ALERT MEMORANDUM

US Agencies Publish Final Revised Vertical Merger Guidelines

July 2, 2020

On June 30, 2020, the US Department of Justice and Federal Trade Commission (the "Agencies") published final Vertical Merger Guidelines. Draft Guidelines were previously released for public comment on January 10. The Guidelines largely reflect the Agencies' current approach and do not appear to represent any significant change in enforcement posture or policy. They replace the existing 1984 Non-Horizontal Merger Guidelines, which were both out-of-date and somewhat misleading. The Guidelines represent a largely middle-of-the-road approach, but suggest a slight inclination to view such deals as most likely procompetitive.

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In connection with the DOJ's and FTC's enforcement of Section 7 of the Clayton Act, which prohibits mergers that may substantially lessen competition, the Agencies periodically publish official guidance explaining their approach to merger review. Published guidelines serve several purposes: (1) providing the public (including practitioners) with transparency about how the Agencies analyse cases; (2) explaining complicated economic concepts to courts outside the context of the advocacy of any particular case; and (3) helping Agency staff to be efficient and rigorous by ensuring that they stick to well-supported theories of harm. The 1984 Guidelines have long been out of step with Agency practice[1] and the bar has been advocating for revisions for some time.[2]

As explained below, among other things the new Guidelines (1) eliminate the proposed safe harbour found in the draft Guidelines; (2) make it clear that injury to downstream customers, not rivals, is the critical issue in vertical merger review; (3) discuss complementary and diagonal product mergers in addition to pure vertical transactions; (4) clarify the role that efficiencies—especially the elimination of double marginalization—play in Agency decisionmaking; and (5) provide detailed examples of theories of harm.

[1] *See, e.g.*, D. Bruce Hoffman, Acting Director, United States Federal Trade Commission, *Vertical Merger Enforcement at the FTC*, Credit Suisse Washington Perspectives Conference, January 10, 2018, *available at* https://www.ftc.gov/system/files/documents/public_statements/1304213/hoffman_vertical_merger_speech_final.pdf; Jon Sallet, Deputy Assistant Attorney General For Litigation, Antitrust Division, US Department of Justice, *The Interesting Case of the Vertical Merger*, ABA Fall Forum, November 17, 2016, *available at* https://www.justice.gov/opa/speech/file/938236/download.

[2] *See, e.g.*, Steven C. Salop and Daniel P. Culley, *Revising the U.S. Vertical Merger Guidelines: Policy Issues and an Interim Guide for Practitioners*, 4(1) J. ANTITRUST ENFORCEMENT 1 (2015).

Vertical Mergers: Theories of Harm and Efficiencies

A vertical merger combines firms that do not compete with each other, but rather operate at different levels of a single supply chain. Conventionally, many in the bar and at the Agencies, as well as antitrust economists, have believed vertical mergers to be less likely to harm competition than mergers between competitors (horizontal mergers), and enforcement against vertical mergers has therefore been relatively uncommon. Nevertheless, vertical mergers may lead to a number of competitive concerns, a few of the most prominent of which are described below:

— **Unilateral effects**

- A firm that purchases a supplier of a critical input to its rivals may be able to profitably raise the price of that input to its rivals or cut those rivals off from the supply of the input entirely ("foreclosure"). This is because, in response to that increase in input prices or lack of input supply, the rivals may increase their downstream prices or restrict their downstream sales, and some of the business the rivals lose as a result may be "re-captured" by the downstream portion of the vertically integrated firm. Whether it will be profitable for the firm to pursue this strategy depends on whether the rivals have alternatives for the input and whether the firm expects that it will recapture a sufficient amount of the business its rivals lose to outweigh the profits lost through decreased sales to the rivals.
- Other theories of harm arising from unilateral effects of a vertical merger include denying rivals scale by cutting off their access to customers, using access to information about downstream rivals' future sales to dissuade them from making competitive moves, or raising barriers to entry by forcing new entrants to simultaneously enter both the upstream and downstream markets.

— **Coordinated effects**

- A firm that purchases a supplier or customer may gain access to information held by that supplier or customer about the firm's competitors. This visibility into rivals' sales might allow the firms to establish an agreement without express communication (*e.g.*, coordinating prices) and subsequently more effectively discipline rivals that do not follow the coordinated agreement.

— **Efficiencies**

- Vertical mergers can result in a particular kind of efficiency called "eliminating double marginalization." Pre-merger, an upstream input supplier and an unrelated downstream manufacturer each charge a margin on their products, resulting in a final price for the end consumer that incorporates both margins. If these two firms merge, the downstream manufacturer will now obtain the inputs it needs at cost. As a result, the merged firm is incentivized to lower its prices because this will increase its volume of sales and thus overall profit, to the benefit of both the firm and of customers.
- While there may be ways for firms to eliminate double marginalization without a merger, for example using contracts with complex price schedules or volume targets, there are good reasons to think that eliminating double marginalization is less speculative than other kinds of efficiencies—including those that may result from horizontal mergers.

Unlike horizontal cases, whether a particular vertical theory of harm holds in a given case tends to be very sensitive to the exact conditions of the market in question. A fact that might be anticompetitive in one context may, given different market conditions, be procompetitive in another. For example, if an input supplier commands high margins, that may signal that it has significant market power. That suggests rivals may be dependent on the input, but it also suggests that the scope for eliminating double marginalization may be large. It can therefore be difficult to determine the net effect of the fact of high margins without detailed economic modeling.

What the Guidelines Say

The Guidelines lay out the Agencies' approach to market definition, address the importance of market structure, describe how the Agencies will address evidence of adverse competitive effects, set forth a number of theories of harm to competition (both unilateral and coordinated), and describe potential efficiencies including eliminating double marginalization.

— **Market Definition**: The Guidelines continue the Agencies' approach to defining relevant markets as set forth in the Agencies' Horizontal Merger Guidelines. The Guidelines introduce a new concept of "related product." A related product is one that is situated upstream or downstream from the relevant market and is provided by the other merging party, and might include such things as an input, a means of distribution, or access to a set of customers. The Guidelines do not explain how the concept of "related product" is intended to relate to a relevant antitrust market.

— **Market Structure**: The Guidelines do not contain a presumption of legality for vertical mergers, as some commentators have advocated, but neither do they contain thresholds for a presumption of illegality, as others have suggested. The Guidelines also state generally that the Agencies may use market shares and market structure in assessing the likely effects of a vertical merger. In particular, they state "high concentration in the relevant market may provide evidence about the likelihood, durability, or scope of anticompetitive effects in that relevant market."

— **Evidence**: The types and sources of evidence the Agencies will consider in assessing the impact of a vertical merger are similar to those considered in the horizontal merger context, and the Guidelines largely incorporate by reference the Horizontal Merger Guidelines on this point. The Guidelines also note that pre-existing contractual relationships may be particularly relevant in the vertical merger context.

— **Harm**: The Guidelines describe unilateral and coordinated theories of harm similar to those described in the section above, focused primarily on input foreclosure. The Guidelines state that where possible the Agencies may use available data to construct merger simulations to predict the expected impact of a vertical merger.

— **Efficiencies**: As described above, elimination of double marginalization may occur through a vertical merger when an integrated company taking into account both upstream and downstream revenues sets a lower profit-maximizing price than it would have set but-for the vertical integration. The Guidelines note that the Agencies may take a simple netting approach with respect to pressure to increase prices to rivals and downward pressure from elimination of double marginalization: The Agencies' evaluation of whether the merger may substantially lessen competition "will generally include an assessment of the likely net effect on competition in the relevant market of all changes to the merged firm's unilateral incentives." In addition to elimination of double marginalization, the Agencies also state that they will consider further efficiencies that may arise through vertical mergers, such as streamlined production, inventory management, or distribution.

What Changed from the Draft

— **Safe Harbor**: The draft Guidelines included a safe harbor for deals below 20% market share, which was widely criticized from both sides. Some argued that such a safe harbor would insulate from scrutiny deals that may be anticompetitive; others that the inclusion of a relatively low safe harbor could be misleading for those who are relatively unfamiliar with actual Agency enforcement practice. The final Guidelines do not include a safe harbor.

— **Locus of Relevant Harm:** The Guidelines explicitly state that downstream consumers are the proper focus of the Agencies' competitive assessment: "The Agencies are concerned with harm to competition, not to competitors. When a merger involves products at different levels of a supply chain, the direct customers the Agencies will consider are actual and potential buyers of the downstream products." This is a major policy decision that was implicit but not expressly stated in the draft Guidelines.

— **Non-Vertical Deals:** The Guidelines now clarify that they apply to complementary product and diagonal transactions, in addition to strictly vertical mergers.

— **Elimination of Double Marginalization ("EDM")**: The Guidelines' discussion of EDM has now been moved from a separate section into the more general discussion of efficiencies, as well as being addressed in various other places in the Guidelines. The Guidelines emphasize that EDM is more verifiable than other efficiencies because it "is not a production, research and development, or procurement efficiency; it arises directly from the alignment of economic incentives between the merging firms." The Guidelines also state that "Creditable quantifications of the elimination of double marginalization are generally of similar precision and reliability to the Agencies' quantifications of likely foreclosure, raising rivals' costs, or other competitive effects."

— **Added Detail and Theories of Harm:** While many commentators criticized the relative paucity of details in the draft Guidelines, the final Guidelines provide additional detail, including through added examples illustrating the theories of harm. The Guidelines now also discuss creating the need for two-level entry as a potential harm, and describe foreclosure in a bargaining model.

— **Foreclosure:** The Guidelines have given additional structure to the section on foreclosure by separately considering whether a merger may lead to increased ability to foreclose and incentive to foreclose.

Commentary

The overall orientation of the Guidelines is modestly pro-vertical merger. Even more than for horizontal mergers, practitioners and commentators are sharply divided on the effects of vertical mergers. On the one hand are those that take the position that vertical mergers are almost never harmful and bring added efficiency to the market through vertical integration. Others believe that the prevailing views of the first group have led to lax enforcement against vertical mergers that have a significant potential to harm competition, and that this type of enforcement should be dramatically increased.

The Guidelines take a relatively middle-of-the-road approach, in particular declining to create a presumption of legality for vertical mergers, something many in the bar had advocated for. Nor do the Guidelines take a particularly aggressive view of the effects of vertical mergers, with their discussion of elimination of double marginalization in particular suggesting that the Agencies would tend to view this efficiency as particularly credible and often tending to lead to a net procompetitive effect. Nevertheless, their statement that "While the agencies more often encounter problematic horizontal mergers than problematic vertical mergers, vertical mergers are not invariably innocuous" suggests a mild inclination to assume that vertical mergers will have procompetitive outcomes.

The Guidelines now explicitly require a showing of harm to downstream customers. Harm to upstream market participants is not sufficient. This is important because the situation will frequently arise where EDM or other efficiencies lead to lower downstream prices, while prices to rivals upstream do increase.

The exact role of "related products" will likely need to be developed through further experience. The Guidelines introduce the concept of a "related product" to describe the particular product that is vertically related to the relevant market (*e.g.*, if the relevant market is automobiles, a related product might be steel used in their construction or dealerships through which they are sold). The alternative approach the Agencies could have taken, which perhaps would have been the more conventional choice as it would not introduce new terminology, would be to simply define a second market that is upstream or downstream of the first. The Agencies' likely view is that the case law requires proof of a relevant market only for the market in which competitive harm is alleged.

The Guidelines' express mention of complementary-product mergers is a notable change; the Agencies have historically been very hesitant to investigate these types of transactions. In the past, while the EU and other jurisdictions have been more aggressive in investigating so-called "conglomerate effects," the US Agencies have tended to leave any challenges to *ex post* enforcement of any potentially anticompetitive practices such as tying, which may be facilitated by a merger of complements. This has reflected a view within the Agencies that these deals tend to have substantial procompetitive effects and that an *ex ante* assessment of such a transaction will have significant difficulty distinguishing between the factors producing procompetitive effects and those that would make anticompetitive conduct more likely to be successful.

The Guidelines maintain a different approach to treatment of EDM versus efficiencies more broadly. While the Agencies generally hold merging parties to a high standard of proof to establish verifiable and merger-specific efficiencies, it is notable that the Guidelines say proof of EDM will be held to the same (generally lower) standard the Agencies apply to their own proof of competitive harm. More generally, the Guidelines' discussion of the competitive analysis as a netting of pro- and anti-competitive effects, by eschewing language of burden-shifting, suggests a view that is generally pro-merger.

Additional potential efficiencies in vertical mergers, by contrast, are still left unmentioned. For example, that access to a guaranteed supplier or a guaranteed customer can facilitate investments where payback is long and conditions are uncertain.

Additional examples and detail regarding theories of harm are welcome additions, but the Guidelines still fail to discuss the types of facts that make those theories more or less likely to occur. The Guidelines now discuss how foreclosure interacts with bargaining dynamics, a notable omission from the draft Guidelines given the Department of Justice's recent loss in its AT&T/Time Warner merger challenge on a related theory.[3] In ruling against DOJ, the District Court found its blackout-based foreclosure theory of harm unsupported by the evidence, and expressed skepticism that the theory was workable at all.

The Guidelines still do not contain much discussion of the types of facts that make the theories they lay out more or less likely to be a problem in a particular case. For example, in many instances upstream market shares are not as relevant to whether a merged firm could profitably raise prices or withhold inputs than is the ease with which a rival could substitute to a different provider of inputs: Withholding an input with a relatively low share can cause rivals to lose sales if consumers have strong brand loyalty or a taste for variety, or if important downstream rivals are locked-in to a particular technology. One recent example of this theory in action is AT&T/Time Warner, where DOJ argued that certain Time Warner content like HBO or CNN was "must-have" and thus contributed to increased bargaining leverage, regardless of what share these networks might have as a portion of total viewing hours.

By contrast, withholding an input with a very large share may not be problematic if the input is interchangeable across suppliers, other input suppliers can easily expand capacity, and there are not substantial cost differences between input providers. A recent example is the Essilor/Luxottica merger.[4] In that case, which combined ophthalmic lens manufacturer Essilor with optical frame manufacturer and optical

[3] Complaint, *United States v. AT&T, Inc.*, No. 1:17-cv-02511 (Nov. 20, 2017), https://www.justice.gov/opa/press-release/file/1012896/download.
[4] Cleary Gottlieb acted as antitrust counsel to the purchaser, Essilor, in the successful clearance of that vertical merger.

distributor Luxottica, the FTC's closing statement explained that the transaction posed little risk of competitive harm, notwithstanding Essilor's high share in lenses, because it is easy for independent opticians to switch lens providers.[5]

Other similarly undiscussed topics include the role that minimum efficient scale plays in whether or not denying rivals access to customers will be successful or how a merger can remove a potential sponsor of new entry.

The Guidelines also remain generic and steer clear of major trends in the enforcement debate. For example, it is notable that despite the active vigorous worldwide debate around digital platforms and data, this topic is not addressed directly in the Guidelines.

Statements of FTC Commissioners

Commissioners Joseph Simons, Noah Phillips, and Christine Wilson of the Federal Trade Commission voted to issue the Guidelines and issued a statement. Commissioners Rohit Chopra and Rebecca Slaughter voted against issuing the Guidelines and wrote separately in dissent.

— **Majority**: The majority praised the new Guidelines as an improvement over the 1984 Guidelines, including because they described expanded theories of harm that require less than full foreclosure and additional means by which coordinated effects might arise. They also noted how the final Guidelines reflected the comments received, including those from Commissioner Slaughter.

— **Commissioner Slaughter**: Commissioner Slaughter's dissent states that the Agencies should not have adopted the Guidelines without further comment. She also states that the Guidelines have failed "to disavow the false assertion that vertical mergers are almost always procompetitive." More specifically, she criticizes the Guidelines for several reasons. First, she faults the Guidelines for "put[ting] a thumb on the scale in favor of vertical mergers" by overemphasizing their benefits. Second, she objects to what she views as a failure to identify what characteristics make a merger more likely to be problematic, which she fears will lead to problems both in initiating investigations and in the competitive assessment. Third, she objects to the Guidelines' treatment of EDM, specifically by in her view failing to fully explain when elimination of double marginalization should not be expected to materialize, when the benefits should not be expected to be passed along to consumers, and when EDM might produce short-term gains but long-term harms through reducing rivals' abilities to finance innovation or expansion. And fourth, Commissioner Slaughter's dissent notes the omission of discussion of buy-side theories of harm, regulatory evasion as a theory of harm, and how remedies for vertical transactions should be structured and enforced.

— **Commissioner Chopra**: Commissioner Chopra wrote to express concern that the Guidelines "support the status-quo ideological belief that vertical mergers are presumptively benign, and even beneficial." His dissent focuses on potential harms to new entrants posed by vertical mergers, including how vertical mergers can suppress the occurrence of new entry. Commissioner Chopra's comments reflect his view that assessment of harm in merger review should be more holistic than it is under current practice and doctrine, including by making value judgments about the characteristics, business models, financial wherewithal and stability, and management priorities and skill of the merging firms.

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[5] Fed. Trade Comm'n, Statement of Federal Trade Commission Concerning the Proposed Acquisition of Luxottica Group by Essilor (Mar. 1, 2018), https://www.ftc.gov/system/files/documents/closing_letters/nid/1710060commissionstatement.pdf.