Comments on the Draft Vertical Merger Guidelines

Daniel P. Culley[*]

The draft Guidelines released on January 10, 2020 represent a marked improvement over the outdated and now affirmatively misleading 1984 Guidelines. That said, there are a number of areas where they could be improved. I expect many commenters will focus on overall policy issues and the general state of enforcement. Although interesting, I do not believe the Guidelines are a good vehicle for signaling enforcement priorities, which will be better developed by simply bringing cases. Instead, the Guidelines should focus on promoting a better understanding of the relevant concepts and methods of analysis among the public, the bar, the agencies' staff, and the courts. My comments are limited to practical suggestions along these lines.

The quasi-safe harbor does not provide meaningful comfort and is likely to end up being misused. It should be eliminated.

The current draft Guidelines state that the agencies are unlikely to challenge a merger where the share of the firm in the relevant market is less than 20% and the related product is used in less than 20% of the relevant market.[1] The Guidelines then state that they may challenge mergers below this, giving a new or growing product as an example where shares may understate concerns. And they clarify that mergers above these thresholds are not presumed to be unlawful.

As I note below, including such a quasi-safe harbor would be a mistake. As the agencies have often found in analyzing horizontal mergers, coming to a reasonably precise view of market shares is often not worth the effort as opposed to simply assessing competitive effects directly. Merging parties would be better counseled to focus on (1) the ease of input substitution; (2) the magnitude of likely loss of sales from foreclosure; and (3) the value of those lost sales that are likely to be recaptured. It may matter a great deal if one of five similarly-sized upstream products is withheld if downstream customers have high brand loyalty or a strong taste for variety. Or it may matter very little if an upstream product with a 50% share is withheld but it can be easily substituted. (And, as noted further below, merging parties would better be able to self-assess if the Guidelines provided more detail about facts that tend to support or refute various theories of harm.)

That said, a simpler statement that the agencies are unlikely to challenge transactions that do not involve at least one oligopoly market would be

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[*] Partner, Cleary Gottlieb Steen & Hamilton LLP. These comments are my own and are not made on behalf of the firm or any of its clients.

[1] Draft Guidelines § 3.

consistent with a focus on the characteristics above.[2] The agencies might consider phrasing this as there being no reason to believe that the combined firm would have "market power" in a relevant market, as that is a term that is used broadly in antitrust and in the case law.

Aside from market shares' lack of utility in predicting effects, there are a number of reasons that a safe harbor may cause problems:

- The Guidelines do not provide any explanation for how the 20% thresholds were determined. Separate public comments by DAAG Barry Nigro indicate that the threshold was not the result of rigorous analysis, but were instead chosen by a consensus of "what people felt comfortable with."[3] But including specific thresholds in the Guidelines lends them an air of credibility that they do not deserve when viewed by those not practicing antitrust day to day, such as by the courts or foreign authorities.

- The 20% thresholds do not provide any insight into actual enforcement practice. Recent enforcement history suggests that the agencies are "unlikely" to challenge transactions until shares are far higher than 20%, regardless of one's views of the merits of those decisions. Adopting a threshold that is out of line with actual practice risks creating one impression for the public and another for members of the antitrust bar who know what the agencies "really do."

- Although the Guidelines specifically say that they do not create a presumption of illegality above the thresholds, they create exactly that danger among staff and in foreign jurisdictions that look to the agencies as examples. In particular, the 20% thresholds differ from the similar 30% guidance provided in the European Commission's Guidelines on Non-Horizontal Mergers.[4] While it is one thing to choose a different set of enforcement priorities than other authorities based on a considered judgment of the risks, or based on a perception that those thresholds have led to underenforcement, that is not what is happening here, and it makes counseling unnecessarily complicated.

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[2] *Compare with* Concurring Statement of Commissioner Wilson to Draft Guidelines ("Safe Harbor… should we limit the area of antitrust concern to oligopoly markets…?").

[3] *See* Bryan Koenig, Vertical Merger Threshold a Compromise, Law 360 (Feb. 10, 2020), https://www.law360.com/articles/1242516/vertical-merger-threshold-a-compromise-doj-says.

[4] European Commission, Guidelines on the Assessment of Non-Horizontal Mergers under the Council Regulation on the Control of Concentrations Between Undertakings ¶ 25 (Oct. 10, 2008) ("The Commission is unlikely to find concern in non-horizontal mergers, be it of a coordinated or of a non-coordinated nature, where the market share post-merger of the new entity in each of the markets concerned is below 30 % and the post-merger HHI is below 2 000."), https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:265:0006:0025:en:PDF.

- The vagueness of "is used in less than 20% of the relevant market" is likely to lead to argument around an issue that is not relevant to competitive effects. In particular, it is unclear what the agencies intend to measure in markets where distributors or retailers typically carry products from many upstream manufacturers. Do the agencies intend the threshold to mean that the upstream product accounts for 20% of the inputs used in the downstream market? That the input is carried by 20% of distributors or retailers? Distributors or retailers representing 20% of retail sales? Each of these measures can be radically different from one another.

Relatedly, a number of commenters may criticize the lack of a "presumption of legality" for vertical mergers, because vertical mergers are supposedly more likely to be procompetitive than horizontal ones. The agencies should stand their ground and not add such a presumption to the Guidelines. The vast majority of all mergers, whether horizontal or vertical, are procompetitive, as reflected by the fact that the agencies only rarely issue Second Requests.[5] And all mergers, whether horizontal or vertical, have an initial presumption of legality because the government has the burden of proof. There is no vertical equivalent to the *Philadelphia National Bank* presumption, nor (rightly) have the Guidelines attempted to establish one. Thus, if the Guidelines were to adopt a presumption of legality, they would be effectively raising the burden of proof.

For the same reason, the agencies should also stand their ground on having left out a presumption of illegality. As noted above, market shares are of limited predictive value. Through the HSR process, the agencies have the tools to gather information to assess the competitive effects directly, and they should do so. Of course, the same criticism could be made of the presumption of illegality in the Horizontal Merger Guidelines, and indeed I would make that criticism. But at least in the horizontal context there is reason to believe there is a rough correlation between concentration and the danger of anticompetitive effects. Any relationship is even more detached in the vertical context.

The Guidelines should provide more guidance on the types of facts that tend to support or refute each of the theories of harm.

In our 2015 article regarding the need for updated vertical merger guidelines, Steve Salop and I provided an extensive list of the types of facts that would be

[5] *See, e.g.,* Fed. Trade Comm'n & U.S. Dep't of Justice, Hart-Scott-Rodino Annual Report, p. 6 (FY 2018), https://www.ftc.gov/system/files/documents/reports/federal-trade-commission-bureau-competition-department-justice-antitrust-division-hart-scott-rodino/fy18hsrreport.pdf (showing Second Requests issued in only 2.2% of reported transactions in 2018 and well under 5% since 2009).

relevant to different theories of harm.[6] The Guidelines of course do not necessarily need to go into that same level of detail, although I do think it would be helpful. But there are several areas in particular where more detail appears critical:

- The Guidelines do not expressly mention the concept of input substitution. The Guidelines should explain that raising the price of an input to a rival or withholding the input from a rival may cause the rival to lose some sales. The more difficult it is for the rival to switch its supply of the input to an alternative supplier (or the higher the costs it incurs by doing so), the more likely that this is to occur. The Guidelines should also explain that, the greater the proportion of the gross margin on a sale is captured by the upstream industry, the more likely it is that it is difficult to substitute inputs, and vice versa.

- The Guidelines should mention that the greater the share of a downstream rival's costs an input represents, the more likely an increase in price or withholding of the input is to lead a rival to lose sales.

- The Guidelines mention diversion, but do not link it directly to the same unilateral effects concepts in the horizontal context. The Guidelines should explain that foreclosure is an indirect way of causing rivals to raise their prices or otherwise restrict their output, and so the agencies can use similar tools to analyze the effects downstream. For example, stating that the greater the value of rivals' lost sales that will be recaptured by the combined firm, the greater will be the agencies' concern about unilateral effects.

- The Guidelines should also explain how switching data might be used to analyze likely diversion. For example, the Guidelines should explain that, where the upstream merger partner can commit to imposing price increases or withholding inputs from many rival downstream firms simultaneously, the combined firm is likely to recapture a greater share of the sales. Thus, the agencies are more likely to have concerns where the upstream firm sells at posted prices or where its prices are subject to MFNs than when it conducts individual negotiations.

- The Guidelines should further explain how a merger can change a firm's bargaining incentives, and under what circumstances the agencies will challenge transactions. Explaining this theory was an issue in the agency's challenge of AT&T / TimeWarner, and the Guidelines provide an outlet to

[6] Steve C. Salop & Daniel P. Culley, *Revising the US Vertical Merger Guidelines: Policy Issues and an Interim Guide for Practitioners*, 2015 J. Antitrust Enforcement 1, https://www.clearygottlieb.com/-/media/organize-archive/cgsh/files/other-pdfs/revising-the-us-vertical-merger-guidelines.pdf.

better explain the mechanics outside of advocacy for a specific case and thus better garner judicial support.[7] The Guidelines should explain that the combined firm's leverage may increase because its best alternative to a negotiated agreement becomes more attractive: if bargaining between the upstream division and a rival breaks down, the combined firm may recapture some portion of the rival's sales. This can lead to a higher price. The Guidelines should also confront the policy decision when this higher price occurs even if the number of units purchased stays the same. This is unlikely to result in immediate harm to downstream customers, but it may, for example, reduce rivals' incentives to innovate. The agencies should say whether they would challenge such as a case. (And I would say they should if the potential for long-term harm is sufficiently concrete or there is a lack of any benefit to downstream customers from, for example, elimination of double marginalization.)

- It appears that the Guidelines intend to cover both input and customer foreclosure in a single section. They should say explicitly that is what they are doing. The Guidelines could then explain that, where the concern is customer foreclosure, the agencies are not concerned with lack of access to a customer in and of itself, but rather how the loss of access to a customer impacts an upstream rival's ability to compete for other customers. Thus, the agencies will be more concerned when there is a potential that the loss of a customer could lead to a loss of minimum viable scale, or where marginal costs are declining with scale.

- Although the draft Guidelines address deterring potential entry in Example 5 in the foreclosure section, the Guidelines should also address the loss of potential sponsors of entry as a separate unilateral theory of harm. Including this only in the foreclosure section suggests that the only way harm can occur is by denying a potential entrant an input. But a firm upstream or downstream of a potential entrant may have incentives to sponsor entry that go beyond simply supplying inputs or purchasing outputs. For example, such a firm might have the incentive to commit to purchasing a particular volume or to supply a particular volume at a favorable rate, or be more willing to finance the potential entrant than would public markets, because that firm will capture some of the benefits of entry through more competition. For example, a dominant software platform may have an incentive to finance rivals to a dominant application that runs on that platform (and vice versa), and that incentive would be eliminated if the two firms merged.

[7] *See* United States v. AT&T, Inc., 916 F.3d 1029, 1039–43 (D.C. Cir. 2019).

The draft Guidelines would be clearer if they were more transparent about significant policy decisions.

The draft Guidelines contain at least three significant policy decisions that end up being mostly implicit: (1) asserting that the agencies will define only a single relevant market; (2) focusing on the change in welfare of the closest to final consumers impacted by a transaction; and (3) declining to identify regulatory evasion as a valid theory of harm. I do not generally disagree with these decisions, but failing to confront them squarely makes the text difficult to follow. It would be better to simply acknowledge these decisions and explain the basis for them.

The Guidelines should explain that the agencies will define only a single relevant market and why, because it would make it clearer what a "related product" is and how identifying such a product is different from market definition. The Guidelines would be much clearer if the agencies simply indicated that in a typical vertical case, the agencies will only define a single product market, the market in which the agencies believe competitive harm will occur. The Guidelines can then go on to explain that the agencies will not define a relevant market for, for example, an input that the combined firm might withhold from rivals, because evaluating foreclosure involves different considerations than market definition, and defining a second market is not usually helpful to the analysis. The agencies might use a merger of a manufacturer and a retailer as an example. Upstream products offered by several suppliers might compete intensely and so all be in the same product market. But if downstream consumers have a taste for variety, or if there is a core group of downstream customers that is very brand loyal, a downstream retailer may have to carry products from all of the manufacturers in order to be attractive to its retail consumers. In evaluating such an industry, "market shares" for the manufacturers would give a misleading picture of how dependent a rival retailer is on each upstream manufacturer.

The Guidelines should state forthrightly that the agencies focus primarily on the welfare of the closest to final customers impacted by a transaction and will prioritize the welfare of those customers over that of other market participants. The Guidelines should specifically state that the agencies will not challenge a transaction the leads to harm to rivals (from higher input prices) if the transaction benefits downstream customers because of elimination of double marginalization or other efficiencies. This policy decision is implicit in the statement that the agencies "will not challenge a merger if the net effect of elimination of double marginalization means that the merger is unlikely to be anticompetitive in any relevant market."[8] Even in cases where eliminating double marginalization is merger specific and leads to strong incentives to reduce downstream prices (which will increase rivals' elasticity of demand for

[8] Draft Guidelines § 6.

the upstream input), there will still often be some residual incentive to increase upstream prices. I do not see choosing this as a policy rule to be meaningfully different from the general rule in evaluating exclusion under Section 1 or Section 2, which is that harm to rivals is irrelevant unless it leads to harm to competition between the firm and its rivals for their downstream customers. Because the situation is likely to arise often, the Guidelines should be clear about how to handle it. That would also allow the Guidelines to clarify that it does not mean there is a requirement to show harm to downstream customers if the agencies can demonstrate that a combined firm would raise prices to rivals, but there would be no offsetting benefits to downstream customers, for example because the input is not compatible with the combined firm's production process.

The Guidelines should state that evasion of regulation is not a theory of harm that the agencies will rely on to challenge transactions. If the agencies were writing on a blank slate, mere omission might be sufficient, but the 1984 Guidelines specifically identified evasion of regulation as a theory of harm. Given the Supreme Court's decisions in, among others, *Verizon Communications Inc. v. Trinko*, the judicial response to such a theory is likely to be that it is for the regulatory agency (or for Congress) to address potential evasion of regulation.[9] The Guidelines should say so. Alternatively, if the agencies are expressly reserving judgment on this issue, then the Guidelines ought to say that the agencies will typically rely on regulatory agencies to police evasion of their own regulations but may bring cases in extraordinary circumstances where that may not be possible and the transaction lacks other consumer benefits.

The section on elimination of double marginalization should be merged with the efficiencies section, but it should explain why it is different from a typical efficiency claim.

I assume that the intent of including the elimination of double marginalization as a separate section between two harm sections was to differentiate how it is treated from how efficiencies are treated more generally. But doing so causes other problems, including by implying that it is only relevant to unilateral theories of harm when it also can reduce the risk of coordination. It also misses an opportunity to more clearly and affirmatively argue why eliminating

[9] *See, e.g.,* Verizon Comm'ns Inc. v. Trinko, 540 U.S. 398, 411–15 (2004) (E.g., "The regulatory response to the OSS failure complained of in respondent's suit provides a vivid example of how the regulatory regime operates. When several competitive LECs complained about deficiencies in Verizon's servicing of orders, the FCC and PSC responded. The FCC soon concluded that Verizon was in breach of its sharing duties under § 251(c), imposed a substantial fine, and set up sophisticated measurements to gauge remediation, with weekly reporting requirements and specific penalties for failure. The PSC found Verizon in violation of the PAP even earlier, and imposed additional financial penalties and measurements with daily reporting requirements.").

double marginalization is different from a typical efficiency claim.

The Guidelines should explain that eliminating double marginalization is different from other types of efficiencies because it operates directly as a change in the combined firm's pricing incentives and the information needed to quantify it is the same information needed to assess potential harms from unilateral effects—margins at both levels and diversions. As a result, it is easier for the agencies to verify the magnitude of benefits from eliminating double marginalization than it is to verify that, for example, bringing together two distribution networks in a horizontal merger would reduce marginal costs by a certain amount. Thus the main question will be whether that magnitude is sufficient and whether it is merger specific.

Similarly, the Guidelines should acknowledge that the size of the benefit from eliminating double marginalization can be related to the size of the potential harm. For example, the greater the bargaining leverage of the input provider, the greater may be its ability to raise downstream rivals' costs, but also the greater may be potential for benefits from eliminating double marginalization. That is of course no guarantee that it is automatically sufficient or that it is merger specific. But the Guidelines could emphasize that it is a reason for serious inquiry.

More generally, this issue exposes that the current Horizontal Merger Guidelines are short on guidance about efficiencies. The result of this lack of guidance has been an unjustified reluctance of courts to accept efficiency claims. The agencies should consider providing further guidance on the topic of efficiencies for all mergers, including more forthrightly noting that the concept of "cognizable" efficiencies is designed to avoid an efficiency "defense" and only focus on efficiencies that change a firm's incentives in ways that avoid anticompetitive effects. There is no shortage of scholarly literature on this topic, and the agencies could surely provide some practical guidance they have found from their own reviews as well.[10]

The Guidelines should not require a similar showing of merger specificity for harms from foreclosure, but they should clarify the inferences that the agencies draw from the pre-merger world.

Commissioner Wilson's statement questioned whether the foreclosure section should have a merger-specificity requirement that parallels the merger-specificity requirement for the elimination of double marginalization.[11] That

[10] *See, e.g.,* Joseph Farrell & Carl Shapiro, *Scale Economies and Synergies in Horizontal Merger Analysis*, 68 Antitrust L.J. 685 (2001).

[11] *See* Concurring Statement of Commissioner Wilson to Draft Guidelines ("Symmetry: Relatedly, given their close correlation, should we assess both procompetitive merger effects (EDM) and anticompetitive merger effects (raising rivals costs, or RRC) symmetrically, including the extent to which they are merger-specific?").

would not be appropriate, because there are not parallel pre-merger incentives to accomplish each.

If foreclosure could be achieved through vertical contracts, then most often the reason why the merging parties will not have attempted them is because they would violated Section 1 of the Sherman Act. Indeed, almost by definition, a contract that raises rivals' costs and leads to harm to downstream customers would violate Section 1. Perhaps the Commissioner is envisioning certain exclusionary non-linear price schedules that might be considered unilateral and reachable only through Section 2, in cases where the merging party does not have monopoly power or does not meet more stringent below-cost pricing tests. But if that outcome can be achieved unilaterally, then it is unclear why the firm would not have already done it pre-merger.

By contrast, firms may not have undertaken steps to eliminate double marginalization by contract because of the prospect of a transaction. Once it is clear that the transaction is no longer possible, the firms may very well have the incentive to negotiate appropriate contracts. That said, the Guidelines should make clearer that the agencies will generally infer from the fact that the parties have not previously reached an agreement that it was not profit maximizing, unless there is evidence that the opportunity has only recently arisen, has been deterred by the prospect of the transaction, or has been temporarily deterred by other non-structural features (e.g., pending MFN agreements).