Vertical Mergers 2020

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So we now have 21st Century Vertical Merger Guidelines, at least in draft. Yay. Do they tell us anything? Yes! Do they tell us much? No. But at least it's a start.

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In November 2018, the FTC held hearings on vertical merger analysis devoted to the questions of whether the agencies should issue new guidelines, and what guidance those guidelines should provide. And, indeed, on January 10, 2020, the DOJ and FTC issued their new Draft Vertical Merger Guidelines ("Draft Guidelines"). That new guidance has finally been issued is a welcome development. The antitrust community has been calling for new vertical merger guidelines for some time. The last vertical merger guidelines were issued in 1984, and there is broad consensus in the antitrust community – despite vigorous debate on correct legal treatment of vertical mergers – that the '84 Guidelines are outdated and should be withdrawn. Despite disagreement on the best enforcement policy, there is general recognition that the legal rules applicable to vertical mergers need clarification. New guidelines are especially important in light of recent high-visibility merger challenges, including the government's challenge to the ATT/Time Warner merger, the first vertical merger case litigated since the 1970s. These merger challenges have occurred in an environment in which there is little up-to-date case law to guide courts or agencies and the '84 Guidelines have been rendered obsolete by subsequent developments in economics.

The discussion here focuses on what the new Draft Guidelines do say, key issues on which they do not weigh in, and where additional guidance would be desirable.

What the Draft Guidelines Do Say

The Draft Guidelines start with a relevant market requirement – making clear that the agencies will identify at least one relevant market in which a vertical merger may foreclose competition. However, the Draft Guidelines do not require a market definition for the vertically related upstream or downstream market(s) in the merger. Rather, the agencies' proposed policy is to identify one or more "related products." The Draft Guidelines define a related product as "a product or service 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."

The Draft Guidelines' most significant (and most concrete) proposal is a loose safe harbor based on market share and the percentage of use of the related product in the relevant market of interest. The Draft Guidelines suggest that agencies are not likely to challenge mergers if two conditions are met: (1) the merging company has less than 20% market share in the relevant market, and (2) less than 20% of the relevant market uses the related product identified by the agencies.

This proposed safe harbor is welcome. Generally, in order for a vertical merger to have anticompetitive effects, both the upstream and downstream markets involved need to be concentrated, and the merging firms' shares of both markets have to be substantial – although the Draft Guidelines do not contain any such requirements. Mergers in which the merging company has less than a 20% market share of the relevant market, and in which less than 20% of the market uses the vertically related product are unlikely to have serious anticompetitive effects.

However, the proposed safe harbor does not provide much certainty. After describing the safe harbor, the Draft Guidelines offer a caveat: meeting the proposed 20% thresholds will not serve as a "rigid screen" for the agencies to separate out mergers that are unlikely to have anticompetitive effects. Accordingly, the guidelines as currently drafted do not guarantee that vertical mergers in which market share and related product use fall below 20% would be immune from agency scrutiny. So, while the proposed safe harbor is a welcome statement of good policy that may guide agency staff and courts in analyzing market share and share of relevant product use, it is not a true safe harbor. This ambiguity limits the safe harbor's utility for the purpose of counseling clients on market share issues.

The Draft Guidelines also identify a number of specific unilateral anticompetitive effects that, in the agencies' view, may result from vertical mergers (the Draft Guidelines note that coordinated effects will be evaluated consistent with the Horizontal Merger Guidelines). Most importantly, the guidelines name raising rivals' costs, foreclosure, and access to competitively sensitive information as potential unilateral effects of vertical mergers. The Draft Guidelines indicate that the agency *may* consider the following issues: would foreclosure or raising rivals' costs (1) cause rivals to lose sales; (2) benefit the post-merger firm's business in the relevant market; (3) be profitable to the firm; and (4) be beyond a *de minimis* level, such that it could substantially lessen competition? Mergers where all four conditions are met, the Draft Guidelines say, often warrant competitive scrutiny. While the big picture guidance about what agencies find concerning is helpful, the Draft Guidelines are short on details that would make this a useful statement of enforcement policy, or sufficiently reliable to guide practitioners in counseling clients. Most importantly, the Draft guidelines give no indication of what the agencies will consider a *de minimis* level of foreclosure.

The Draft Guidelines also articulate a concern with access to competitively sensitive information, as in the recent Staples/Essendant enforcement action. There, the FTC permitted the merger after imposing a firewall that blocked Staples from accessing certain information about its rivals held by Essendant. This contrasts with the current DOJ approach of hostility to behavioral remedies.

What the Draft Guidelines Don't Say

The Draft Guidelines also decline to weigh in on a number of important issues in the debates over vertical mergers. Two points are particularly noteworthy.

First, the Draft Guidelines decline to allocate the parties' proof burdens on key issues. The burden-shifting framework established in *U.S. v. Baker Hughes* is regularly used in horizontal merger cases, and was recently adopted in *AT&T* in a vertical context. The framework has three phases: (1) the plaintiff bears the burden of establishing a prima facie case that the merger will substantially lessen competition in the relevant market; (2) the defendant bears the burden of producing evidence to demonstrate that the merger's procompetitive effects outweigh the alleged anticompetitive effects; and (3) the plaintiff bears the burden of countering the defendant's rebuttal, and bears the ultimate burden of persuasion. Virtually everyone agrees that this or some similar structure should be used. However, the Draft Guidelines' silence on the appropriate burden is consistent with the agencies' historical practice: The 2010 Merger Guidelines allocate no burdens and the 1997 Merger Guidelines explicitly decline to assign the burden of proof or production on any issue.

Second, the Draft Guidelines take an unclear approach to elimination of double marginalization (EDM). The appropriate treatment EDM has been one of the key topics in the debates on the law and economics of vertical mergers, but the Draft Guidelines take no position on the key issues in the conversation about EDM: whether it should be presumed in a vertical merger, and whether it should be presumed to be merger-specific.

EDM may occur if two vertically related firm merge and the new firm captures the margins of both the upstream and downstream firms. After the merger, the downstream firm gets its input at cost, allowing the merged firm to eliminate one party's markup. This makes price reduction profitable for the merged firm where it would not have been for either firm before the merger.

The Draft Guidelines state that the agencies will not challenge vertical mergers where EDM means that the merger is unlikely to be anticompetitive. OK. Duh. However, they also claim that in some situations, EDM may not occur, or its benefits may be offset by other incentives for the merged firm to raise prices. The Draft Guidelines do not weigh in on whether it should be presumed that vertical mergers will result in EDM, or whether it should be presumed that EDM is merger-specific.

These are the most important questions in the debate over EDM. Some economists take the position that EDM is not guaranteed, and not necessarily merger-specific. Others take the position that EDM is basically inevitable in a vertical merger, and is unlikely to be achieved without a merger. That is: if there is EDM, it should be presumed to be merger-specific. Those who take the former view would put the burden on the merging parties to establish pricing benefits of EDM and its merger-specificity.

Our own view is that this efficiency is pervasive and significant in vertical mergers. The defense should therefore bear only a burden of producing evidence, and the agencies should bear the burden of disproving the significance of EDM where shown to exist. This would depart from the typical standard in a merger case, under which defendants must prove the reality, magnitude, and merger-specific character of the claimed efficiencies (the Draft Guidelines adopt this standard along with the approach of the 2010 Horizontal Merger Guidelines on efficiencies). However, it would more closely reflect the economic reality of most vertical mergers.

Conclusion

While the Draft Guidelines are a welcome step forward in the debates around the law and economics of vertical mergers, they do not guide very much. The fact that the Draft Guidelines highlight certain issues is a useful indicator of what the agencies find important, but not a meaningful statement of enforcement policy. On a positive note, the Draft Guidelines' explanations of certain economic concepts important to vertical mergers may serve to illuminate these issues for courts. However, the agencies' proposals are not specific enough to create predictability for business or the antitrust bar or provide meaningful guidance for enforcers to develop a consistent enforcement policy. This result is not surprising given the lack of consensus on the law and economics of vertical mergers and the best approach to enforcement. But the antitrust community – and all of its participants – would be better served by a more detailed document that commits to positions on key issues in the relevant debates.