier, whom they fear will misuse their competitively sensitive information). Competition from upstream competitors can deter input foreclosure. But Guideline 5 unfortunately omits an explanation of how foreclosure tactics (*e.g.*, withholding or raising the price of an input) may incentivize competing suppliers to accommodate the foreclosure by raising their input prices, which would exacerbate the foreclosed rivals' disadvantage. It also omits an explanation of how foreclosure may facilitate tacit coordination, rather than simply leading to unilateral harms. Guideline 5 does not mention evasion of regulation, but it is apparently captured in Guideline 13A ("Avoid a Regulatory Constraint").

The rebuttal section of the Guidelines does not include a section focused on claims and evidence that intense post-merger competition would prevent anticompetitive effects. This would be useful because such claims are commonly made by defendants.

The Guidelines are properly skeptical of "speculative" rebuttal arguments relating to reputational harms and of merging parties' voluntary commitments when these conflict with the parties' underlying profit-maximizing incentives.

The Guidelines unfortunately fail to explain how elimination of double marginalization (EDM) is commonly analyzed incorrectly. For example, in *Illumina/Grail*, the ALJ accepted EDM claims even though Illumina's expert only carried out an illustrative calculation of the gross margin that did not properly estimate the opportunity cost of passing through the EDM as a lower downstream price, as pointed out in the Commission decision. Anticipation of matching price decreases is another potential impediment to passing through EDM.

Guideline 5 lacks an explicit requirement that the agency show anticompetitive harms such as higher prices, reduced quality, or lessened innovation. If the agencies' concern is that this burden of proof is inappropriately too high, it might take the middle ground position that a showing of ability and incentive to foreclose is sufficiently likely to cause these competitive harms such that the burden then should be shifted to the defendant to prove that these anticompetitive effects will not occur.

By contrast, Guideline 6 suggests a return to the *Brown Shoe* approach (which also was applied in the FTC's *Illumina/Grail* decision). We do not think this is necessary to prevent anticompetitive mergers. It would be sufficient to apply the "foreclosure share" presumption to Guideline 5, eliminate a quantitative evidence burden in the agency's *prima facie* case, treat the "plus factors" as relevant evidence, and set a substantial rebuttal burden on the parties for disproving anticompetitive effects and EDM.

Some Suggested Next Steps

We hope that the final Guidelines will include the various omitted factors and changes we have noted here. Beyond the text, it will be important for the agencies to evangelize the new Merger Guidelines to attract support from commentators and courts. The Guidelines cite the law but do not include references to the supportive industrial organization economics and decision theory analyses that also may be important to courts. The agencies might consider adding explanatory hypothetical examples. In separate commentary, it would be useful to indicate analyses and real-world examples of shortcomings in past vertical merger enforcement that explains how these Guidelines would have supplied useful guidance. This work could further weaken the case for procompetitive presumptions and further support placing a lower burden on the agencies' *prima facie* case or applying additional anticompetitive presumptions.

Similar work could help convince courts to be more skeptical of behavioral and contractual commitments and reputational constraints. Courts may also need further convincing that they should monitor, enforce, and potentially modify the parties' commitments and not simply rely on parties' pie-crust promises. The DOJ's *Assa Abloy* settlement points the way by including a provision to modify the consent decree if it does not preserve competition.

Finally, the Guidelines do not articulate an economic-based competition justification in today's economy for the irrebuttable nature of the anticompetitive presumptions in Guideline 8 ("Mergers Should Not Further a Trend Toward Concentration") and Guideline 6. These Guidelines appear likely focused on the "frog in the pot" problem of sequential small mergers in a market. The rebuttal section also states that "efficiencies are not cognizable if they will accelerate a trend toward concentration … or vertical integration." This approach could prevent some mergers that benefit customers, workers and other suppliers by reducing prices (or raising wages), raising quality and innovation, and increasing output. They also may prevent some smaller firms from growing large enough to countervail the substantial monopsony (or market) power of their dominating suppliers (or corporate customers). Thus, it is important to explain the goal of these Guidelines, the rationale for the efficiencies being non-cognizable, along with possible trade-offs.

Author Disclosures:

Steven Salop has not consulted for the litigants or merger opponents in any of these matters, but he is currently consulting with other parties that have a financial stake in agency Merger Guidelines enforcement.

Jennifer Sturiale represented Illumina, Inc., in connection with the Illumina/Grail merger in her capacity as Of Counsel with Huth Reynolds LLP. She is not working or consulting for any party with a financial interest in the Merger Guidelines.

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